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EXHIBIT
Q-27
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-01051B-99-105

REBUTTAL TESTIMONY OF

WILLIAM E. TAYLOR, Ph.D.

SENIOR VICE PRESIDENT
NATIONAL ECONOMIC RESEARCH ASSOCIATES, INC.

ON BEHALF OF

QWEST CORPORATION

August 21, 2000

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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

REBUTTAL TESTIMONY OF WILLIAM E. TAYLOR, Ph.D.

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I. INTRODUCTION AND PURPOSE

Q. PLEASE STATE YOUR NAME, OCCUPATION, AND BUSINESS ADDRESS.

A. My name is William E. Taylor. I am Senior Vice President of National Economic Research Associates, Inc. ("NERA"), head of its Communications Practice, and head of its Cambridge office located at One Main Street, Cambridge, Massachusetts 02142.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL, PROFESSIONAL, AND BUSINESS EXPERIENCE.

A. I have been an economist for over twenty-five years. I earned a Bachelor of Arts degree from Harvard College in 1968, a Master of Arts degree in Statistics from the University of California at Berkeley in 1970, and a Ph.D. from Berkeley in 1974, specializing in Industrial Organization and Econometrics. For the past twenty-five years, I have taught and published research in the areas of microeconomics, theoretical and applied econometrics, which is the study of statistical methods applied to economic data, and telecommunications policy at academic and research institutions. Specifically, I have taught at the Economics Departments of Cornell University, the Catholic University of Louvain in Belgium, and the Massachusetts Institute of Technology. I have also conducted research at Bell Laboratories and Bell Communications Research, Inc.

I have participated in telecommunications regulatory proceedings before several state public service commissions. In addition, I have filed testimony before

the Federal Communications Commission ("FCC") and the Canadian Radio-television Telecommunications Commission on matters concerning incentive regulation, price cap regulation, productivity, access charges, local competition, interLATA competition, interconnection and pricing for economic efficiency. Recently, I was chosen by the Mexican Federal Telecommunications Commission and Telefonos de Mexico ("Telmex") to arbitrate the renewal of the Telmex price cap plan in Mexico.

I have also testified on market power and antitrust issues in federal court. In recent work years, I have studied—and testified on—the competitive effects of mergers among major telecommunications firms and of vertical integration and interconnection of telecommunications networks.

Finally, I have appeared as a telecommunications commentator on PBS Radio and on The News Hour with Jim Lehrer. My curriculum vita is attached as Exhibit WET-01.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I have been asked by Qwest Corporation ("Qwest") to evaluate the economic testimony filed on August 9, 2000 regarding five issues: (i) the use of price cap regulation as proposed by Staff,[1] (ii) the treatment of loop costs as joint costs of

[1] Testimony of Harry M. Shooshan III, Docket No. T-1051B-99-105, August 9, 2000, on behalf of the Staff of the Arizona Corporation Commission ("Staff").

telecommunications services in testimonies sponsored by the Staff[2] and RUCO,[3] (iii) whether pricing carrier access service above incremental cost is anticompetitive as alleged by AT&T,[4] (iv) whether Qwest's proposed competitive zone pricing flexibility plan inadequately protects customers as claimed by AT&T and Cox,[5] and (v) whether prices for payphone access lines should be set at forward-looking economic cost as asserted by the Payphone Association.[6]

Q. PLEASE SUMMARIZE YOUR CONCLUSIONS.

A. The gist of my conclusions regarding the five economic points under review follows.

1. While price cap regulation has superior incentive properties compared with traditional rate of return regulation, the plan proposed by the Staff is flawed. It increases pressure to move prices away from cost, and it reduces Qwest's ability to rebalance rates. Mr. Shooshan's data do not support the productivity offset he offers: he has used the wrong formula to calculate X and based his estimate on a small subsample of the data. Initiating price caps with a reduction in the price cap index to account for service quality problems is unwarranted and will reduce Qwest's incentives to invest in Arizona infrastructure.
2. Residential basic exchange service is subsidized at current rates. In concluding the opposite, Dr. Johnson and Mr. Dunkel commit the time-honored economic fallacy of allocating loop costs to services other than the basic exchange services in which network access is bundled. The incremental cost of a loop is

[2] Direct Testimony of Thomas Regan, Direct Testimony and Schedules on Rate Design Issues of William Dunkel, on behalf of Staff.

[3] Direct Testimony of Ben Johnson, Ph.D., on behalf of the State of Arizona Residential Utilities Consumer Office ("RUCO").

[4] Direct Testimony of Arleen M. Starr, on behalf of AT&T Communications of the Mountain States, Inc. ("AT&T").

[5] Direct Testimonies of Dr. Francis R. Collins, on behalf of Cox Arizona Telecom, L.L.C. ("Cox"), and Dr. Lee L. Selwyn, on behalf of AT&T.

[6] Direct Testimony of Michael J. Ileo, on behalf of on behalf of the Arizona Payphone Association ("APA").

straightforward to measure, and to assign its cost to other services (i) reduces economic efficiency because too many people would purchase loops at a price of $2 per month and (ii) destroys local exchange competition because no entrant can compete against a $2 per month price for a service that would cost it an order of magnitude more to provide.

3. Pricing Qwest's carrier access above incremental cost is not anticompetitive. The contribution Qwest earns from providing carrier access does not give it an advantage in the toll market because for every minute of toll it supplies, Qwest forfeits a minute's worth of carrier access contribution. Qwest's long distance affiliate pays the same access charges as AT&T. In addition, AT&T and Qwest's long distance affiliate are in the same situation with respect to access charges: AT&T pays an access charge for most toll minute it carries and Qwest gives up an access charge for most toll minutes it carries.

4. In assessing Qwest's competitive zone pricing proposal, market share is a flawed indicator of the ability of a company to control the market price. Other indicators of competitiveness are more useful in the current context.

5. Neither FCC rules nor economic principles requires that payphone access lines be priced at forward-looking economic cost. As long as entrant and incumbent payphone suppliers pay the same price for services, there is nothing anticompetitive in recovering a reasonable amount of shared fixed and common costs from payphone line services.

II. WHILE PRICE CAP REGULATION CAN ENHANCE ECONOMIC EFFICIENCY, STAFF'S PRICE CAP PROPOSAL IS FUNDAMENTALLY FLAWED.

Q. WHAT ARE THE BASIC ECONOMIC ELEMENTS TO THE STAFF'S PROPOSED PRICE CAP PLAN?

A. As outlined by Mr. Shooshan (Section 5), each of Qwest's regulated services would be assigned to one of three baskets: (1) basic/essential retail services, (2) essential wholesale services other than UNEs and (3) advanced/competitive/nonessential services. Starting with the service prices established in this docket, prices in Basket One would fall relative to inflation on average by 4.2 percent per year. Prices in Basket Two would be frozen for five years except for carrier access services which would fall 20 percent over the five year period of the plan. Services

in Basket Three would qualify for streamlined rate treatment. Retail prices would fall between a maximum specified by tariff and a TSLRIC price floor. Services would be assigned to Basket Three when they meet the requirements of A.C.C. R14-2-1108.

Q. MR. SHOOSHAN OUTLINES POSSIBLE BENEFITS FROM PRICE CAP REGULATION IN SECTION 6. DO YOU AGREE WITH HIS DISCUSSION OF THE BENEFITS OF PRICE CAP REGULATION COMPARED WITH TRADITIONAL RATE OF RETURN REGULATION?

A. In some respects. For services whose prices remain regulated, price cap regulation produces better economic outcomes than traditional cost-plus, rate of return regulation. The opportunity to shift costs and cross-subsidize services is virtually eliminated under price cap regulation, and Qwest's incentives to reduce costs, expand output, invest and innovate would be much closer to those of unregulated firms' incentives under price cap regulation than under traditional rate of return regulation. Price cap regulation is especially useful when markets have been opened to competition so that competitive gains and losses actually flow through to the bottom line for Qwest as they do for unregulated firms.[7]

Q.DO YOU RECOMMEND THAT THE COMMISSION ADOPT THE STAFF'S PRICE CAP PROPOSAL?

[7] Under rate of return regulation, prices of less-competitive services could be raised to offset lower earnings from losses among more-competitive services.

A. No. As it stands, many of the potential benefits from price cap regulation would not be realized in the proposed plan. First, at the initial price levels proposed by the Staff, the price cap plan would prevent Qwest from moving prices of services which are already below incremental cost towards cost and instead would subject them to pressure for further reductions. Such price changes would reduce rather than increase economic efficiency and the resulting increased subsidization of residential basic exchange service would further retard the development of facilities-based competition for this service. Second, the pricing restrictions in Basket Two effectively reduce carrier access charges without permitting rate rebalancing or spreading the support for basic exchange service over a wider array of services. Third, the inability to rebalance rates combined with mandatory price reductions undermines the Staff's calculated productivity offset of 4.2 percent. Fourth, the Staff's proposed productivity offset ("X") of 4.2 percent is calculated incorrectly from the data used by the Staff.

Q. HOW WOULD THE STAFF'S PROPOSED PLAN DISTORT COMPETITION FOR RESIDENTIAL BASIC EXCHANGE SERVICE?

A. Staff proposes large initial reductions in residential basic exchange service prices, irrespective of the outcome of the revenue requirement phase of the case.[8] Prices for these services are already significantly below incremental costs (based on the Commission-approved unbundled loop rate of $21.98), and at the beginning of the

[8] See Schedule WDA-20 of Dunkel at 2.

Plan would be even further below incremental cost. The Staff's plan explicitly prevents increases in residential basic exchange prices through its "hard cap" on all basic exchange service prices in Basket One. In addition, the plan would subject basic/essential/retail services to average annual (real) rate reductions of 4.2 percent irrespective of the relationship between service prices and costs. As a result, residential basic exchange prices would not increase towards cost during the five years of the plan and would be under increasing pressure to decrease further below cost. Pricing residential basic exchange service below cost effectively prevents potential competitors from building their own facilities (or using Qwest's unbundled loops) to compete for residential basic exchange service.

Q. HOW DOES THE STAFF'S PROPOSED PLAN HELP REBALANCE RATES TOWARDS COSTS?

A. In some very basic ways, it doesn't. The Staff plan requires certain reductions in carrier access charges in Basket Two combined with a freeze on all other prices in that basket.[9] Thus the reductions in carrier access charges cannot be offset by increases to any other service prices, nor can they count as rate reductions in meeting the price cap constraint in any other basket.

[9] Staff's proposal in Mr. Shooshan's testimony doesn't make sense, taken literally. It requires Qwest to reduce access charges by "20 percent per year from their initial levels so that by the end of the initial five-year period they are equivalent to U S WEST's interstate access charges at July 2000 levels" [at 12]. Five years of 20 percent annual price reductions would drive access charges to zero, not to their interstate levels. I presume the proposal would move access charges to their interstate levels at a constant rate over a 5 year period.

When the FCC acted to reduce the contribution towards basic exchange service embodied historically in switched access rates, it rebalanced rates by increasing subscriber line charges and PICCs to offset reductions in the carrier common line charge. Because basic exchange rates are in a different basket from carrier access charges, the Staff plan rules out any kind of rate rebalancing as part of its proposed reduction in carrier access charges. That is, the Staff's proposed treatment of carrier access charges cannot be viewed as moving contribution historically assigned to carrier access charges back to basic exchange services.

Q. IS IT GOOD PUBLIC POLICY TO REDUCE CARRIER ACCESS CHARGES WITHOUT RATE REBALANCING?

A. Not in my opinion. Economic efficiency can be unambiguously increased by shifting the contribution previously recovered from carrier access charges to other services, particularly those that are flat-rated or are priced below incremental cost. However, rate reductions absent rate rebalancing do not necessarily increase economic efficiency.

Moreover, from a policy perspective, the Staff's proposal flies in the face of recent attempts to solve the rate rebalancing dilemma. In a recent paper, Mr. Shooshan argued that

> [i]f rate rebalancing, as traditionally conceived, is impossible, how do we get to a rate structure that is more economically efficient, sustainable and capable of addressing social concerns about affordability? The tack espoused later in this paper is to afford carriers much greater operating flexibility to define and price a diverse family of service packages

> combining different types of services and different pricing arrangements.[10]

According to the authors, the object of this greater operating and pricing flexibility is

> to permit ILECs to recover fixed network costs over a broad range of offerings (rather than loading them primarily on long-distance access charges and local line charges). The wider the range of services that an ILEC can offer on a subscriber's loop, the less any one service will have to bear of the fixed costs of that loop.[11]

By isolating carrier access services in Basket Two, Mr. Shooshan's current plan specifically prevents recovery of fixed loop costs over a wider range of services.

Q. HOW DOES THE INABILITY TO REBALANCE RATES BETWEEN BASKETS ONE AND TWO UNDERMINE THE STAFF'S PROPOSED PRODUCTIVITY OFFSET OF 4.2 PERCENT?

A. Because prices of all of the remaining services in Basket Two are frozen, carrier access price reductions cannot be offset by price increases for any other service. Twenty percent annual reductions in carrier access charges exceed inflation less 4.2 percent, so that the regulated firm will be required to lower prices on average by more than the reduction of 4.2 percent (relative to inflation) implied by the Staff's productivity analysis.[12] If the value of 4.2 percent were correct for the aggregate of

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[10] John Haring and Harry M. Shooshan III, "Cutting the Gordian Knot of Rate Rebalancing," presented at the 29th Annual Conference of the Institute of Public Utilities, "Reconciling Competition and Regulation," Williamsburg, Virginia, December 5, 1997 at 2.

[11] *Ibid.*, at 15-16.

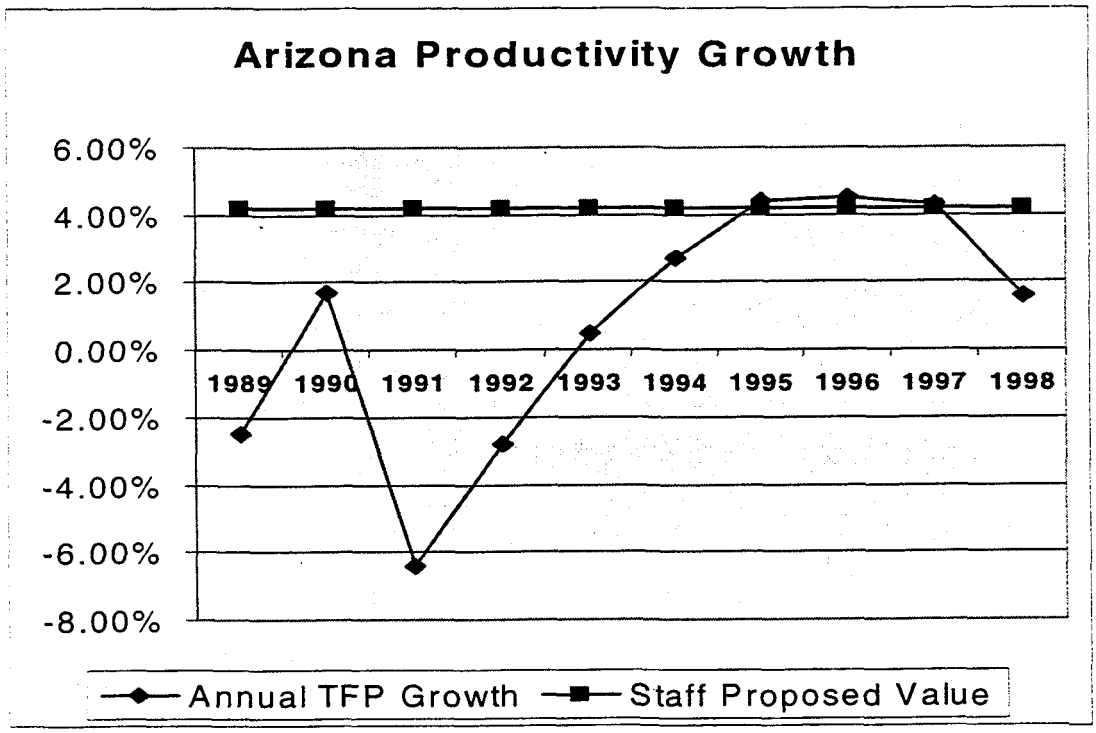
[12] Staff's productivity offset of 4.2 percent appears to pertain to all intrastate operations. Assuming regulatory oversight for the remaining services in Basket 2, (Shooshan (at 12) assumes these services will be "subject to further review by the Commission"), it is reasonable to assume that real intrastate prices will fall at approximately 4.2 percent per year. Basket One service prices fall at this rate by design. Prices of unbundled network elements explicitly follow unit costs which Shooshan asserts are falling at 4.2 percent in real terms. Similarly, it is reasonable to assume that prices of services in the competitive basket will fall at the same rate as

(continued...)

Qwest's regulated services, then the Staff's plan would reduce overall prices at a faster rate than unit costs were falling. The net result would be that even if Qwest could generate sufficient productivity growth to meet the Staff's target, its earnings would fall, since its average price would fall faster than its unit costs.

Q. DO YOU AGREE WITH MR. SHOOSHAN'S CALCULATION OF A 4.2 PERCENT HISTORICAL PRODUCTIVITY OFFSET?

A. No. Mr. Shooshan calculates "an average productivity of 3.7 percent" for 1995-1998 from data provided by Qwest. Actually, average productivity growth in the data cited by Mr. Shooshan is 0.8 percent, calculated using all of the data supplied.



(...continued)

unit costs. Under these assumptions, the 20 percent reductions in carrier access prices will lead to real aggregate price reductions in excess of 4.2 percent.

Moreover, total factor productivity ("TFP") growth for individual companies varies significantly from year to year, as can be observed in the above data supplied by Qwest, so that an average over the longest possible period of data is necessary in order for the average to be truly representative of the actual trend of TFP growth. Mr. Shooshan confines his average to 1995-1998 because this period "follow[s] [Qwest's] most recent rate case" [at 13]. However, the argument that the data should begin with Qwest's last rate case makes no sense. TFP growth is measured by the difference in growth rates of physical outputs and physical inputs and has nothing to do with the output prices that change in the wake of a rate case. There is no reason to expect a rate case—or changes in output prices for any other reasons—to affect TFP growth, and thus there is no reason to limit the analysis to 1995-1998.

Q. ARE THERE OTHER PROBLEMS WITH MR. SHOOSHAN'S CALCULATION?

A. Yes, even if Mr. Shooshan's TFP growth rate were correct, he has used the wrong formula to calculate the productivity offset X from Qwest's historical TFP growth. In setting the annual price adjustment formula for a price cap regulated firm, the productivity offset X is <u>not</u> set equal to the historical TFP growth of the regulated firm. Rather, the object of the exercise is to ensure that average prices decline in real terms at the same rate as the historical reduction in real unit costs. The formula that produces this result adjusts prices annually by U.S. inflation less X where

X = [Telco TFP Growth] – [U.S. TFP Growth]

– {[Telco Input Price Growth] – [U.S. Input Price Growth]}

Because the input price growth differential averages zero in the long run, the formula for X simplifies to the difference between LEC and U.S. average TFP growth. Since U.S. TFP growth averages about 1 percent per year (actually about 0.7 percent from 1995-1997 which is the latest data available from the Bureau of Labor Statistics), Mr. Shooshan's incorrect formula overstates the implied X factor by about one percentage point.

There are several additional problems with basing a productivity offset on the data used by Mr. Shooshan. First, productivity offsets are generally based on the historical productivity growth of the industry, not the regulated firm. Using historical firm productivity growth to set a productivity growth target for the firm for the future sets up an obvious distortion in the firm's incentives to increase its productivity growth. Second, the calculation for Arizona used by Mr. Shooshan uses the difference between rate-adjusted operating revenues and deflated expenses as a measure of productivity growth. Rate-adjusted revenue is only a rough approximation to an output quantity index and deflated operating expenses is an equally rough approximation to an input quantity index. While these data may be indicative of the pattern of input and output quantity growth rates, the calculation is far more approximate than those used to set productivity offsets in state and federal regulatory proceedings. Third, the data used pertain to intrastate revenues

1 and expenses and are thus subject to the uneconomic vagaries of the separations
2 process. For example, changes in separations factors or rules that shifted costs
3 from the intrastate to the interstate jurisdiction would appear as an increase in
4 productivity growth even though there was no change in the behavior of the firm.
5 On a more fundamental level, for technologies characterized by fixed costs shared
6 across services, TFP growth is not defined for a subset of services (such as
7 intrastate services).[13] This fact has been recognized by the FCC, which bases its
8 productivity offset for interstate services on TFP studies for the LEC industry that
9 use unseparated data.[14]

10 **Q. MR. SHOOSHAN PROPOSES AN ADDITIONAL OFFSET TO THE PRICE CAP**
11 **FORMULA TO ACCOUNT FOR INCREASED INCENTIVES TO REDUCE**
12 **SERVICE QUALITY. DO YOU AGREE THAT A SERVICE QUALITY OFFSET IS**
13 **NECESSARY?**

14 A. I understand that Qwest already has service quality standards with self-effectuating
15 refunds and penalties in place, which, in principle, were set to provide proper
16 incentives for Qwest to supply an efficient level of service quality. An arbitrary
17 increase to those penalties in the form of additional price reductions for basic
18 exchange services distorts the incentives, assuming they were set correctly in the

[13] A simple example shows why. Suppose switch modernization drives productivity growth, and switches are replaced and modernized more rapidly as usage grows and switch capacity must be expanded. Here, an increase in interstate or intrastate usage leads to the same increase in productivity (or decrease in unit costs). Thus, there is no meaningful measure of intrastate or interstate TFP growth for the firm.

first place. Even if there were no service quality standards in place, using the price cap annual adjustment formula to encourage the Company to improve service quality is far too blunt an instrument when markets are opened to competition. For example, if Qwest fails to provide comparable service quality to its wholesale and retail customers, penalties paid to wholesale customers or reductions in wholesale prices provide better incentives for wholesale quality improvement than requiring a reduction in retail basic exchange rates.

In addition, Mr. Shooshan apparently endorses an initial offset—i.e., an initial reduction in the price cap index—to address the Commission's concern with Qwest's current level of service quality [at 19]. Such a proposal diminishes whatever effects on incentives the Commission's service quality rules might have. If service quality penalties can be determined and applied after the fact, using a set of rules different from those under which the regulated firm thought it was operating, how can we expect the firm to respond to the incentives we establish in the price cap plan? Moreover, what lesson would we expect the regulated firm to learn from this exercise? That it can assume the rules are fixed and that it can safely invest sufficient amounts to make earnings as large as possible under the plan? On the contrary, an initial reduction in rates to account for current

(...continued)

[14] In the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, FCC 97-159, *Fourth Report and Order*, (released May 21, 1997).

1 inadequate service quality will only discourage the very investment that is
2 necessary to bring service quality to a level acceptable to the Commission.

3 **III. THE LOCAL LOOP IS *NOT* A SHARED FACILITY AND ITS COST IS PART OF THE COST OF**
4 **BASIC EXCHANGE SERVICE**

5 **Q. HAS THE QUESTION OF ASSIGNING THE COST OF THE LOCAL LOOP TO**
6 **SPECIFIC TELECOMMUNICATIONS SERVICES ARISEN IN THIS DOCKET?**

7 A. Yes. Despite the fact that the economic issues in determining the cost of basic
8 exchange service have been settled for many years, Mr. Dunkel and Dr. Johnson
9 raise this question on behalf of the Staff and RUCO.

10 **Q. WHAT DO MR. DUNKEL AND DR. JOHNSON PROPOSE?**

11 A. They claim that the cost of the local loop is a joint or shared fixed cost of all of the
12 services that use the loop. Mr. Dunkel asserts that the total service long run
13 incremental cost ("TSLRIC") of residential basic exchange service should not
14 include the cost of the loop since a loop is necessary to provide other services. On
15 this basis, Mr., Dunkel and Dr. Johnson conclude that residential basic exchange
16 service does not receive a subsidy, since its price exceeds the TSLRIC of
17 residential basic exchange service, ignoring the cost of the loop. These views of
18 the cost of basic exchange services then drive Mr. Dunkel's and Dr. Johnson's
19 view of appropriate rates for those services.

20 **Q. DO YOU AGREE WITH MR. DUNKEL'S CONCLUSION (AT 42) THAT THE**
21 **COSTS OF THE LOCAL LOOP SHOULD NOT BE INCLUDED IN THE TSLRIC**
22 **OF RESIDENTIAL BASIC EXCHANGE SERVICE?**

A. No. This position has been thoroughly discredited in the economics literature, most persuasively in a classic article by A.E. Kahn and W.B. Shew, in which this point is the first of six pricing fallacies.[15] Mr. Dunkel's conclusion is contrary to sound economic principles and based on a misunderstanding of economic costs and the cost recovery process. A public policy based on Mr. Dunkel's conclusion would promote economic inefficiency, lead to a wasteful use of society's scarce resources, and distort consumption and production incentives. In contrast to Mr. Dunkel's conclusion, economic principles dictate that the cost of a loop should be recovered in the price of the service—network access—the demand for which brought about the production of that loop. To recover the cost of a loop based on any other principle would be a departure from sound economic reasoning.

From a practical perspective, suppose residential local exchange service were priced at the TSLRIC Mr. Dunkel calculates (around $2 per month). Economic efficiency would suffer because customers who valued the service at only $2 per month would sign up, even though the cost of providing network access to them certainly exceeds 10 times that amount, based on the unbundled loop rate of $21.98. Competition would also be distorted. Competitors who wish to sell telecommunications services to these residential customers will be pleased to provide local usage, long distance usage, vertical services, carrier access, Internet access, etc., but they will not be able to provide a local loop profitably, given that

[15] A.E. Kahn and W.B. Shew, "Current Issues in Telecommunications Regulation: Pricing," Yale Journal on Regulation, 4, 1987 at 191-256. See also, W.E. Taylor, "Efficient Price of Telecommunications Services: The (continued...)

1 Qwest must sell them for $2. Instead, network access would be exclusively
2 supplied by Qwest at a rate level which was an order of magnitude below the cost
3 to Qwest to supply network access. To serve a residential customer profitably
4 under these circumstances, Qwest would have to mark up the prices of its usage
5 and vertical services—the very services which competitors have targeted—by at
6 least $20 per month for an average customer in order to break even.

7 **A. Economic Principles**

8 **Q. WHAT ARE THE RELEVANT ECONOMIC PRINCIPLES ON WHICH YOU RELY**
9 **TO FORM YOUR CONCLUSION ABOUT HOW THE COST OF A LOOP**
10 **SHOULD BE ASSIGNED?**

11 A. The fundamental principle is *cost causation*, that principle in economics that aligns
12 the price paid by a consumer with the costs incurred by society to fulfill that
13 consumer's demand. Simply put, cost causation provides the answer to the
14 question of why the resources used in providing the loop have been expended.
15 The costs associated with the loop are caused by a customer gaining access to the
16 network. Applying the principle of cost causation leads directly to an efficient
17 economic outcome which, in this case, is that the cost of a loop should be assigned
18 only to Qwest's local exchange service, which is a bundled service consisting of
19 local usage and network access.

(...continued)

State of the Debate," Review of Industrial Organization, Vol. 8, pp. 21-37, 1993.

Q. BOTH MR. DUNKEL AND DR. JOHNSON ASSERT THAT LOOP COSTS ARE A COMMON OR JOINT COST OF PROVIDING A NUMBER OF SERVICES AND THAT THOSE SERVICES SHOULD PROVIDE A CONTRIBUTION TOWARDS RECOVERING THE COST OF THE LOOP. WHAT ARE THE RELEVANT COST PRINCIPLES YOU RELY UPON TO FORM YOUR CONCLUSION REGARDING HOW THE COST OF A LOOP SHOULD BE ASSIGNED?

A. A fundamental problem with this analysis is the assertion that loop costs are a common cost of providing a number of services. In economic theory, costs are categorized as directly assignable (i.e., activity-specific) or shared or common (i.e., not specific to any single activity). In addition, costs are categorized as volume-sensitive or volume-insensitive. The significance of such classifications is in how each kind of cost is recovered.

- Volume-sensitive (or *variable*) cost is the cost that varies with the level of the activity that generates it. For example, the total cost of switching within a telephone network depends on the volume of peak hour usage (toll or access switched traffic) on that network. As that traffic increases, more switches are installed and the cost of switching increases in proportion.
- Volume-insensitive (or *fixed*) cost, on the other hand, is a cost that is generated by an activity but does not vary with the level of that activity. Such a cost may not be increased or reduced; it is either incurred or avoided. The only way to avoid a volume-insensitive cost is to cease altogether the activity that generates it. An example of a fixed or volume-insensitive cost is the right-to-use fee for software installed on network facilities. Such software is necessitated by switched traffic over the network (the activity), but its cost does not vary with the level of usage on the network. That cost may only be avoided by eliminating the need for the software, i.e., by ceasing to carry the traffic that depends on the software.
- Volume-sensitive costs are usually always *directly assignable*. That is, since a volume-sensitive cost varies with the level of a specific activity, it is always possible to identify the "cause" of that cost (namely, that activity) and, hence, to attribute all of the cost to that activity.

- Volume-insensitive costs, in contrast, may be either directly assignable (i.e., activity-specific) or shared or common (i.e., *not* specific to any single activity). An example of a directly assignable volume-insensitive cost (alternatively, *service-specific fixed cost*) is the right-to-use fee for software that is only used to provide a single type of telephone service. Such a service-specific fixed cost could be avoided only by ceasing to provide the telephone service in question in its entirety.
- *Shared fixed* costs are the fixed costs that are shared by two or more, but less than all, of the activities of a firm. Ceasing one or the other of these activities will not avoid these shared costs; only the cessation of all of *that subset of activities* will avoid the shared costs. An example is the Advanced Intelligent Network (AIN) which, when installed, can be used to provide a variety of AIN services; however, not providing any one service in that group will not avoid any portion of the cost of that network.
- *Common fixed* costs are the costs that are shared by *all* of the activities of a firm. Common fixed costs can only be avoided by ceasing *all* of the activities of the firm altogether. The classic example is the president's desk. Typically, corporate functions like accounting, finance, human resources, legal, etc. are examples of common fixed costs. These are sometimes referred to as *overhead* costs.

The principle of cost causation requires that activity-specific costs be assigned to (and recovered in the price of) the service that required the activity to occur. The recovery of costs that are truly shared or common is also guided by economic theory, albeit not primarily by the principle of cost causation. If only allocative economic efficiency mattered, shared fixed and common costs would be recovered by marking up service prices above direct cost in inverse proportion to their price elasticities of demand so that services would be consumed in the same proportions as if all services were priced at incremental cost.

Q. HOW DO YOU RESPOND TO MR. DUNKEL'S CONTINUING CLAIM THAT IF QWEST WERE TO DISCONTINUE OFFERING RESIDENTIAL BASIC

EXCHANGE SERVICE ALONE, IT WOULD ONLY AVOID THE COSTS OF LOCAL USAGE AND SOME OTHER MINOR COSTS?

A. It is instructive to present Mr. Dunkel's views in his own words. While explaining how, in his view, the TSLRIC of a service should be calculated, he states [at 40] that:

> USWC included 100% of the unseparated loop costs in what it claims to be the basic exchange TSLRIC. 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...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.

First, because residential basic exchange service is really an integrated offering of two distinct and separable services—non-usage-sensitive network access and local usage—any withdrawal of that integrated service will mean that Qwest will avoid not just the cost of local usage service but also of the network access service (the loop).

A perfect example of this principle is the telephone set. Prior to divestiture in 1984, the telephone set was owned by the local telephone company and was explicitly an integral, non-traffic sensitive part of the local loop. In January 1984, the Bell System sold its telephone sets to its subscribers and, in most cases, no longer owned that portion of the loop. If the cost of the telephone set—like the rest of the loop—were really a common cost of local and toll usage services, then local

1 and long distance companies would be reimbursing customers for the (joint) cost of
2 originating or terminating calls on their telephone sets. Of course, such
3 reimbursement has never taken place, and there are no economic forces in play
4 that would lead to such payments. When a friend calls me and AT&T terminates
5 the call on my phone, that call imposes no cost whatsoever on my part of the local
6 loop—i.e., my phone. I don't bill AT&T for using my phone, and IXCs and LECs get
7 to use my part of the local loop—my phone—for free. In just the same way, when
8 a carrier terminates a call to me, no cost is imposed on the part of the local loop
9 owned by Verizon. There are no costs that Verizon can bill to the carrier, and
10 carriers do, and should, get to use Verizon's local loop for free.

11 Second, CLECs and IXCs frequently offer local usage service to customers
12 without supplying network access to them. Indeed, that is exactly the model that
13 applies when a CLEC provides usage services of its own to the customer but
14 leases an unbundled loop from the incumbent LEC on behalf of that customer.
15 Here, too, the cost of the unbundled loop stands on its own: the CLEC that leases
16 it must fully compensate the incumbent LEC for that cost. The CLEC may *choose*
17 to recover that cost from its customer by spreading it into the prices it charges for
18 various usage services, but the cost at the original point at which the loop was
19 provisioned by the incumbent LEC to the competitive LEC remains intact and is
20 recovered in its entirety by the supplier of the loop.

21 Third, contrary to Mr. Dunkel's assertion, a LEC like Qwest would *not* have
22 to stop providing the entire family of access and usage services in order to avoid

1 the cost of the loop. If Qwest were to decide to cease the supply of all services
2 *except* for basic exchange service, it would not avoid the cost of the loop. But, if it
3 decided to withdraw only its basic exchange service—specifically, the network
4 access part—and kept all the other services, then it would definitely avoid the cost
5 of the loop, just as long distance carriers, alarm companies, and other enhanced
6 service providers do. This is the acid test of a shared cost: Does the entire cost of
7 the allegedly shared facility disappear when one of the services it is claimed to
8 support is withdrawn? If the answer is "yes," then that facility cannot be shared.
9 As its cost disappears with the withdrawal of basic exchange service, the local loop
10 cannot be a shared facility.

11 **Q. DR. JOHNSON CLAIMS (AT 4 AND APPENDIX C AT 3) THAT THE COST OF**
12 **THE LOOP IS A JOINT COST. DO YOU AGREE?**

13 A. No. There are three important reasons why the cost of a loop is not a joint cost of
14 producing other telecommunications services. First, access to the network is a
15 service which customers value in isolation and which telephone companies can
16 and do supply in isolation. The fact that the loop is an <u>output</u> of suppliers and not
17 simply an input into the production of other telephone services distinguishes it from
18 the classical cases of joint costs such as hay producing beef and hides or chicken
19 feed producing egg yolks and whites. Second, loops and telephone usage are not
20 supplied in fixed proportions. Some customers use their loops frequently for a
21 variety of services; others, not at all or for a different mix of services. Third, there is
22 no ambiguity in calculating the incremental cost of supplying the loop, and

1 economic efficiency is enhanced if customers who demand a loop be dedicated to
2 their service for a month actually pay a price equal to the cost of supplying that
3 loop to that customer for a month. Note that this conclusion holds irrespective of
4 the reason why a customer wants a loop: e.g., to receive calls, to make local or
5 long distance calls or to hang the wash out to dry. The cost that the decision to
6 demand a loop imposes on the supplier is the same regardless of the reason or the
7 use.

8 **B. Treating the Loop as a Common Cost Violates the Principle of Cost**
9 **Causation.**

10 **Q. PLEASE EXPLAIN WHY THE TREATMENT OF LOOP COSTS AS COMMON OR**
11 **SHARED IS SO CONTRARY TO ECONOMIC PRINCIPLES.**

12 A. Economists generally disagree with this view of the local loop because it conflicts
13 with the fundamental principle of cost causation. This principle tells us why the
14 resources used in providing the loop have been expended. The answer is simple:
15 the costs associated with the loop are caused by *a customer gaining access to the*
16 *network.* That is true whether that access is gained as part of a standard bundled
17 offering like residential basic exchange service or, in the new environment, by
18 purchasing an unbundled loop. Once the loop is provisioned, the cost has been
19 incurred. The way in which it is *used* (if at all) *does not change that cost.*

20 This is a subtle, but important, point. A customer that purchases (or leases)
21 the loop essentially acquires the *right* to access the network and receive services
22 of his or her choosing. Actual usage of the loop does not matter for cost causation.

The loop has been provisioned—and a cost incurred—regardless of whether the customer uses the loop at all, accesses only one service, or accesses multiple services. The cost of a loop is independent of its use and it should be recovered regardless of its actual use. The contrary position taken by Mr. Dunkel—that the loop's cost should depend on *how* it is used—is based on a fallacy.

To see why that is so, ask whether the cost of the loop should be recovered in different amounts from different customers, depending on how many services (including none at all) they access with it. If the answer is "yes," then the fallacy just gets deeper and leads to absurd results. For example:

- Should the cost of constructing a highway be considered a shared cost to butchered meats, milk, stereo equipment, and dry cleaning because distributors of these products use that highway to receive them?[16]
- Similarly, should a car be considered a shared cost of motels since access to motels is facilitated by the car?

The fallacy of equating shared cost with shared use can be avoided by thinking of the loop facility as providing access to the network—a service in its own right and, therefore, a facility with its own unique cost and price. This requires that the loop be thought of as an "output" rather than as an "input."

It is instructive to further explore the idea that access to the network (the loop) is a service in its own right. A customer may take just the network access service (in order to *receive* calls) but avoid originating toll or other types of calls

[16] Steve G. Parsons, "Seven Years After Kahn and Shew: Lingering Myths on Costs and Pricing Telephone Service," *Yale Journal on Regulation*, 11, 1994, at 149-170.

over the telephone network. That is, while network access service logically precedes consumption of any other service, taking the network access service does not *require* that some other service also be taken. Once a customer acquires network access or a loop, other services can only be made available to that customer at *additional* cost. For example, provision of toll service to a customer would cause the network to incur a cost that is separate from that for the loop. Therefore, the loop cannot be a shared cost.

Economists have offered several other arguments against regarding the loop as a shared or common cost. Some of these are as follows.[17]

- Charges for access alone are frequently found in competitive markets (e.g., clubs, credit cards, on-line computer services, long distance telephone service, etc.).
- The cost of a service should not be confused with the *benefits* that service provides. Loop costs belong to subscriber access regardless of whether the loop provides value to other services or customers. Your careful maintenance of your car makes the road safer for me, but don't expect me to pay for it.

Q. IS IT ECONOMICALLY EFFICIENT TO CHARGE FOR THE LOCAL LOOP AS A SEPARATE NETWORK ACCESS SERVICE?

A. Yes. Under current practice, that is exactly how it is priced (with network access and usage bundled together to form the core residential basic exchange service). The cost causation principle provides guidance about the economically efficient pricing of the loop. Consider the following two questions that were asked, and answered, by Alfred Kahn and William Shew over a decade ago.

[17] Kahn and Shew, and Parsons, *op cit.*

> ... First, does subscriber access have a separate identifiable incremental cost associated causally with providing it? The answer is, unquestionably, yes. Connecting a customer to the network uses scarce resources, even if he or she never uses the connection. The customer who subscribes to two access lines imposes a greater cost than a customer who subscribes to one, even if they make the same number of calls at the same times and places.
>
> Second, does charging for access serve a purpose? The answer is that it serves the very important purpose of economic efficiency if buyers are confronted, in each of their purchase decisions, with prices that reflect the respective incremental costs to society of their taking more or less of each available good and service or, to put it another way, what costs society would save if they took less of each.
>
> ... Using the price of telephone calls to recover access costs that do in fact not vary as more or fewer calls are made therefore induces wasteful choices by customers. It encourages them to order underpriced access lines that they value less than the incremental costs to society of providing the lines, and it discourages them from making overpriced calls whose value to them would have exceeded the incremental cost to society. The same result would follow if an electric utility were to supply its customers with all the appliances they wanted at no charge and recovered the costs in the price of electricity—wasteful overpurchasing of appliances and underconsumption of electricity.[18]

Only a price reflecting the cost of the loop will ensure the socially optimal level of use of that facility. If the loop is part of a bundled basic exchange service, then the cost of the loop should be assigned to that bundled service.

C. Practical Problems Arise if Loop Costs are Treated as Common.

Q. WHAT PROBLEMS ARISE IF NON-TRAFFIC SENSITIVE LOOP COSTS ARE RECOVERED FROM USAGE SERVICES ON A MINUTE-OF-USE BASIS?

[18] Kahn and Shew, *op cit.*, at 201. Footnote in text omitted.

A. Consider the case of Fred and Barney. Fred only calls Wilma once a day, while Barney's teen-age daughter keeps the phone in constant use. Suppose some portion of the loop cost is allocated to usage and recovered on a minute of use basis. At the end of the month, Fred will not have paid for his loop (because his usage is below average), and Barney will have paid for his loop many times over. To say nothing of fairness or efficiency, once competition begins, such pricing is not even sustainable. Any firm that prices loops at their full cost—and doesn't recover a portion of those costs from usage—will attract the Barneys of the world, and any firm that continues to try to recover loop costs from usage will find that its customer mix looks a lot like Fred. Like a perverse Lake Wobegon, all its customers will have below average use, and the firm will not be able to price its usage to recover the portion of loop costs assigned to usage.

Q. HAS THE FCC ADDRESSED THE ISSUE OF RECOVERING LOOP COSTS FROM SERVICES THAT USE THE LOOP?

A. Yes. At the interstate level, the FCC has already moved to replace some past pricing anomalies (like minutes-based carrier common line charges for carrier access) with more appropriate fixed line charges.

> In rationalizing the switched access rate structure in this Order, our primary goal is to ensure that traffic-sensitive costs are recovered through traffic-sensitive charges and NTS costs are recovered through flat-rated charges, wherever appropriate. Because many NTS costs are currently recovered through per-minute charges, the principal effect of our Order is to reduce the amount recovered

> through per-minute interstate access charges and increase the amounts recovered through flat-rated charges.[19]

There are several theoretical and practical reasons for not resorting to arbitrary minutes-based allocators of the loop cost. In addition, there is little economic justification for any allocation mechanism that recovers the *same* proportion of shared and common costs from a set of designated services. Such an allocation is no more or less arbitrary than one which relies on minutes of use; in fact, any assignment of costs not based on cost causation would be arbitrary and, therefore, without any economic basis.

Q. WHAT OTHER PRESCRIPTIONS DOES THE FCC HAVE REGARDING HOW COSTS SHOULD BE RECOVERED?

A. A key issue in this question is the treatment of NTS costs. The FCC has repeatedly shown by its rulings that it clearly understands that economic efficiency is reduced if non-traffic sensitive (NTS) costs are recovered using traffic-sensitive (TS) rates. With respect to the portion of the loop cost allocated to the interstate jurisdiction, the FCC has moved away from usage-based recovery:

> Because common line and other NTS costs do not increase with each additional minute of use transmitted over the loop, the current per-minute CCL charge that recovers [interstate] loop costs represents an economically inefficient cost-recovery mechanism and implicit subsidy. A rate structure that recovers NTS costs through per-minute charges creates an incentive for customers to underutilize the loop by requiring them to pay usage rates that significantly exceed the incremental cost of using the loop. Additionally, a rate structure that

[19] In the Matter of Access Charge Reform, CC Docket No. 96-262, First Report and Order, FCC 97-158, ¶53 (rel. May 16, 1997).

> forces high-volume customers to pay significantly more than the cost of the facilities used to service them is not sustainable in a competitive environment because high-volume customers can migrate to a competitive LEC able to offer an efficient combination of flat and per-minute charges, even if the competitive LEC has the same or higher costs than the incumbent LEC.[20]

With respect to the recovery of cost for unbundled network elements (UNEs), the FCC again has clearly expressed its requirement that costs of dedicated (activity-specific) facilities "including, but not limited to, charges for Unbundled loops, dedicated transport, interconnection and collocation" be recovered on something other than a usage basis. The Commission requires that:

> ...flat-rated charges [be assessed] for dedicated facilities. Usage-based charges for dedicated facilities would give purchases of access to network elements an uneconomic incentive to reduce their traffic volumes. Moreover, purchases of access to network elements with low volumes of traffic would pay below-cost prices, and therefore have an incentive to add lines that they would not add it they had to pay the full cost.[21]

Q. HAVE STATE REGULATORS ADDRESSED THE ISSUE OF RECOVERING LOOP COSTS FROM SERVICES THAT USE THE LOOP?

A. Yes, but state regulators have historically been required to make decisions that balance a variety of concerns—and until recently, economic efficiency was not the most important consideration. Before the Telecommunications Act of 1996 and the elimination of entry barriers that opened telecom markets to competition, one primary objective of state regulatory decisions was to keep the price of basic local

[20] In the Matter of Access Charge Reform, CC Docket No. 96-262, First Report and Order, FCC 97-158, ¶69 (rel. May 16, 1997).

1 sufficiently low to assure that universal service objectives were met. The informal
2 compact formed by state and federal regulators and local exchange telephone
3 companies purposefully shifted cost recovery responsibility for the local loop away
4 from local service and to long-distance, access and vertical services to achieve that
5 goal. Thus, when we observe, as Mr. Dunkel and Dr. Johnson do, that regulators
6 historically appear to have made decisions that shifted loop cost recovery to other
7 services, that observation does not validate the premise that the loop constitutes a
8 shared cost, but rather that regulators decided to subsidize basic exchange service
9 to achieve an explicit policy objective.

10 One state regulatory decision of which I am aware explicitly considered the
11 issue of economic efficiency and determined that "it would not be appropriate to
12 treat the loop as a shared cost." This decision relied, in part, on the arguments
13 presented in Kahn and Shew, *op cit.*[22]

14 **Q. PLEASE SUMMARIZE YOUR OBJECTIONS TO THE CHARACTERIZATION**
15 **THAT THE COST TO PROVIDE A LOCAL LOOP IS COMMON OR SHARED**
16 **COST THAT SHOULD BE RECOVERED IN PRICES OF ALL THE SERVICES**
17 **THAT CAN BE DELIVERED OVER THE LOOP.**

(...continued)

[21] In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, First Report and Order, FCC 96-325, ¶744 (rel. August 8, 1996).

[22] Public Utilities Commission of the State of California Decision 96-08-021, August 2, 1996.

A. This view is based on several misconceptions and fallacies. Specifically, my objections to that view are as follows:

1. It ignores or misuses the economic principle of cost causation. As a result, it confuses the cost-causer (namely, the consumer or purchaser of the loop) with the entity that incurs, and needs to recover, the cost (namely, the supplier of the loop). It stands cost causation on its head by focusing on the possible *uses* of the loop—whether intended or not by its purchaser—as opposed to the economic activity that gave rise to its cost. The cost of the loop arises as it is first provisioned; how it is used subsequently does not change that cost.
2. It fails to distinguish between network access (provided by the loop) and usage services that are typically bundled into basic exchange service. Hence, it fails to recognize that network access is an output, not an input, and may be demanded independently in its own right.
3. Charging for network access separately from usage services is economically efficient. It also avoids having to engage in nightmarish calculations of the share of the loop's cost that must be borne by other services, particularly (1) when consumers may consume usage services in different proportions and those proportions may change over time, and (2) the services are provided by different service providers, all using the same loop as a delivery vehicle. Any method of allocating the loop cost is likely to be arbitrary and fraught with uncertainty.

D. Consequences of Errors.

Q. SUPPOSE THE COMMISSION ERRS IN ASSIGNING LOOP COSTS TO TOLL AND ACCESS. WHAT ARE THE CONSEQUENCES FOR ARIZONA CONSUMERS?

A. If loop costs are assigned to usage services, prices of basic exchange service will be below cost and prices of toll and access will be set further above cost than if the error were not made. Pricing basic exchange service below cost is inefficient (customers face incorrect incentives to subscribe to service), but such pricing has little effect in aggregate because the demand for basic exchange service is

extremely price inelastic: that is, a small reduction in price will not induce many new customers to subscribe to service. In contrast, pricing toll and access above cost leads to a much larger reduction in efficiency because the price elasticity of the demand for toll service is (comparatively) elastic. Thus, a large number of calls whose value to customers exceeds their cost will not be made because the price of toll was set above cost.

Q. SUPPOSE THE OPPOSITE HAPPENS, AND, FOR WHATEVER REASON, THE PRICE OF BASIC EXCHANGE SERVICE IS SET <u>ABOVE</u> COST. WHAT WOULD BE THE ECONOMIC CONSEQUENCES OF THAT DECISION?

A. There is nothing unusual in telecommunications economics about setting the price of a service above its cost. Because telecommunications services are provided using large proportions of fixed costs, if all services were priced at their direct costs, no telecommunications provider would be able to recover its total cost in revenue. Thus, it is common to find telecommunications service prices marked up above their direct cost, and the problem of efficient cost recovery is to choose which services to mark up more above cost and which to mark up less. If efficiency were the only concern, economists would mark up service prices in inverse proportion to their price elasticity of demand, because that set of prices would minimize the distortion caused by the need to price above direct cost in the aggregate. Technically, the mark ups that minimize the loss in allocative efficiency are those that cause customers to demand services *in the same proportion* that they would if all prices were set at direct cost. Thus, inelastically-demanded

services like basic exchange service would receive comparatively *high* mark ups, while comparatively elastic services like toll or access would receive lower mark ups.

IV. PRICING CARRIER ACCESS SERVICE ABOVE INCREMENTAL COST IS NOT ANTICOMPETITIVE.

Q. ON BEHALF OF AT&T, MS. STARR ASSERTS (AT 31) THAT QWEST IS ABLE TO EXERT A PRICE SQUEEZE AGAINST ITS COMPETITORS, DESPITE ADHERENCE TO THE ARIZONA IMPUTATION RULES. IS THIS CLAIM CORRECT?

A. No. This claim—and Ms. Starr's example—fails the tests of basic economics and common sense. The example supposes that access charges are 7.8 cents per minute while the cost of supplying switched access is 1.2 cents. Non-access costs of providing toll service are assumed to be 2 cents per minute for both AT&T and Qwest. Ms. Starr then observes that the cost of service for AT&T "truly is" 9.8 cents per minute while Qwest's "switched access *cost* for that toll minute is only 3.2 cents." If the imputed price floor for Qwest is 9.8 cents per minute (non-access cost plus access price), Qwest still earns a profit, Ms. Starr claims, of 6.6 cents per minute which

> is a profit from a monopoly service that can, among other things, be used to fund advertising campaigns, make network improvements that will win customers for its toll services or network upgrades to provision advances (*sic*) services...This is an enormous economic barrier for competitors to overcome. [at 30-31].

There are several problems with this line of thought. First, carrier access is a regulated service which is priced above incremental cost. Therefore, it is true that when Qwest provides carrier access service, it generates contribution which can be used to support shared fixed and common costs, subsidized services or any other expenditure flow of the corporation. However, that contribution flow is not a barrier that toll competitors must overcome.[23]

Q. WHY IS THIS HYPOTHETICAL 6.6 CENT PRICE ADVANTAGE FOR QWEST NOT A BARRIER FOR TOLL COMPETITORS?

A. Suppose, as Ms. Starr does on p. 31, that toll competition drives the toll price down to 9.8 cents. As Ms. Starr calculates

> [w]hen the price reaches 9.8 cents, it is no longer profitable for [Qwest's] competitors to enter or remain in the market over the long run, because that is the point at which the competitor's price equals its cost. On the other hand, at a price of 9.8 cents, [Qwest] still makes a profit of 6.6 cents. [at 31]

The first flaw in Ms. Starr's example is that, under the law, Qwest must charge its long distance affiliate precisely the same 7.8 cents per minute that it charges AT&T. This was Congress' answer to any concern about anticompetitive conduct arising from the *level* of the access rate. The second flaw in Ms. Starr's reasoning is that Qwest will receive the same 7.8 cents per minute in access charges, *irrespective* of which long distance provider actually carries the call.

[23] AT&T cannot object to the fact that Qwest derives positive contribution from a service. Surely AT&T derives contribution from its cable services which can be used to support no end of competitive purposes among the services AT&T provides.

However, if its *affiliate* were to carry the call, Qwest would not receive 7.8 cents per minute in access charges from any unaffiliated long distance carrier. Thus, a Qwest manager attempting to optimize corporate profits would have to recognize the 7.8 cents in access *cost* to Qwest whenever the Qwest long distance affiliate carried the long distance call—not because of imputation rules or separate affiliate accounting formulas, but because the 7.8 cents per minute that used to go into its corporate pocket would no longer do so when its own affiliate carried the long distance call. What Ms. Starr characterizes as a 6.6 cents "profit" to Qwest even under imputation turns out, under closer scrutiny, to really be a cost.

Thus, when AT&T carries the call, Qwest Corporation earns a contribution of 6.6 cents per minute for providing carrier access services. When Qwest itself carries the call (at a retail price of 9.8 cents per minute), Qwest Corporation earns a contribution of 6.6 cents per minute—9.8 cents less non-access costs of 2 cents and access costs of 1.2 cents. At a retail price below 9.8 cents, Qwest would lose money by providing long distance service—providing access would be more profitable. If Qwest's non-access costs were higher than 2 cents—perhaps because of the advertising campaigns or network upgrades that Ms. Starr believes to be anticompetitive—it would similarly be unprofitable for Qwest to supply long distance service at a price of 9.8 cents. In short, the decisions that a profit-maximizing manager of Qwest's long distance service would make—e.g., pricing, marketing, network investment—would be precisely the same as those that an AT&T manager would make. AT&T incurs an access cost of 7.8 cents when it

carries a long distance call; Qwest incurs an access cost of 1.2 cents plus an opportunity cost of 6.6 cents (lost contribution from access) when it carries a long distance call. While Qwest certainly benefits from the contribution from carrier access, that contribution does not give it any advantage in the toll market, and every company, AT&T included, earns contribution from services other than toll.

V. QWEST'S COMPETITIVE ZONE PROPOSAL WILL LEAD TO EFFICIENT LOCAL EXCHANGE COMPETITION.

Q. HOW HAVE WITNESSES FOR QWEST'S COMPETITORS RESPONDED TO ITS PROPOSAL TO PERMIT PRICING FLEXIBILITY IN AREAS WHERE SERVICES ARE SUBJECT TO COMPETITION?

A. In response to Mr. Teitzel's testimony, Dr. Collins argues that current conditions in Arizona do not warrant approval of any applications for competitive zone designations. According to Dr. Collins, Qwest's loss of market share is still too small for the Commission to conclude that any true and sustainable competition exists in any Arizona market. Dr. Collins argues that "Qwest has failed to meet its burden of proof that the Arizona telecommunications market has robust competition and has in fact proven it does not."

Dr. Selwyn, on behalf of AT&T, also states that not enough competition has yet materialized in Arizona to allow Qwest's request for competitive zone designation to be granted. He also expresses his concerns that some of the indicators that Qwest uses to support its claims that competition is materializing in the Arizona marketplace—such as the proximity of access lines to competitor fiber

and the extent of collocation—are irrelevant. Both Dr. Collins and Dr. Selwyn criticize Qwest's criteria for determining whether or not competitive losses have occurred—arguing that even the loss of a single line to resale could trigger a request for competitive zone classification—and both appear to argue that market share is the primary indicator of the emergence of competition.

Q. PLEASE SUMMARIZE YOUR RESPONSE TO THESE CLAIMS.

A. In responding to these witnesses, I place special emphasis on the following issues:

1. Market share used in isolation is a flawed indicator of present and future competition.
2. Past and current market share are of limited predictive value in assessing the state of competition.
3. Dr. Selwyn and Dr. Collins ignore or attack other indicators of competitiveness which are useful in the present context.
4. There are regulatory precedents that the Commission should keep in mind when faced with Qwest's request for competitive zone designation.

A. Market Share is Not a Reliable Predictor of Future Behavior

Q. DR. COLLINS (AT 2-5) AND DR. SELWYN (AT 7-9) IMPLY THAT QWEST HAS NOT LOST SUFFICIENT MARKET SHARE AND, THEREFORE, SHOULD NOT QUALIFY FOR PRICING FLEXIBILITY OF THE KIND IT IS SEEKING IN ITS APPLICATION. DO YOU AGREE?

A. No. I believe the emphasis placed by both witnesses on the market share measure for assessing the merits of Qwest's application is incorrect for several reasons. First, measuring market share loss in terms of lines says less about the intensity of competition or about the stakes for which the competitors are playing than market

share loss in terms of alternative measures such as revenues or profits. Second, market share measured for *outcomes* (such as lines sold or revenues/profits earned) says less about the ability of firms to act strategically in the market than market share measured for *determinants* of those outcomes (such as capacity). Third, when a market is moving in the direction of *decreasing* concentration, the market share measure says less about expected future behavior of the competitors than when the market is moving in the direction of *increasing* concentration, say, because of a horizontal merger or acquisition. Fourth, market share is not a sufficient indicator of either the presence or absence of effective competition or of the strength or fragility of competition. Finally, market share is only a supporting statistic that must always be used in conjunction with other, more important indicators of market behavior such as entry and exit conditions.

Q. PLEASE EXPLAIN WHY MEASURING MARKET SHARE IN TERMS OF LINES IS NOT VERY INFORMATIVE ABOUT THE INTENSITY OF COMPETITION OR THE STAKES FOR WHICH RIVAL FIRMS ARE COMPETING.

A. ILECs and CLECs do not compete for lines *per se*, but rather for that which lines make possible, namely, revenues and profits. If *every* line sold generated exactly the same amount of revenue or profit, then that distinction would not matter. But, that is rarely, if ever, the case. Two facts are particularly important in this context.

1. ILECs and CLECs sell not merely access lines to customers but also other services that can be delivered over those lines. As competition, deregulation, and liberalization push those carriers increasingly toward offering comprehensive packages of services (along with single-source billing

convenience), the loss of each line could mean the loss of more than just the revenue associated with the line and basic local exchange service itself.

2. A relatively small proportion of customers or, more precisely, access lines typically accounts for a relatively large proportion of the revenues (and profits) earned by a carrier. This is true of both business and residential customers, though that observed discrepancy may be more pronounced for business customers.

Taken together, these two facts explain why measuring market share loss in terms of lines may *understate* the real intensity of competition, i.e., the real degree of competitive loss. Suppose 20 percent of the lines served by a LEC account for 60 percent of its revenues. If all of those lines were lost to competitors, that LEC—which initially served 100 percent of lines—would be left with 80 percent market share in terms of lines, but only 40 percent market share in terms of revenue. There is no question that a firm that loses 60 percent of its revenues despite losing only a moderate proportion of the lines it serves is considerably worse off than before. Although this example is fictitious, it demonstrates how seriously the real impact of competition may be understated by using a line-based measure of market share.

Q. WHY IS MARKET SHARE MEASURED IN TERMS OF OUTCOMES (LIKE LINES OR REVENUES) LESS INFORMATIVE ABOUT A FIRM'S POTENTIAL BEHAVIOR THAN MARKET SHARE MEASURED IN TERMS OF DRIVERS OR DETERMINANTS OF THOSE OUTCOMES?

A. Market share has no inherent meaning or value to a firm: it is possible for a firm to have disproportionately large market share and, yet, not be able to extract any undue advantage from it. Market share only matters if it places the firm in a

position to extract extra profit from the industry or market in which it operates. Economists typically examine whether a firm with a large market share also has market *power*, i.e., the ability to influence the market price to its advantage. In many instances, a firm with a large market share may *not* have that kind of power, such as when the market is effectively *contestable* and barriers to entry and exit are low or non-existent or when the firm in question is regulated and its prices are subject to regulatory approval.

Measuring market share in terms of *capacity* or the stock of productive facilities instead gives a more reliable predictor of the firm's future (strategic) behavior. The capacity-based share measures the total volume of output that the firm's installed productive facilities could produce. For this reason, in industries characterized by fixed costs, a firm's capacity is a determinant or driver of outcomes such as the number of lines sold or revenue dollars earned. Larger capacity usually translates into an ability to serve greater volumes of existing or new demand. The capacity share measure is sometimes depicted directly in terms of the size of the facilities themselves (e.g., the number of route-miles of installed fiber from which various services could be provided).

A market share based on outcomes, e.g., revenue, does not automatically say anything about the firm's ability to restrict or retard competition by acting strategically. A capacity share measure, on the other hand, better conveys just how much of a barrier to competitive entry could be raised by a firm that uses its installed capacity as a strategic instrument. For example, a firm that has built up

substantial *excess* capacity, i.e., capacity beyond the level needed to serve current volumes of demand, would have the ability to quickly and comprehensively meet any sudden surge (or even gradual increase) in demand, even before any actual or potential competitor is able to deploy new or additional facilities for doing so.[24] Therefore, a capacity-related measure of market share is a more meaningful indicator of potential barriers to entry or strategic behavior by a firm and, hence, a predictor of potential market power.

Market share measures based on current or past firm performance outcomes often have little predictive value for future firm behavior with respect to its competitors. Although these measures may shed some light on past or current market circumstances, they may say little or nothing about a *dynamic* market in which the composition of participating firms and their output and pricing actions change frequently.

Q. WHY IS MARKET SHARE (OR CHANGE IN SHARE) LESS MEANINGFUL WHEN CONCENTRATION IN A MARKET IS DECREASING THAN WHEN IT IS INCREASING?

A. Markets change and evolve over time as production conditions change, new products are introduced, the regulatory climate changes, and a whole host of other factors also evolve. In the U.S., federal antitrust authorities, e.g., the DOJ and the

[24] The FCC has repeatedly found that excess capacity in a market is a sufficient constraint on the exercise of market power by the dominant firm in that market (i.e., the firm with the highest revenue market share). See, e.g., the *AT&T Non-Dominant Order*, at ¶¶58-62.

1 FTC, have traditionally monitored changes in market share only when events in the
2 market have given rise to *increasing* market concentration. It is commonplace for
3 these agencies to evaluate the potential state of competition in a market when,
4 e.g., mergers happen between competing firms or when one firm acquires a
5 competitor. For this purpose, the FCC relies on the Herfindahl-Hirschman Index
6 ("HHI") to measure the change in market concentration following a merger or
7 acquisition. The HHI is simply the sum of the squared market share of each firm in
8 a market.[25] To use this index for antitrust purposes, the DOJ published two sets of
9 guidelines and established certain benchmark values of the HHI for evaluating the
10 state of potential competition following a merger or acquisition.[26] However, as is
11 evident from the way the DOJ uses the HHI, it is not so much the actual *level* of the
12 HHI itself that the DOJ monitors closely as it is the *increase* in the HHI following a
13 merger or acquisition. The greater the increase in the HHI, the more worrisome the
14 consequences of the market event would appear to be.

15 HHI values between 1,000 and 1,800 trigger no alarms from an antitrust
16 perspective. However, these are arbitrary benchmarks based on a judgment of
17 what the HHI would be in a market in which market power is likely to be absent.
18 But, does that mean that market power can *never* exist in a market when the HHI is

[25] Theoretically, the range of the HHI is between 10,000 and zero. In a market with a single firm (pure monopoly), the market share is 100 percent and the HHI is 100×100=10,000. At the other extreme, if there are thousands of competing firms, each with an infinitesimally small market share, then the sum of their respective squared market shares would be quite close to zero.

[26] The guidelines and benchmarks in question are described in the *1984 Merger Guidelines* and the *1992 Horizontal Merger Guidelines*, both issued by the DOJ (the latter in association with the FTC).

less than 1,800? Alternatively, must market power *necessarily* arise in a market in which the HHI exceeds 1,800? The answer to both questions is "no." A particular value of the HHI is neither necessary nor sufficient for market power to exist or be exercised. For this reason, the DOJ typically confines its antitrust analysis to judgments about how steeply the HHI *increases* because of specific market events, rather than what level the HHI attains in the process.

There is an important asymmetry between increasing and decreasing concentration in a market and, for this reason, the HHI is typically of no practical value when concentration is decreasing. When a market with a single firm is opened to competition, the HHI—measured on the basis of whatever outcome or driver—necessarily starts out at its ceiling value of 10,000 (100 percent squared) and then declines as that firm loses market share to new entrants. Naturally, 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. Does that mean that the HHI in that market would have to fall from 10,000 to near 1,800 before the market could be declared competitive? Absolutely not. The 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 that ability to exercise market power, a high HHI says nothing about the actual and potential state of competition in the market. This fact is particularly true for regulated telephone companies whose

1 initial market share of 100 percent was due to regulation rather than to any inherent
2 characteristic of the firm or the technology.[27]

3 **Q. PLEASE EXPLAIN WHY THE HHI IS AN INADEQUATE INDICATOR OF**
4 **MARKET BEHAVIOR IN THESE CIRCUMSTANCES.**

5 A. First, it is obvious that prior to the authorization of local exchange competition
6 (under Sections 251 and 252 of the Telecommunications Act of 1996), each market
7 was served by a single LEC and, therefore, had an HHI of 10,000. However,
8 because that LEC's service prices were all subject to regulatory approval and
9 control, there could be no prospect of the anticompetitive behavior that an HHI of
10 10,000 would otherwise signify.

11 Second, the market for interstate long distance services is now widely
12 considered to be competitive. Indeed, the once dominant firm in that market—
13 AT&T—is no longer price regulated. Yet, according to the latest revenue market
14 share statistics, the HHI in that market is 2,641 and, in 1995, when AT&T was
15 declared a non-dominant carrier by the FCC, the HHI was 3,197.[28] How, then,
16 could that market be viewed as competitive?

17 The answer is straightforward: there is significant excess capacity in the
18 long distance market. Among them, the four largest inter-exchange carriers
19 ("IXCs")—AT&T, MCI-WorldCom, Sprint, and Qwest—have several times more

[27] See W.M. Landes and R.A. Posner, "Market Power in Antitrust Cases," *Harvard Law Review*, 94, 1981.

[28] FCC, Common Carrier Bureau, *Trends in Telephone Service*, March 2000, Table 11.3.

capacity than is needed to serve the current level of demand for long distance services.[29]. More importantly, each of the largest three of these IXCs *individually* has enough installed capacity to be able to serve the demand of the others' customers besides its own.[30] As a consequence, there is little ability on the part of any of the large facilities-based IXCs to exercise strategic control over the market price.

Third, strict reliance on the DOJ's HHI benchmarks can lead to absurd conclusions. A market with four firms that all have the *same* market share (i.e., 25 percent) would have an HHI of 2,500—well in excess of the 1,800 benchmark level. Yet, could anyone seriously characterize such a market as having a single firm capable of exercising market power? Of course not. There is a remarkable corollary to this example: 2,500 is also the *lowest* HHI that could ever be achieved in a market with only four firms.[31] Thus, no amount of erosion of Qwest's market share could *ever* reduce the HHI in that market below the 1,800 benchmark level. Even if Qwest were to disappear altogether from that market, the HHI would not sink to or below 1,800. No sensible public policy in Arizona could be based on the

[29] For a sense of just how much capacity growth has occurred in the long distance market, see FCC, Common Carrier Bureau, *Fiber Deployment Update, End of Year 1998*, September 1999, Table 1 which indicates that IXCs' fiber route miles have about doubled in the last decade and grown eight-fold since 1985.

[30] This fact was first recognized by the FCC in its *AT&T Non-Dominant Order*, ¶70. AT&T itself made the same point and rejected market share as a valid measure of market power, pointing to the excess capacity in the IXC market as a constraint on the ability to restrict output. *Id.*, ¶42.

[31] In fact, it would take between five and six equal-share firms to reduce the HHI to 1,800 or below. But, even with four equal-share firms, as long as collusion—tacit or overt—is prohibited, no one can seriously argue that the market cannot be competitive.

1 faulty expectation that with enough reduction of Qwest's market share, the market
2 could safely be declared a competitive zone.

3 Finally, suppose the market has a single facilities-based firm with 40 percent
4 market share and 30 resellers, each with 2 percent market share. Despite such a
5 lopsided market structure, the HHI in that market would only be 1,720, well within
6 the 1,800 benchmark level. Does that mean that market power could not be
7 exercised in that market? Not necessarily because that depends on the type of
8 resale permitted. If resale is based on a wholesale discount off the retail price set
9 by the lone facilities-based carrier and, if that retail price is higher than what would
10 prevail in a competitive market, then the resellers would likely charge prices that
11 are higher than the competitive price as well. By not being charged the competitive
12 price, consumers would be worse off, and the resellers would, in effect, be strung
13 along with the market power of the facilities-based carrier that set the high retail
14 price in the first place. On the other hand, if resale is conducted on the basis of
15 volume or term discounts, then the lone facilities-based carrier would, by raising its
16 retail price, risk losing market share to resellers who could effectively undercut its
17 price.

18 **Q. WHY IS A MARKET SHARE MEASURE INADEQUATE FOR ASSESSING THE**
19 **PRESENCE, ABSENCE OR STRENGTH OF COMPETITION?**

20 A. It should be clear from the above discussion that market share *per se* is not the
21 item that should interest public policymakers; rather it is whether the conditions
22 exist for one or more firms in the market to exercise market power. As the

examples I provided demonstrate, it is hazardous to draw inferences about a firm's market power by looking only at its market share. When competition is present in a market (and is strong), no single firm is able to exercise market power. Therefore, rather than focusing on market share, I would urge the Commission to examine whether indicators of market power are present in each of the wire center markets for which Qwest is seeking a competitive zone declaration.

B. Dr. Selwyn And Dr. Collins Ignore Other Indicators Of Competitiveness

Q. HOW DO YOU RESPOND TO DR. COLLINS' IMPLICATION [AT 3] THAT RESOLD LINES AND UNE PROVISIONING ARE MERELY REVENUE STREAM SHIFTS AND SHOULD NOT BE VIEWED AS FULL MARKET SHARE LOSSES?

A. While Dr. Collins has correctly noted that under resale and UNE provisioning, Qwest is likely to replace its retail revenues with wholesale revenues, it is hard to see why that fact is relevant for determining whether Qwest retains market power. If CLECs can use Qwest's wholesale services to compete against Qwest's retail services, Qwest cannot price its retail services with impunity. Dr. Collins' claim that Qwest doesn't lose everything when it loses a customer is correct but irrelevant in assessing Qwest's ability to hold the price of retail services above a competitive market level. Even in competitive zones, Qwest's wholesale prices remain regulated, so that any attempt by Qwest to raise retail prices could be defeated by CLECs using Qwest's UNEs to compete. As Staff Witness Shooshan observed,

> ...if regulators control the wholesale of input prices, there is seemingly little need for additional controls on retail or output prices in a competitive

> environment. As long as there is nondiscriminatory access by competitors to bottleneck network components and ILECs must impute appropriate costs to the services they offer and are prohibited from pricing below those costs, there is no obvious reason to think that efficient retail rates could not be established.[32]

Moreover, though Qwest may receive wholesale revenue in place of retail revenue when its retail lines are resold or substitute services are provided using Qwest-supplied UNEs, Qwest stands to lose a lot more than just the spread between retail and wholesale revenues when it loses a customer. One of the most important sunk costs of entry is that associated with building a loyal and profitable customer base. Resale and UNE-based entry provides potential customers an opportunity to develop that customer base *without* incurring that sunk cost. Qwest competes not merely to sell access lines but other retail services as well—often in service packages. Thus, in time, as a reseller or UNE-user takes enough customers away from Qwest for it to be able to deploy its own facilities and provide its own services, Qwest's loss from losing a customer will include not merely the spread between retail and wholesale revenues associated with the access line but also all other service revenues and contribution that previously accrued from that customer. In an era of competition by service packages, that will not be a trivial loss. In that respect, Dr. Collins' oversight of the true extent of the competitive loss comes from failing to take a longer term view of competition in the market.

[32] Haring and Shooshan, *op. cit.* at 14.

Q. HOW DO YOU RESPOND TO DR. SELWYN'S ASSERTION [AT 10] THAT COLLOCATION "PROVES VERY LITTLE" ABOUT THE PRESENCE OF COMPETITION—PRESENT AND FUTURE—IN A MARKET?

A. Dr. Selwyn's position is surprising, given the importance that the FCC places on collocation as a measure of competition in a market. For example, the FCC has divided up the process of acting on an initial request for regulatory relief and pricing flexibility into two phases. In Phase I, the FCC planned to grant a price cap ILEC pricing flexibility for special access and dedicated switched transport services if the ILEC could demonstrate that:

1. Competitors were collocated in 15 percent of the wire centers in the Metropolitan Statistical Area ("MSA") in which the relief was being sought; and,
2. Competitors were collocated in wire centers that accounted for at least 30 percent of the ILEC's revenues from special access (other than channel terminations) and dedicated transport.[33]

The collocation trigger for Phase I relief was based on the FCC's reasoning that collocation with competitive transport was the single best indicator of competitive presence. Moreover, the FCC saw collocation (even more than the leasing of capacity through UNEs) as a strong signal of irreversible or sunk investment, a demonstration of the competitor's commitment to the market, and an effective barrier against predatory or exclusionary pricing by the ILEC. Finally, the FCC found it administratively easier and less costly to establish the presence of irreversible competitive investments by observing the collocation factor directly,

[33] Fifth Report and Order, at ¶95.

rather than by trying to verify the extent to which competitors had installed their own facilities, undertaken marketing efforts, and competed for the ILEC's customers.[34]

Thus, the FCC, like other industry regulators and observers, views collocation as perhaps one of the best indicators of market competitiveness and future market direction, possibly because, from an economic perspective, collocation triggers a large increase in the capacity of a CLEC to serve customers. There is very little support for Dr. Selwyn's contention (at 10) that "from a pragmatic viewpoint, the very fact that competitors' actual gains are so small for customers served over UNE loops suggests that co-location rights alone are insufficient to permit the CLECs to compete."

C. Broad Principles For Assessing Requests For Pricing Flexibility

Q. ARE THERE SOME OVER-ARCHING REGULATORY AND ECONOMIC PRINCIPLES THAT YOU WOULD RECOMMEND THE COMMISSION TAKE INTO ACCOUNT WHEN EVALUATING QWEST'S APPLICATION FOR DESIGNATION OF COMPETITIVE ZONES?

A. Yes. I would strongly encourage the commission to follow the example of the FCC in according pricing flexibility to ILECs. The FCC has shown an increasing willingness to defer to market forces in circumstances such as those faced by Qwest in the Tucson and Phoenix markets. For example, the FCC has decided to

[34] *Id.*, at ¶¶77-80.

no longer require ILECs to file zone pricing plans in advance of tariff filings, presuming instead that market forces, along with restrictions on zone sizes, would force ILEC zone prices to reflect cost characteristics.[35] Also, in first undertaking reform of interstate switched access charges, the FCC adopted a market-based, rather than an overtly regulatory, approach.[36] The FCC explained that deference thus:

> ... we will not require incumbent LECs to demonstrate that they no longer possess market power in the provision of any access services to receive pricing flexibility, for two reasons. First, ... regulation imposes costs on carriers and the public, and the costs of delaying regulatory relief outweigh any costs associated with granting that relief before competitive alternatives have developed to the point that the incumbent lacks market power. Second, non-dominance showings are neither administratively simple nor easily verifiable. As several BOCs note in their forbearance petitions, the Commission previously has based non-dominance findings on several complex criteria, including market share and supply elasticity. Market share analyses require considerable time and expense, and they generate considerable controversy that is difficult to resolve. ... Measuring supply elasticity also can be controversial[.][37]

and

> ... because regulation is not an exact science, we cannot time the grant of regulatory relief to coincide precisely with the advent of competitive alternatives for access to each individual end user. We conclude that the

[35] FCC, *In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Interexchange Carrier Purchases of Switched Access Services Offered by Competitive Local Exchange Carriers, Petition by QWEST Communications, Inc. for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona, MSA*, Fifth Report and Order and Further Notice of Proposed Rulemaking ("*Access Reform Fifth Report and Order*"), CC Dockets 96-262, 94-1, 98-63, and 98-157, released August 27, 1999, at ¶65.

[36] FCC, *In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, End User Common Line Charges*, First Report and Order ("*Access Reform First Report and Order*"), CC Dockets 96-262, 94-1, 91-213, and 95-72, released May 16, 1997.

[37] *Access Reform Fifth Report and Order*, at ¶90. Various footnotes omitted.

> costs of delaying regulatory relief outweigh the potential costs of granting it before IXCs have a competitive alternative for each and every end user. The Commission has determined on several occasions that retaining regulations longer than necessary is contrary to the public interest. Almost 20 years ago, the Commission determined that regulation imposes costs on common carriers and the public, and that a regulation should be eliminated when its costs outweigh its benefits. More recently, the Commission recognized that retaining tariffing requirements for non-dominant IXCs imposes costs in the form of a less efficient market. In Section III of this Order, we conclude that the new service rules currently in effect limit incumbents' incentives to innovate. The Part 69 rate structure can impose costs on an incumbent LEC by limiting its ability to develop rate structures in response to market forces. Thus, retaining the Part 69 rate structure imposes costs on society by perpetuating inefficiencies in the market for interstate access services. The triggers we adopt for Phase II flexibility are sufficient to ensure that incumbent LECs cannot exercise any remaining monopoly power indefinitely. If an incumbent LEC charges an unreasonably high rate for access to an area that lacks a competitive alternative, that rate will induce competitive entry, and that entry will in turn drive rates down. Accordingly, we will not delay Phase II regulatory relief until access customers have a competitive alternative for access to every end user.[38]

Although these principles were adopted in a different context (i.e., forbearance from regulation of exchange access services), they demonstrate a keen appreciation of the losses of social welfare and economic efficiency that can follow from delaying or stretching out the process of relaxing pricing regulations as markets turn competitive. Whenever the benefits from granting pricing flexibility outweigh possible costs of such a policy, the FCC has chosen firmly in favor of relaxing regulation. That may be characterized as the first principle of regulatory prudence observed by the FCC.

[38] *Id.*, at ¶144. Various footnotes omitted.

1 The second principle of regulatory prudence is particularly important in
2 Arizona's context. While competition in its most vigorous form is presently
3 occurring in Tucson and Phoenix wire centers, eventually such competition will
4 become state-wide. Does that mean that the Commission should repeat this
5 complex, time-consuming, and contested process every time Qwest submits an
6 application for pricing flexibility in a different part of the state? The FCC has
7 strongly suggested that to proceed in that manner would be unwise, inefficient, and
8 unnecessarily burdensome. Rather, it would be prudent to establish—on the basis
9 of this proceeding—a set of criteria or "triggers" which the Commission could then
10 repeatedly apply, without the need for full-blown contested proceedings, to rule on
11 future Qwest applications for pricing flexibility.

12 **Q. AS BACKGROUND, WHAT PATH DID THE FCC FOLLOW FOR GRANTING**
13 **PRICING FLEXIBILITY FOR EXCHANGE ACCESS SERVICES?**

14 A. The FCC divided up the process of acting on an initial request for regulatory relief
15 and pricing flexibility into two phases. I discussed Phase I in rebutting Dr. Selwyn's
16 assertion that collocation is not an important indicator of market competitiveness.

17 In Phase II, the FCC required that, in addition to a firm commitment to
18 competition, an ILEC's rivals should demonstrate a significant market presence.
19 This added condition was explained by the FCC thus:

20 Because Phase II grants incumbent LECs considerably greater flexibility
21 than Phase I, we adopt triggers to ensure that competitors have
22 established a significant market presence, *i.e.*, that competition for a
23 particular service within the MSA is sufficient to preclude the incumbent
24 from exploiting any monopoly power over a sustained period. ... By

> significant market presence, we mean that IXCs [purchasers of access service] have a competitive alternative for dedicated transport services needed to reach the majority, although not necessarily all, of their long distance customers throughout the MSA, and that almost all special access customers have a competitive alternative.[39]

In effect, the FCC permitted greater pricing flexibility in Phase II as evidence of a stronger competitive presence became available through collocation statistics.

Q. DID THE FCC TIE THESE TRIGGERS FOR PRICING FLEXIBILITY TO MARKET SHARE OR ANY REQUIREMENT THAT THE ILEC IN QUESTION BE FIRST FOUND NON-DOMINANT?

A. No. In fact, the FCC explicitly rejected that tie-in:

> We conclude that the Phase II regulatory relief we grant below is warranted when competitors have established a significant market presence in an MSA, and we need not require a showing of non-dominance. Upon a Phase II showing, we will not grant incumbent LECs all the regulatory relief we afford to non-dominant carriers. Specifically, incumbent LECs in Phase II are still required to file generally available tariffs, while non-dominant LECs and CAPs are permitted, but not required, to file tariffs. Furthermore, our relief is limited to certain services and certain areas, and will be granted only upon satisfaction of the triggers we adopt here. Thus, Phase II relief is not tantamount to non-dominant treatment.[40]

The FCC did not find that, to grant pricing flexibility in areas or limited markets with competition, it had to go through extensive analyses of demand and supply conditions, market share, or prices. Instead, it was sufficient to establish that a

[39] *Id.*, at ¶¶141-142.

[40] *Id.*, at ¶151. Footnote omitted.

1 countervailing competitive presence had emerged in the market or area in which
2 pricing flexibility was being sought.

3 **VI. PRICING PAYPHONE ACCESS LINES ABOVE INCREMENTAL COST IS NEITHER**
4 **INEFFICIENT NOR ANTICOMPETITIVE.**

5 **Q. WHAT PAYPHONE ISSUES ARE RAISED IN THIS CASE?**

6 A. The testimony of Michael J. Ileo, on behalf of the Arizona Payphone
7 Association ("APA") raises several economic and regulatory issues including (i)
8 how payphone access line services provided by Qwest to payphone service
9 providers ("PSPs") including independent payphone service providers ("IPPs") and
10 Qwest's own payphone service should be priced and (ii) whether those prices
11 conform to the statutory requirements of the Telecommunications Act of 1996 ("TA
12 96") and the standards established by the FCC to implement those requirements.

13 **Q. PLEASE SUMMARIZE YOUR POSITION ON THOSE ISSUES.**

14 A. Dr. Ileo argues that (i) Qwest's current tariffed rates for payphone access line
15 services violate TA 96 and tests established by the FCC for the pricing of those
16 services, and (ii) were those rates to be affirmed by the Commission, economic
17 harm could occur to the competitors in the local market in Arizona.

18 Upon careful consideration of those claims (especially in light of the record
19 developed by the FCC on those matters), I conclude that Qwest's tariffed rates in
20 Arizona appear to satisfy all statutory requirements, are fair and reasonable,

conform to efficient pricing principles, and do not portend ill for the growth of competition in the local market in the state.

Q. HOW IS YOUR REBUTTAL TESTIMONY ORGANIZED?

A. This section is composed of three parts. First, I provide some background information about the payphone industry that is germane to my subsequent discussion of the economic issues raised in the testimony of Dr. Ileo. Second, I demonstrate that Dr. Ileo errs in his analysis of the statutory requirements that Qwest's rates for payphone services must satisfy for this Commission to reaffirm them. Third, I provide conclusions based on my analysis.

Q. PLEASE DESCRIBE THE CHARACTERISTICS OF TELEPHONE SERVICE PROVIDED THROUGH PAYPHONES.

A. Payphones may be used to place (and receive) most kinds of telephone calls that are traditionally made from privately-owned telephones by residential and business subscribers to the public switched network. However, payphones differ from privately-owned telephones in some important respects.

1. Unlike privately-owned telephones, payphones are owned and maintained by PSPs.
2. PSPs install their payphones on property provided—typically, commercially leased—by "location providers." Privately-owned telephones are typically located on the premises of the telephone owners themselves.
3. Payphone service typically involves four parties: the PSP that owns the payphone, the location provider that provides the site for installing the payphone, the telecommunications carriers that actually carry calls from the payphone to their eventual destinations, and the payphone user. In contrast, service from privately-owned telephones only involves two parties: the telephone owner and the carriers used to place and receive calls.

4. Unlike privately-owned telephones for which services are typically billed on a monthly basis, payphone users must pay at the time they make their calls.

Just like privately-owned telephones, payphones may be used to make local, long distance toll, and toll-free (800 number) calls. However, payphone users have the option of either paying in cash (i.e., receive service on a "coin" basis) or charging to telephone calling cards or other parties (i.e., receive service on a "coinless" basis).

Payphones are typically presubscribed to designated interexchange carriers ("IXCs") or operator service providers ("OSPs") for the carriage of inter- and intrastate long distance calls or to designated local exchange carriers ("LECs") for the carriage of local and intrastate long distance calls.[41] The payphone owners, i.e., the PSPs, may, therefore, not be telecommunications carriers themselves. As I explain below, this fact has an important bearing on the structure of the payphone market. It also means that revenues earned from payphone users are shared among three parties: the carriers, the IPPs, and the location providers (who receive "commissions").

Q. PLEASE DESCRIBE THE STRUCTURE OF THE PAYPHONE MARKET.

[41] OSPs are usually IXCs that provide operator-assisted long distance service. They may be "presubscribed" (i.e., OSPs to whom long distance payphone calls would be automatically sent) or "non-presubscribed" (i.e., OSPs whom payphone callers may reach by use of special access codes). An access code is a sequence of numbers that needs to be dialed to connect the caller to the OSP associated with that sequence, as opposed to the OSP presubscribed to the originating line. Access codes include 1010XXX in equal access areas and "950" Feature Group B dialing (950-0XXX or 950-1XXX) anywhere, where the three-digit XXX denotes a particular IXC. Some OSPs use an 800 number as an access code. Dial around calls are all calls that bypass any presubscribed carrier. The Telephone Operator Consumer Services Improvement Act ("TOCSIA") of 1990 prohibits PSPs from blocking access to non-presubscribed OSPs (by access code or dial around calls) by payphone users.

1 A. In order to assemble its retail payphone service, a PSP must use an access line to
2 connect its payphone set to the public switched network (at a central office) and
3 provide local usage services and various features (e.g., central office blocking and
4 screening and, optionally, billed number screening). Although, from an economic
5 standpoint, the access line and other services/features would appear to be
6 intermediate goods, i.e., resources needed to support payphone use, they are
7 viewed from a regulatory perspective as tariffed *business* exchange services and
8 the PSPs themselves are viewed as (retail) business end-users.

9 Qwest provides these components of payphone service in two forms: Basic
10 PAL ("BPAL") and Smart PAL ("SPAL").[42] Traditionally, Arizona IPPs have
11 purchased these services from Qwest, the *incumbent* LEC. However, as
12 *competing* LECs ("CLECs") expand their operations in the state, the access line
13 services needed for payphone service are becoming increasingly available from
14 non-Qwest sources.[43]

15 BPAL and SPAL are both tariffed business services that have traditionally been
16 priced at or near the level of rates for *business* local exchange service. The prices
17 of these payphone services have also traditionally included contribution toward the

[42] http://www.uswest.com/wholesale/win/pal_description.html. BPAL is designed to work with "smart" payphone sets equipped with software for rating calls, collecting coins, and diagnosing maintenance problems. In contrast, SPAL is designed to work with "dumb" payphone sets, i.e., those which rely on central office-based software for carrying out the same functions.

[43] CLEC competition is growing in Arizona. It is my understanding that, as of August 1, 2000, at least 33 CLECs (a mix of facilities-based carriers and resellers) were certificated to operate in the state and 77 were awaiting Commission approval. According to the FCC, 60 percent of Qwest access lines are served out of offices where CLECs have collocation arrangements (Trends In Telephone, Table 9.6, March 2000).

universal service program under which *residential* local exchange service rates are held at low levels, frequently below cost. Those prices have also included some contribution toward Qwest's shared and common costs.

Q. WHY DO PRICES OF SERVICES LIKE BPAL AND SPAL INCLUDE CONTRIBUTION TOWARD QWEST'S SHARED AND COMMON COSTS?

A. There are broadly two types of cost: (i) direct incremental cost that is incurred when adding or expanding the provision of a specific service (such as BPAL or SPAL), and (ii) shared cost that is not specific to any single service but arises in the process of adding or expanding the provision of several services. A common cost is simply a cost that is shared by *every* service, e.g., that arising from administrative, legal, human resources, and financial functions. Shared and common costs are sometimes referred to as *overhead* costs: unlike direct incremental costs, they cannot be identified with specific services.

While it is economically efficient for service prices to be set as close to underlying incremental costs as possible, in certain capital-intensive industries like telecommunications that form of pricing is simply not feasible. In those industries, firms typically experience relatively high fixed and shared and common costs and relatively low service-specific incremental costs. Setting prices to recover only those incremental costs would, therefore, prevent firms from recovering their substantial shared and common costs and from breaking even (making a normal return on capital). In those circumstances, economic theory prescribes specific rules for marking service prices above incremental costs so as to recover *all* costs

in an economically efficient manner. This is the rationale for including contribution toward shared and common costs in the prices of BPAL and SPAL service.

Q. IS THE PAYPHONE INDUSTRY COMPETITIVE TODAY?

A. Yes. Retail payphone service has been declared to be competitive by the FCC, although it has not yet been freed totally from all federal or state regulation. At Divestiture in 1984 (when the old Bell System was broken up under a consent decree), payphone service was considered a part of basic local service and assigned entirely to the Bell Operating Companies ("BOCs")—of which Qwest (then U S West) is one—rather than to AT&T or other IXCs. The advent of smart payphones in the mid-1980s and a subsequent FCC reclassification of smart payphones as terminal equipment rather than network elements led to the emergence of non-LEC providers of payphone service. In the years since, almost 1.75 million LEC payphones have been placed in service nationwide,[44] and the number of IPP payphones has long since surpassed 350,000.[45]

Retail payphone service is competitive today, and the FCC and state commissions retain authority over several aspects of their operation. Since the passage of TA 96, the FCC has issued a series of orders (collectively the

[44] FCC Common Carrier Bureau, *Statistics of Communications Common Carriers*, 1998/99 edition, Table 2.10.

[45] FCC, *In the Matter of Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996*, CC Docket No. 96-128, Notice of Proposed Rulemaking ("NPRM"), released June 6, 1996, ¶ 6 (citing an *ex parte* letter, dated April 24, 1996, from Cincinnati Bell to the Common Carrier Bureau).

Payphone Orders)[46] implementing the provisions of Section 276 of TA 96 that affect various aspects of the payphone industry. In the course of issuing these orders, the FCC has stated and reaffirmed its belief that the payphone industry is competitive. For example:

> ... the payphone industry has the potential to be very competitive. Entry into the payphone business appears to be easy. The ability to purchase a payphone, secure a location contract, obtain a payphone line from the LEC, and maintain the payphone are, together, the minimal technical requirements to enter into the payphone business. In addition, payphone lines are part of the tariffed offerings of local exchange carriers and, in some jurisdictions, only a simple business line is required to the [sic] payphone service. As contracts come up for renewal, or as location providers find it economical to put in new payphones, PSPs [payphone service providers] and [IXCs] routinely make themselves available to negotiate new agreements among themselves and the location provider.
>
> A payphone can be removed and used at another location, which facilitates entry and exit. If a PSP can easily redeploy its assets, it will be more willing to place a payphone in response to a small increase in price, because the risk of such placement is lower. In addition, there appear to be no significant scale or scope economies or network externalities that would impede entry of new firms. As a result, barriers to entry appear to be very low. In fact a large number of firms, both large and small, have entered the industry since it was initially opened to competition in 1984, and those firms have provided competition in at least some segments of the payphone market.[47]

[46] FCC, *In the Matter of Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996*, CC Docket No. 96-128, Report and Order ("FCC 96-388 Order"), released September 20, 1996; Order on Reconsideration ("FCC 96-439 Order"), released November 8, 1996; Order (Common Carrier Bureau DA 97-678, "Bureau Waiver Order"), released April 4, 1997; Order (Common Carrier Bureau DA 97-805, "Second Bureau Waiver Order"), released April 15, 1997; Second Report and Order ("FCC 97-371 Order"), released October 9, 1997.

[47] FCC 96-388 Order, ¶¶ 11-12. (Footnotes omitted)

Q. GIVEN THE FCC'S FINDING THAT PAYPHONE SERVICE IS COMPETITIVE, HOW HAVE ITS ACTIONS TAKEN THROUGH THE PAYPHONE ORDERS AFFECTED THE PAYPHONE INDUSTRY?

A. Through its *Payphone Orders* the FCC has laid out a roadmap for eventually removing all regulation and tariffing requirements from the payphone industry. Its finding that the industry is currently competitive and has the potential to become even more so has prompted the FCC to initiate steps to further reduce entry barriers in this industry. The FCC has taken four specific steps.

- First, acting on the mandate provided by Section 276 of TA 96 (discussed later), the FCC has decreed that BOC-owned and operated payphones be reclassified as customer premises equipment ("CPE") rather than as network elements, and unbundled from the payphone access and usage services (such as BPAL and SPAL) that are available from BOCs. Such unbundling is intended to prevent any cross-subsidization of BOC payphone service by other BOC services like basic exchange and exchange access.[48]
- Second, the FCC has retained tariffing requirements for BOC-provided payphone access and usage services, particularly where a BOC is itself a provider of retail payphone service. As I discuss later in my testimony, those requirements (or *non-structural safeguards*) involve demonstrating that tariffed rates of payphone access and usage services are cost-based and non-discriminatory and that they pass the new services test to which all price-capped LECs are subject.[49]
- Third, recognizing that its actions, and particularly the non-structural safeguards, eliminate the possibility of anticompetitive pricing of payphone access and usage services by Qwest and other BOCs (or incumbent LECs), the FCC has specifically and pointedly declined to adopt *structural* safeguards such as requiring that BOCs that also provide retail payphone service do so through separate affiliates (that maintain a separate corporate structure and accounting books from the BOCs themselves).[50]

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[48] FCC 96-388 Order, ¶¶ 142-144.

[49] *Id.*, ¶ 146.

[50] *Id.*, ¶ 145.

- Fourth, the FCC has specifically and pointedly declined to require that payphone access and usage services provided by Qwest and other incumbent LECs be subject to the same pricing regime that applies under Sections 251 and 252 of TA 96 to interconnection and unbundled network elements ("UNEs").[51]

As for retail payphone service itself, the FCC has instituted per-call compensation mechanisms that would compensate PSPs that receive no revenue whenever payphone customers make toll-free (subscriber 800), dial around long distance (or access code), and debit card calls. Significantly, the FCC has declined to set per-call compensation rates on a cost plus markup basis, insisting instead that retail payphone competition should be trusted to produce efficient market-determined rates.[52]

Q. PLEASE EXPLAIN WHAT SECTION 276 OF TA 96 ENVISIONS FOR PAYPHONE SERVICE.

A. Section 276 of TA 96 requires, *inter alia*, that any BOC that provides payphone service: (i) shall not subsidize its payphone service directly or indirectly from its telephone exchange service operations or its exchange access operations; and (ii) shall not prefer or discriminate in favor of its payphone service. These are the basis for several non-structural safeguards that the FCC has sought to implement through its *Payphone Orders*. The critical requirement is that a BOC's tariffed rates

[51] *Id.*, ¶ 147.

[52] *Id.*, ¶¶ 118-119 (especially, fn. 323).

for payphone access line services pass the "new services test" which evolved as a non-structural safeguard from the FCC's *Computer III* docket.[53]

The new services test—which I describe below—subsumes three specific requirements: that the tariffed rates in question be (i) cost-based, (ii) consistent with the requirements of Section 276 with regard, e.g., to the removal of subsidies from basic exchange and exchange access services, and (iii) non-discriminatory.

Q. WHAT DOES IT MEAN FOR A PRICE OR RATE TO BE "COST-BASED?"

A. A price is said to be cost-based if it is set in some relationship to the underlying economic cost. In general, a cost-based rate is the sum of direct incremental cost and a market-determined markup that recovers other costs. At a minimum, a cost-based rate must recover the direct incremental cost.

Q. DOES THAT MEAN THAT A COST-BASED PRICE SHOULD BE *EQUAL TO* A SPECIFIC MEASURE OF COST?

A. No. A cost-based price may differ from a specific measure of cost for a number of reasons. For example, the price need not be equal to direct incremental cost because of the need to include a contribution toward shared and common costs. As I mentioned before, in certain industries like telecommunications, if all service prices were set exactly equal to their respective incremental costs, the firm would fail to recover all of its costs. Therefore, there are circumstances in which prices of

[53] Amendment of Section 64.702 of the FCC's Rules and Regulations ("Computer III").

1 services must deviate efficiently from their incremental costs in order for the firm to
2 earn a normal return on its investment. Other special circumstances may warrant a
3 greater degree of markup for prices above incremental cost. For example, in the
4 present environment, LECs are obliged to price their residential basic exchange
5 service below the incremental cost of that service. Sustaining such a price is only
6 possible by including contribution toward residential basic exchange service in the
7 prices of some or all of LECs' other services.

8 Basing a price on the underlying cost ensures that the price is cost-causative,
9 i.e., what the customer is asked to pay depends on the cost of the resources that
10 were specifically used to provide the service to the customer. A cost-based price
11 also insures against anticompetitive behavior. For example, a price that is no less
12 than the underlying incremental cost cannot be predatory. Also, a price that is no
13 less than the underlying total service long run incremental cost ("TSLRIC") cannot
14 be receiving a cross-subsidy.[54] Thus, a firm that charges a price that is at least
15 equal to incremental cost or TSLRIC cannot be pricing anticompetitively.

16 **Q. WHAT DOES IT MEAN FOR A PRICE TO CONFORM TO THE REQUIREMENTS**
17 **OF SECTION 276 OF TA 96?**

[54] In economic theory, incremental cost refers only to the additional cost of producing the next increment (or unit) of a service. TSLRIC refers to the additional cost of producing the entire volume of that service. By definition, that includes all variable and fixed costs specific to that service.

1 A. Section 276 of TA 96 forbids the price (here, the prices of Qwest's payphone
2 access line services, BPAL and SPAL) from receiving a cross-subsidy from any
3 basic exchange or exchange access service.

4 **Q. DO YOU AGREE WITH DR. ILEO'S POSITION (AT 21) THAT SECTION 276 OF**
5 **TA 96 REQUIRES THAT PAL RATES NOT CONTAIN SUBSIDIES TO OTHER**
6 **TELECOMMUNICATIONS SERVICES OF ILECS?**

7 A. Absolutely not. Section 276 of TA 96 specifically relates to payphone services, and
8 nowhere in that section does it require that PAL services not contain subsidies (or
9 contribution) to other telecommunications services. To the extent payphone
10 access services contain implicit subsidies, such subsidies are addressed by
11 Section 254 of TA 96 which requires the elimination of all implicit subsidies, to be
12 replaced with explicit support. By doing this, regulators are forced to determine
13 which services, if any, are being subsidized, and can replace implicit mechanisms
14 with explicit mechanisms. Indeed, the FCC has spent considerable time and effort
15 implementing Section 254 of TA 96 in CC Docket No. 96-45. Furthermore, it is
16 impossible to determine whether any particular service (in this case BPAL or
17 SPAL) subsidizes another particular service without looking at the other services—
18 the ones <u>being</u> subsidized. That is why neither the Act nor any FCC rules require
19 the elimination of subsidies (in the form of reduced contribution) from any particular
20 service, payphone access services or otherwise.

Q. HOW DOES DR. ILEO'S INCORRECT SUMMARY OF TA 96'S REQUIREMENTS AFFECT HIS TESTIMONY?

A. Dr. Ileo's incorrect understanding of Section 276 of TA 96 renders many of his arguments baseless. Throughout his testimony he argues (at 9, 14-15, 19, 23, 31, 35, 40, 42, 47, 48, 49) that Qwest's BPAL rates are not in compliance with Section 276 of the Act because the rates are set at a level that subsidize other services. However, Dr. Ileo's understanding of Section 276 is incorrect, as I discuss above, and the argument is wrong. Therefore, in instances where Dr. Ileo bases his arguments on the mandates in Section 276— which constitutes most of his testimony—his arguments should be considered groundless.

Q. DR. ILEO ARGUES (AT 6, 24) THAT "THE PRESENCE OF UNLAWFUL SUBSIDIES ALONG WITH THE GRANTING OF PRICING FLEXIBILITY...COULD ENDANGER THE FURTHER DEVELOPMENT OF LOCAL COMPETITION IN ARIZONA." PLEASE RESPOND.

A. The majority of Dr. Ileo's testimony rests on the argument that PAL services priced above long run incremental costs contain unlawful subsidies. While this argument is baseless, as I describe above, on page 24 of his testimony he makes a slightly different argument—that subsidies could endanger local competition. Although Dr. Ileo does not fully develop his argument, I understand his argument to be that local services are supposedly subsidized by PAL services. Therefore, his argument would be that Qwest has the ability to price anticompetitively below cost for local services, thwarting competition in the local market. Dr. Ileo argues, then, that

1 eliminating subsidies in PAL services will eliminate Qwest's ability to price local
2 services anticompetitively. This argument has no place in assessing payphone
3 access line service rates, and whether they are (i) cost-based, (ii) consistent with
4 the requirements of Section 276 of TA 96, specifically with respect to the removal
5 of subsidies to payphone service from basic exchange and exchange access
6 services, (iii) non-discriminatory, and (iv) able to pass the new services test that
7 applies to price cap LECs. A determination of anticompetitive pricing in the local
8 market requires an analysis of local rates, not PAL rates.

9 **Q. WHAT DOES IT MEAN FOR A PRICE TO BE NON-DISCRIMINATORY?**

10 A. Non-discrimination—another requirement of Section 276 of TA 96—implies that the
11 provider of a service cannot charge different prices to different customers. While
12 price discrimination is fairly common in mature and competitive markets for retail
13 services, Section 276's purpose here is to augment whatever protection is afforded
14 by growing payphone service competition by prohibiting price discrimination for the
15 payphone access line service that both a LEC and its competitor (an IPP) may use
16 to provide payphone service.[55] This safeguard ensures that the LEC that supplies
17 payphone access services does not derive an unfair advantage by charging its own
18 payphone affiliate less for those services than it does its IPP competitors.
19 However, as IPPs are increasingly able to acquire those services from non-Qwest

[55] Price discrimination is not inherently bad unless it confers on the price discriminating firm an unfair competitive advantage. For example, if a firm has monopoly control over an essential wholesale service which both it and (continued...)

1 sources, the *economic* significance of the non-discrimination requirement will
2 decline.

3 **Q. WHAT IS THE NEW SERVICES TEST?**

4 A. The new services test is described in Part 61.49(f)(2) of the *Code of Federal*
5 *Regulations.* It is more fully explained in an amendment of the FCC's Part 69
6 access charge rules[56] that enabled the BOCs to offer unbundled Open Network
7 Architecture ("ONA") services. In its Order in that proceeding, the FCC modified
8 the LEC Price Cap Order new services test to give "additional pricing flexibility to
9 price cap local exchange carriers[.]"[57] As described in Part 61.49(f)(1-2), when a
10 price cap LEC introduces a new service, it is required to submit cost data sufficient
11 to establish that the new service will generate a "net revenue increase" and that the
12 new service will not recover "more than a reasonable portion of the carrier's
13 overhead costs." The purpose of this test is clearly to insure that the new service—
14 here, BPAL or SPAL—is not priced anticompetitively.

15 It is obvious that a price that passes the new services test must be cost-based
16 because it would have to be set in some relationship to underlying cost, namely, at

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(...continued)

its competitors must use to provide a retail service, then charging itself a lower price for the wholesale service than the price it charges its competitors can be an unfair and anticompetitive form of price discrimination.

[56] *In the Matter of Amendments of Part 69 of the Commission's Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture Policy and Rules Concerning Rates for Dominant Carriers*, FCC 91-186, Report and Order, Order on Further Reconsideration and Supplemental Notice of Proposed Rulemaking ("FCC 91-186 Order"), CC Docket Nos. 89-79 and 87-313, released July 11, 1991.

[57] *Id.*, ¶ 1.

1 or above TSLRIC. A price that is at or above TSLRIC would also, by definition, not
2 be cross-subsidized—by basic exchange, exchange access, or any other service—
3 and, thus, conform to Section 276 of TA 96. Finally, it cannot be discriminatory if it
4 applies equally to Qwest's own payphone affiliate and to that affiliate's IPP
5 competitors.

6 **Q. HAS THE FCC DETERMINED A SPECIFIC IMPLEMENTATION OF THE NEW**
7 **SERVICES TEST?**

8 A. No. While the FCC has addressed the issue on various occasions, it appears not
9 to have settled on one definitive interpretation of the new services test. In most
10 instances I am aware of, a showing that the price is some multiple (with a minimum
11 of one) of the direct cost has—where uncontested—been sufficient to pass the test.
12 Only in circumstances in which other parties have contested a LEC's proposed
13 price, has the FCC felt compelled to rule on whether the proposed price
14 unreasonably exceeds the underlying direct cost.[58] This is sufficient reason for *this*
15 Commission to interpret the new services test flexibly, based on appropriate
16 economic reasoning and sound public policy.

[58] For example, see FCC rulings on payphone-related tariff filings by Bell Atlantic and GTE in *In the Matter of Local Exchange Carriers' Payphone Functions and Features* (CC Docket No. 97-140), *Bell Atlantic Telephone Companies Revisions to Tariff F.C.C. No. 1* (Transmittal Nos. 962 and 966), *GTE System Telephone Companies Revisions to Tariff F.C.C. No. 1* (Transmittal Nos. 206 and 1112), *GTE System Telephone Companies Revisions to Tariff F.C.C. No. 1* (Transmittal Nos. 1095 and 217), Memorandum Opinion and Order ("FCC 97-392 Order"), released October 29, 1997.

Q. IN YOUR OPINION, WHAT SHOULD THIS COMMISSION CONSIDER WHEN CONDUCTING THE NEW SERVICES TEST?

A. There are, in my view, two important aspects to the new services test. The first concerns the choice of the *cost standard* that best measures the "direct cost" element of the new services test. The second concerns a determination whether the markup or *overhead loading* by which the tariffed rate exceeds the direct cost is reasonable.

Q. HAS THE FCC EVER REQUIRED THE ADOPTION OF A SPECIFIC COST STANDARD FOR THE NEW SERVICES TEST?

A. No. Apart from ruling out one specific cost methodology (discussed below), the FCC has never clearly indicated what cost standard should be selected for the purposes of the test. However, in the past it did state:

> Under our approach, a LEC introducing new services will be required to submit its engineering studies, time and wage studies, or other cost accounting studies to identify the direct costs of providing the new service, absent overheads, and must also satisfy the net revenue test. ... LECs may develop their own costing methodologies, but they must use the same costing methodology for all related services.[59]

Even when the FCC had an opportunity in 1997 to revisit this issue, it issued no new instructions.[60] That is in sharp contrast to the level of detail that the FCC has gone to in directing how a new cost methodology should be employed to determine costs and rates for UNEs (discussed below).

[59] FCC 91-186 Order, ¶ 42.

[60] FCC 97-392 Order.

Q. DR. ILEO [AT 5] EQUATES THE COMMISSION'S TASK IN THIS PROCEEDING TO THAT IN COMMISSION DECISION NO. 60635 (IN WHICH COST-BASED RATES FOR UNBUNDLED NETWORK ELEMENTS WERE ESTABLISHED). IS THAT A PROPER COMPARISON?

A. Absolutely not. While there are some surface similarities between the tasks in that proceeding and the present one, it is dangerous to read too much into those similarities. It is true that cost-based and non-discriminatory rates needed to be established for UNEs in that proceeding, just as such rates need to be established for Qwest's payphone access line services in this proceeding. However, the cost standard on which rates for UNEs were to be based is *not* the same as the one that would apply in this proceeding.

Going by Sections 251 and 252 of TA 96, the FCC had interpreted the pricing rules therein to mean that prices of all UNEs should be set equal to their respective total *element* long run incremental costs ("TELRICs"). The FCC defined TELRIC to include "... the forward-looking costs directly attributable to the specified element, as well as a reasonable allocation of forward-looking common costs."[61] It is extremely important to understand that the TELRIC methodology that had also been adopted in Commission Decision No. 60635 does *not* apply in the current proceeding for the following reasons:

[61] FCC, *In the Matter of Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98, First Report and Order ("Local Competition Order"), released August 19, 1996, ¶ 682.

1. TELRIC pricing applies to unbundled network *elements*, not *services*. Elements are simply functionalities or network components that need to be combined in order to form telecommunications services. Those elements are of no value in and of themselves to end-users. Services, on the other hand, have value to end-users or other customers. As the FCC itself has recognized, services frequently share resources (e.g., retailing resources) and, therefore, have shared costs, whereas UNEs may have little shared costs. Therefore, the cost standard for UNEs, namely, TELRIC, is very different from the cost standard for services, namely, TSLRIC. In Commission Decision No. 60635, the Commission had established TELRICs for UNEs, *not* TSLRICs for services.
2. As I pointed out earlier, the FCC has itself specifically *ruled out* the application of pricing rules from Sections 251 and 252 of TA 96 to tariffed rates for BOC payphone services.[62] Therefore, any reasonable costing methodology that is appropriate for services (e.g., Qwest's choice of TSLRIC or some other) would be consistent with the new services test, but *not* the TELRIC methodology or the framework provided by Sections 251 and 252 of TA 96.

Therefore, it would also be wrong to apply to payphone access services anything arising out of Federal Court decisions regarding UNEs. For example, Dr. Ileo makes the claim (at 19) that subsidies should not be incorporated in BPAL rates because of the recent Federal Court decision that states "costs of universal service subsidies should not be included in the costs of providing the network elements." However, because BPAL is not an unbundled network element and payphone providers are end users, not carriers, Dr. Ileo's argument does not apply.

Q. HAS QWEST EMPLOYED THE PROPER COST STANDARD IN THIS PROCEEDING?

A. Yes. In this proceeding, rates are being determined for services, not elements. Therefore, for reasons stated above, the TELRIC cost standard is not appropriate.

[62] See footnote 11, *supra*.

1 Instead, Qwest's choice of the TSLRIC cost standard is appropriate because
2 TSLRIC measures direct cost (as required by the new services test) for the two
3 services consistently with how that cost is caused.

4 **Q. HAS THE FCC PROVIDED GUIDELINES ON WHAT WOULD CONSTITUTE A**
5 **REASONABLE OVERHEAD LOADING IN A TARIFFED RATE THAT IS**
6 **SUBJECT TO THE NEW SERVICES TEST?**

7 A. No. The FCC has not stated a precise methodology for determining a reasonable
8 loading factor (i.e., the percent markup above direct costs). This Commission has
9 the latitude to apply its own best judgment for determining the proper loading factor
10 for all of Qwest's services, including payphone services. A review of the previous
11 FCC Orders, however, indicates that the FCC is interested in efficient pricing and in
12 granting adequate flexibility. For example, at one point the FCC decided:

13 [t]o provide the flexibility needed to achieve efficient pricing, we are not
14 mandating *uniform* loading, but BOCs will be expected to justify the
15 loading methodology they select as well as any deviations from it.[63]

16 At a later time, the FCC reaffirmed this decision[64] and stated in addition:

17 Dramatic rate variance alone does not establish that individual rates are
18 unreasonable.[65]

19 In fact, the FCC has broadly interpreted what constitutes a reasonable loading
20 or markup. In a more recent decision, the FCC once again stated that uniform

[63] FCC 91-186 Order, ¶ 44.

[64] FCC, *In the Matter of Open Network Architecture Tariffs of Bell Operating Companies*, CC Docket No. 92-91, Order ("FCC 93-532 Order"), released December 15, 1993, ¶ 5.

[65] *Id.*, ¶ 12.

1 loadings are not required.[66] In that same Order, the FCC approved loadings as
2 high as 4.8 times direct costs.

3 **Q. AS AN ECONOMIST, WHAT IS YOUR RECOMMENDATION TO THIS**
4 **COMMISSION ABOUT HOW IT SHOULD DETERMINE WHAT A REASONABLE**
5 **LOADING IS IN THIS CASE?**

6 A. For the purposes of this case, the Commission should be guided by economic
7 efficiency and the effect of price changes on competition. From an economic
8 perspective, welfare is maximized when demand considerations are taken into
9 account to determine a proper markup above direct costs. It is a well-established
10 economic principle that prices that are equal to their corresponding direct
11 incremental costs result in economically efficient and welfare-maximizing
12 outcomes. However, as I explained earlier in my testimony, due to considerable
13 economies of scale and scope in telecommunications,[67] pricing at direct
14 incremental cost fails to recover shared and common costs and leads the regulated
15 firm into bankruptcy. As a result, markups above direct costs are needed.

16 Markups result in higher prices than would be the case without them. As a
17 result some demand may be suppressed—a condition called *allocative inefficiency*.

[66] FCC 97-392 Order, ¶ 13.

[67] Economies of scale arise when the average incremental cost of providing a service falls as volume increases. This condition is usually associated with a situation I described earlier for capital-intensive firms: high fixed capital costs alongside low variable or incremental costs. Economies of scope arise when different services share resources. The more services share resources, the cheaper it is for a single firm to provide them together than for each service to be provided separately by different firms. LECs like Qwest display both economies of scale (because of their cost structure and the high volumes they serve) and economies of scope (because a multitude of different services are provided out of a common network where many facilities are shared in use).

1 This means that the Commission must strike a balance between the firm's
2 (Qwest's) need to remain financially solvent by recovering all its costs and users'
3 desire to get their services at the lowest possible prices (i.e., with minimum losses
4 due to allocative inefficiency). Economic theory prescribes that such a balance be
5 struck by setting markups in prices of different services in a way that minimizes
6 consumer welfare losses due to allocative inefficiency. The best known rule for
7 that purpose is Ramsey Pricing (or some variant of it) according to which the
8 markup in a service price should be inversely related to the market elasticity of
9 demand[68] for that service.[69] In this way, a relatively higher markup on those
10 services that are the least elastic in demand results in the least consumption loss
11 (and allocative inefficiency) to society while ensuring that the service provider
12 remains financially solvent. At the prices that result from the Ramsey pricing rule,
13 customers would purchase services in the same proportions as they would if all
14 prices were set equal to marginal cost.

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[68] The elasticity of demand measures how sensitive customers are to changes in prices. The Law of Demand tells us that, other things being equal, price and demand move in opposite directions. However, a higher price may suppress demand a little, some, or a lot (and similarly with a lower price stimulating demand). When demand changes by *more* than the percentage change in price, then demand is called *elastic*. As the terminology suggests, the more elastic is demand, the more sensitive customers are to price changes (in either direction). When demand changes by *less* than the percentage change in price, then demand is *inelastic*. The polar case of the latter is *zero* elasticity when demand shows no sensitivity whatsoever to a price change.

[69] Ramsey pricing is named after its original proponent, economist Frank R. Ramsey. See his 1927 article, "A Contribution to the Theory of Taxation," *Economic Journal*, 37, at 47-61. Ramsey pricing has stood the test of time, particularly for application in regulated industries. There are now several more sophisticated pricing rules based on Ramsey pricing (e.g., multi-part pricing) that provide economically efficient outcomes. In fact, there are several instances of Ramsey-like pricing in the real world even in deregulated or competitive industries in which firms experience economies of scale and scope. For example, in the competitive airline industry, passengers who have the flexibility to plan weeks in advance are, in effect, contributing less to an airline's common costs (have lower markups in their prices) than business travelers who have less time to plan. Their
(continued...)

The logic of this optimal markup rule makes two things perfectly clear:

1. Because the elasticity of demand varies among services (e.g., from payphone to various non-payphone services), there is *absolutely no support* for the proposition that loadings or markups should be the same or uniform in every service provided by a LEC. As I documented earlier, the FCC has also acknowledged this important fact. (Unfortunately, Dr. Ileo [at 27-28] appears not to have when he proposes that the loading that Qwest applied for TELRIC pricing of UNEs in Commission Decision No. 60635 be applied in Qwest's tariffed rates for payphone services.)
2. In a firm the size of Qwest, the non-traffic-sensitive and shared and common costs are often the dominant component of total cost. Therefore, it should not be surprising that markups in prices directed to recover those costs could—depending on market demand conditions—end up being several multiples of the underlying direct incremental costs. "High" markups are *not*, on their face, unreasonable. Besides, markups are also subject to the market sustainability test. Markups that are unjustifiably high would also not be able to withstand competitive pressures. At any rate, in an industry in which *more* (rather than less) competition and reliance on market forces are being encouraged, it may be impossible—and ultimately, unnecessary—for a single Commission with limited informational resources to try to second-guess the market with its multitude of complex interactions. That is why the FCC, in its wisdom, refrained—on several occasions—from spelling out precise boundaries on the markup that should be applied to each and every service that LECs provide. The "invisible hand" of a dynamic marketplace can perform that task far better.

Q. SHOULD THE MARK-UP FOR PAYPHONE ACCESS LINE SERVICES BE COMPARED WITH THE MARKUP IN UNE PRICES IN ORDER TO JUDGE REASONABLENESS?

A. No. UNEs are not comparable to the payphone access line services in the sense explained above. IPPs do not compete with users of UNEs (generally, CLECs) in the provision of local exchange services. Unlike those CLECs, IPPs are generally

(...continued)

ticket prices—even for the same class of service—may differ by several hundred dollars. That is just the way efficient markets work.

not telecommunications carriers. Therefore, it is incorrect to suggest that the markup in payphone access line service prices should be comparable to that in UNE prices.

Q. DO YOU BELIEVE THAT THE MARKUPS IN QWEST'S RATES FOR BPALS AND SPALS ARE REASONABLE?

A. Yes. In light of Qwest's cost structure and the FCC's interpretation of what constitutes reasonable loadings (and, particularly, the absence of any requirements that loadings be uniform), I believe that the markups in Qwest's rates are reasonable.

Q. DO YOU CONCLUDE THAT QWEST'S RATES FOR BPAL AND SPAL SATISFY ALL STATUTORY REQUIREMENTS?

A. Yes. The statutory requirements are that payphone access line service rates be (i) cost-based, (ii) consistent with the requirements of Section 276 of TA 96, specifically with respect to the removal of subsidies to payphone service from basic exchange and exchange access services, (iii) non-discriminatory, and (iv) able to pass the new services test that applies to price cap LECs. I conclude that the rates are based on cost. Qwest has employed the proper cost standard for services, namely, TSLRIC, and demonstrated that the rate for each service at least recovers that cost (so that it cannot be anticompetitive). I conclude that the tariffed rates are not discriminatory because the services in question are available to Qwest's payphone affiliate and to competing independent IPPs on exactly the same

charges, terms, and conditions. Moreover, I have explained why "high" rates for those services are not, on their face, unreasonable or likely to favor Qwest's payphone services its competitors. Finally, I conclude that the rates pass the new services test within the parameters and guidelines provided (particularly with respect to acceptable degrees of overhead loadings or markups) by the FCC.

Q. DO YOU CONCLUDE THAT QWEST'S RATES FOR BPAL AND SPAL SERVICE ARE FAIR AND REASONABLE?

A. Yes. My analysis demonstrates that the rates for those services are not predatory or cross-subsidized, i.e., they are not anticompetitive. The loadings in those rates are also reasonable, particularly because of the parity between those rates and rates for business local exchange service. It should be kept in mind that BPAL and SPAL are *business* services and, therefore, unlike residential local exchange service, not subject to the public policy that keeps rates low, even below cost. Moreover, being services, they are not subject to the TELRIC pricing methodology employed for interconnection or UNEs (as in Docket No. U-3021-96-448, et al.).

Q. DO YOU CONCLUDE THAT QWEST'S RATES FOR BPAL AND SPAL CONFORM TO EFFICIENT PRICING PRINCIPLES?

A. Yes. As I explained in my testimony, Qwest (like other LECs) has a cost structure that is typical of capital-intensive firms: large fixed and shared and common costs in comparison to low direct incremental costs for the services they provide. Those firms experience economies of scale and scope as a result. For that reason, it is

1 vitally important that prices be set to recover not merely the incremental costs but
2 the substantial other costs as well. That, in turn, means the use of economically
3 efficient markups in service prices. Because uniform loadings or markups are not
4 economically efficient as long as the demand conditions differ across services, the
5 Ramsey pricing rule (or some variant of it) should be employed to include market-
6 determined markups in individual service prices. Because of the cost structure that
7 Qwest has, overhead loadings or markups that are several multiples of direct
8 incremental cost are not, on their face, unreasonable or inefficient.

9 **Q. WHAT IS YOUR OVERALL CONCLUSION?**

10 A. My overall conclusion is that contrary to the testimonies from the payphone
11 industry witness in this proceeding, Qwest's rates for payphone access line
12 services, BPAL and SPAL, have been constructed on the basis of sound economic
13 principles and within FCC-provided guidelines and parameters. This Commission
14 should not apply the TELRIC pricing methodology that was employed to determine
15 rates for interconnection and UNEs in Docket No. U-3021-96-448, et al. Qwest's
16 rates that are being examined in this proceeding are fair and reasonable and
17 should give no cause for alarm about either the potential for further competition in
18 Arizona's payphone market or for the prospects of long-term survival of that
19 market.

20 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

21 A. Yes.

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-01051B-99-105

EXHIBITS OF

WILLIAM E. TAYLOR, Ph.D.

SENIOR VICE PRESIDENT
NATIONAL ECONOMIC RESEARCH ASSOCIATES, INC.

ON BEHALF OF

QWEST CORPORATION

August 21, 2000

n/e/r/a
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Dr. Taylor received a B.A. magna cum laude in Economics from Harvard College, an M.A. in Statistics and a Ph.D. in Economics from the University of California at Berkeley. He has taught economics, statistics, and econometrics at Cornell and the Massachusetts Institute of Technology and was a post doctoral Research Fellow at the Center for Operations Research and Econometrics at the University of Louvain, Belgium.

At NERA, Dr. Taylor is a Senior Vice President, heads the Cambridge office and is Director of the Telecommunications Practice. He has worked primarily in the field of telecommunications economics on problems of state and federal regulatory reform, competition policy, terms and conditions for competitive parity in local competition, quantitative analysis of state and federal price cap and incentive regulation proposals, and antitrust problems in telecommunications markets. He has testified on telecommunications economics before numerous state regulatory authorities, the Federal Communications Commission, the Canadian Radio-Television and Telecommunications Commission, federal and state congressional committees and courts. Recently, he was chosen by the Mexican Federal Telecommunications Commission and Telmex to arbitrate the renewal of the Telmex price cap plan in Mexico. Other recent work includes studies of the competitive effects of major mergers among telecommunications firms and analyses of vertical integration and interconnection of telecommunications networks. He has appeared as a telecommunications commentator on PBS Radio and on The News Hour with Jim Lehrer.

He has published extensively in the areas of telecommunications policy related to access and in theoretical and applied econometrics. His articles have appeared in numerous telecommunications industry publications as well as *Econometrica*, the *American Economic Review*, the International *Economic Review*, the *Journal of Econometrics*, *EconometricReviews*, the *Antitrust Law Journal*, *The Review of Industrial Organization*, and *The Encyclopedia of Statistical Sciences*. He has served as a referee for these journals (and others) and the National Science Foundation and has served as an Associate Editor of the *Journal of Econometrics*.

EDUCATION

UNIVERSITY OF CALIFORNIA, BERKELEY
Ph.D., Economics, 1974

UNIVERSITY OF CALIFORNIA, BERKELEY
M.A., Statistics, 1970

HARVARD COLLEGE
B.A., Economics, 1968
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EMPLOYMENT

NATIONAL ECONOMIC RESEARCH ASSOCIATES, INC. (NERA)
1988- Senior Vice President, Office Head, Telecommunications Practice Director. Dr. Taylor has directed many studies applying economic and statistical reasoning to regulatory, antitrust and competitive issues in telecommunications markets. In the area of environmental regulation, he has studied statistical problems associated with measuring the level and rate of change of emissions.

BELL COMMUNICATIONS RESEARCH, INC. (Bellcore)
1983-1988 Division Manager, Economic Analysis, formerly Central Services Organization, formerly American Telephone and Telegraph Company. While at Bellcore, Dr. Taylor performed theoretical and quantitative research focusing on problems raised by the implementation of access charges. His work included design and implementation of demand response forecasting for interstate access demand, quantification of potential bypass liability, design of optimal nonlinear price schedules for access charges and theoretical and quantitative analysis of price cap regulation of access charges.

BELL TELEPHONE LABORATORIES
1975-1983 Member, Technical Staff, Economics Research Center. Performed basic research on theoretical and applied econometrics, focusing on small sample theory, panel data and simultaneous equations systems.

MASSACHUSETTS INSTITUTE OF TECHNOLOGY
Fall 1977 Visiting Associate Professor, Department of Economics. Taught graduate courses in econometrics.

CENTER FOR OPERATIONS RESEARCH AND ECONOMETRICS
Université Catholique de Louvain, Belgium.
1974-1975 Research Associate. Performed post-doctoral research on finite sample econometric theory and on cost function estimation.

CORNELL UNIVERSITY

1972-1975 Assistant Professor, Department of Economics. (On leave 1974-1975.) Taught graduate and undergraduate courses on econometrics, microeconomic theory and principles.

MISCELLANEOUS

1985-1995 Associate Editor, *Journal of Econometrics*, North-Holland Publishing Company.

1990- Board of Directors, National Economic Research Associates, Inc.

1995- Board of Trustees, Treasurer, Episcopal Divinity School, Cambridge, Massachusetts.

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Nebraska Public Service Commission, on behalf of U S WEST (Application No. C-1628), October 20, 1998. Reply November 20, 1998.
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August, 2000

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 APPPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN.	)	DOCKET NO. T-1051B-99-105 AFFIDAVIT OF WILLIAM E. TAYLOR
COMMONWEALTH OF MASSACHUSETTS	) :	ss
COUNTY OF MIDDLESEX	)	

William E. Taylor, of lawful age being first duly sworn, depose and states:

1. My name is William E. Taylor. I am Senior Vice President, National Economic Research Associates, Inc., of Cambridge, Massachusetts. I have caused to be filed written testimony and exhibits in support of Qwest in Docket No. T-1051B-99-105.

2. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct to the best of my knowledge and belief.

Further affiant sayeth not.

William E. Taylor

SUBSCRIBED AND SWORN to before me this 18 day of August, 2000.

Notary Public
Cambridge, MA

My Commission Expires: 9-24-04

EXHIBIT
Q-28
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-01051B-99-0105

REBUTTAL TESTIMONY

OF

DAVID L. TEITZEL

QWEST CORPORATION

AUGUST 21, 2000

REBUTTAL TESTIMONY OF DAVID L. TEITZEL

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EXECUTIVE SUMMARY

Qwest has proposed a new "Competitive Zones" concept in this Docket that establishes the capability for Qwest to compete on par with its competitors in specific geographic areas of Arizona. Other parties have filed testimony in opposition to this concept and have taken the position that Qwest should continue to be constrained from competing on an equivalent basis with its competitors in targeted areas in which those competitors have chosen to market their services. The parties are wrong. Qwest's proposal is entirely consistent with the objectives of the Telecommunications Act of 1996 (the Act), the FCC's subsequent rulings in support of the Act and existing ACC rules. The overarching goal of the Act is to open markets to competition and to establish a regulatory framework within which competitors may compete vigorously, creatively and on equal footing. Qwest's Competitive Zones proposal establishes a mechanism to promote fair competition in geographic areas in which competition exists. When approved, the Competitive Zones proposal will be to the ultimate benefit of Arizona consumers, who will be rewarded with the fruits of full, open and fair competition in the telecommunications market.

Opposing parties have also chosen to generally oppose the retail services rate design in this Docket, which was proposed to address Qwest's positive revenue requirement in Arizona. Qwest's rate design proposal strikes an appropriate balance between multiple objectives: the need to begin to remove implicit subsidies from Qwest's rate structure

pursuant to the mandates of the Act, the need to establish cost-based prices to facilitate the growth of efficient competition in all markets throughout Arizona, the need to align "deaveraged" wholesale and retail pricing structures to avoid creation of pricing anomalies and rate arbitrage opportunities, the need to simplify and streamline traditional rate structures, the need to comply with existing ACC pricing rules and the need to minimize overall impacts of rate changes upon Arizona customers to the extent practicable. A major recurring theme in the parties' complaints regarding Qwest's retail pricing design is that the loop cost for local exchange services should be "shared" among virtually all retail services Qwest offers in Arizona. This theme is based on seriously flawed economic principles. When Qwest's retail services pricing proposal is viewed in the context of TSRLIC as the proper cost basis, this proposal is in full alignment with the above policy objectives. On this foundation, I respectfully suggest that the Commission dismiss opposing parties' complaints and approve Qwest's retail pricing proposal as filed.

I. INTRODUCTION AND PURPOSE

Q. PLEASE STATE YOUR NAME, OCCUPATION, AND BUSINESS ADDRESS.

A. My name is David L. Teitzel. I am employed by Qwest Corporation (Qwest), formerly known as U S WEST Communications, Inc., as Director-Product and Market Issues. My business address is 1600 7th Avenue, Room 2904, Seattle, WA, 98191.

Q. DID YOU FILE DIRECT TESTIMONY IN THIS DOCKET ON JANUARY 8, 1999 AND SUPPLEMENTAL DIRECT TESTIMONY ON MAY 19, 2000?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. The purpose of my testimony is to address and respond to various issues raised by intervening parties in this Docket, including Mr. William Dunkel, Dr. Francis Collins, Dr. Lee Selwyn, Dr. Ben Johnson and Ms. Arleen Starr.

II. RESPONSE TO MR. WILLIAM DUNKEL

Competitive Zones

Q. MR. DUNKEL CHARACTERIZES QWEST'S COMPETITIVE ZONE PROPOSAL AS A MEANS FOR QWEST, AS THE INCUMBENT LOCAL EXCHANGE CARRIER (ILEC), TO PRICE DISCRIMINATE (DUNKEL,

PAGE 8) AND DISCOURAGE COMPETITION (DUNKEL, PAGES 9, 10). PLEASE COMMENT.

A. Qwest's proposal to have specific wire centers designated as competitive zones is presented in response to an increasingly competitive telecommunications market where alternatives to Qwest's services abound. It is not a design to discriminate between classes of customers or customers situated in different locales; nor is it a proposal intended to block or discourage competition. Rather, Qwest's proposal is an appropriate <u>response</u> to competition in specific geographic areas as competitors enter those areas.

Q. IS THE ABILITY TO PRICE SERVICES DIFFERENTLY BETWEEN VARIOUS GEOGRAPHIC AREAS OF THE STATE BECAUSE OF THE EXISTENCE OF COMPETITION "UNDUE PRICE DISCRIMINATION," AS MR. DUNKEL TERMS IT ON PAGE 6 OF HIS TESTIMONY?

A. No. If it were, Qwest's competitors would be guilty of such discrimination. Qwest's competitors are picking and choosing the most lucrative areas of the state to serve, based on profitability potential. For example, competitive alternatives exist for residence and business consumers in most parts of metro Phoenix; however, Qwest is the only provider serving consumers in outlying areas of the the city as well as the state where significantly more investment is required. Not only are Qwest's competitors electing to serve limited geographical areas of the *state*, they

are also electing to serve only select sub-segments of certain *cities*. For example, a competitor such as AT&T Local Service may only serve business customers in downtown Phoenix. Cox has taken a very systematic approach to rolling out service, limiting availability to one area until it is ready to move on to the next. In this proceeding, Qwest is requesting the ability to respond to the competition *where it is occurring* with the flexibility necessary to compete.

Q. MR. DUNKEL MAINTAINS THAT GIVING QWEST THE PRICING FLEXIBILITY IT IS REQUESTING WILL ALLOW IT TO INCREASE RATES IN AREAS OF THE STATE WHERE EFFECTIVE COMPETITION DOES NOT EXIST. IS THIS AN ACCURATE ASSESSMENT?

A. No. Qwest remains regulated by this Commission. Prices for regulated services outside of the competitive zones will continue to be set by the Commission.

Q. WILL QWEST BE ABLE TO ESTABLISH RATES AND CHARGES WITHIN THE COMPETITIVE ZONES WITHOUT COMMISSION APPROVAL, AS MR. DUNKEL SUGGESTS ON PAGE 8 OF HIS TESTIMONY?

A. As indicated above, Qwest remains a regulated entity, subject to Commission oversight. Qwest will be able to implement pricing between

proposed minimum and maximum rate bands without formal Commission approval; however, all regulated aspects of Qwest's business remain under the ultimate authority of the Commission.

Q. WHAT PROBLEMS DOES MR. DUNKEL ANTICIPATE WILL ARISE IF QWEST IS GRANTED COMPETITIVE ZONE FLEXIBILITY?

A. Frankly, I am unclear as to what Mr. Dunkel's position is relative to the effect competitive zones will have on competition. On Page 10, Lines 6-7, he indicates Qwest could choose to underprice its competitors, thus "discouraging" them from competing. In another area of his testimony (Page 23, Lines 6-13), Mr. Dunkel states that a major problem with Qwest's proposal is that, if approved, the Company could double most of its rates. On one hand, it appears he is concerned the company will respond to competition by lowering rates and on the other hand, he fears the Company will increase rates. Mr. Dunkel appears to prefer that this Commission continue to use its regulatory authority to govern price increases and price decreases in the traditional sense for fear that Qwest may abuse any pricing freedom afforded it. However, in doing so, he overlooks the most important characteristic of a competitive market –i.e, the power of the market itself. The market will determine efficient prices. Qwest will lose market share if it attempts to sustain prices that are not market-based in Arizona markets subject to competition.

Q. ISN'T IT TRUE THAT QWEST'S COMPETITORS CURRENTLY HAVE AN ADVANTAGE IN THE MARKETPLACE?

A. Yes. As indicated above, Qwest's competitors are selective in determining the areas of the state they will serve. Competitors also have the ability to price under maximum rates while Qwest is required to provide thirty days notice of most price changes.[1] Competitors are also able to offer a broader array of services than Qwest, due to the prohibition against interLATA entry. While granting competitive zone status to selected markets will not completely level the competitive playing field, it will afford Qwest reasonable flexibility in attempting to retain existing customers and recapture former customers.

Q. HAVE QWEST'S COMPETITORS USED THE REGULATORY CONSTRAINTS QWEST MUST ADHERE TO IN ORDER TO FURTHER THEIR MARKETPLACE ADVANTAGE?

A. Yes. As Mr. Dunkel points out on Page 9 of his testimony, Cox offers non-cable customers telephone service for $13.00 per month, undercutting the Qwest residential line rate of $13.18. The differential becomes more pronounced if the consumer subscribes to Cox cable and

[1] Services already classified by the Commission as "competitive" have maximum price bands established which Qwest may price beneath. Qwest is not able to increase non-price banded rates or increase maximum price bands outside of a rate case, or as provided by R14-2-1110.

telephone service - $11.75 for the first line and $6.50 for the second line. These prices are significantly lower than Qwest's residential access line service which is currently priced below cost. Mr. Dunkel's hypothetical example of price undercutting on Pages 9 and 10 of his testimony are actually quite real – the actions of the players he identified are reversed. Rather than Qwest possibly undercutting Cox if competitive zone flexibility is granted, Cox is currently competing with Qwest by undercutting services that are already priced below cost. Under today's regulatory rules, there is very little Qwest can do to respond. Qwest is not proposing competitive zone pricing flexibility to discourage competition; rather, it is asking for the ability to respond to competition under the same conditions currently enjoyed by its' competitors.

Q. AT PAGE 9 OF HIS DIRECT TESTIMONY, MR. DUNKEL IMPLIES THAT QWEST COULD USE COMPETITIVE ZONE PRICING FLEXIBILITY TO "...ASSURE COMPETITORS WERE NOT SUCCESSFUL." DOES HE OFFER FACTUAL SUPPORT FOR THIS ALLEGATION?

A. No. In fact, I'm sure Mr. Dunkel is aware that a total of 49 wire centers in Oregon are currently classified as competitive zones, and local competition is flourishing in that state. The specter of anticompetitive conduct that Mr. Dunkel attempts to construct simply is not founded in fact.

Q. DOES MR. DUNKEL OFFER AN ALTERNATIVE TO QWEST'S COMPETITIVE ZONE PROPOSAL?

A. Yes. He suggests that prices in different geographic areas not be allowed to vary "by an amount 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 ACC approval."

Q. WHAT IS YOUR REACTION TO MR. DUNKEL'S PROPOSAL?

A. Again, Mr. Dunkel has ignored the primary tenet of competition – that market forces are the appropriate "regulators" in a competitive environment. Mr. Dunkel's first proposal, if I understand it correctly, would specify that market prices be based solely on cost. His second proposal appears to require that existing price differentials between geographic areas be carried forth into the competitive marketplace under explicit Commission control. This "micromanaging" would result in this Commission paying mere lip service to the stated goals of the Telecommunications Act of 1996 (Act), i.e., "<u>to promote competition and reduce regulation</u> in order to secure lower prices and higher quality

services for American telecommunications consumers and encourage the rapid deployment of new telecommunications technologies." (emphasis added) Such oversight is unnecessary and, in fact, contrary to the facilitation of a fully functioning competitive marketplace.

Q. ON PAGE 11 OF HIS TESTIMONY, LINES 10-11, MR. DUNKEL STATES THAT IF A COMPETITOR OFFERS EVEN ONE RESIDENTIAL SERVICE IN A COMPETITIVE ZONE, ALL RESIDENTIAL SERVICES ARE DEEMED COMPETITIVE. WHAT IS YOUR REACTION TO THIS STATEMENT?

A. Mr. Dunkel has taken the competitive zone proposal to the extreme. The scenario he lays out in his testimony is unrealistic and not reflective of the competitive marketplace. Competitors have become full service providers, offering consumers a wide range of telecommunications products. As Mr. Dunkel points out on Page 30 of his testimony, "competitors evaluate the total revenue opportunities, not just the revenues from only one service (basic exchange)." Cox reinforces this strategy and has publicly stated its bundling goal: "Utilize our ability to offer integrated bundles of services as a competitive advantage to drive incremental customer profitability." (See Exhibit DLT-1). The competitors offering service in the competitive zones proposed in my Direct and Supplemental Direct are not offering a single service. They are offering a

full slate of services including local exchange, features, interstate and intrastate long distance, Internet services, and more. Mr. Dunkel's concern that approval of a competitive zone will provide pricing flexibility for services that are not competitive is not reflective of the current full-service provider marketplace.

In addition, the wire centers identified in my direct testimony as possessing a sufficient degree of competition to warrant classification as competitive zones all have a large number of customers currently being served by facilities-based alternative providers. To the extent Qwest desires additional wire centers to be so classified in the future, the Commission will continue to have the authority to review the petition and either approve or deny it on its merits. I agree with Mr. Dunkel that it would be extremely unlikely that the Commission would approve a competitive zone request on the basis of Qwest's loss of one residential line to a competitor in that wire center. The Commission should rest assured that Qwest's factual support for such a request would be much more robust, similar to the factual support provided in my direct testimony in this Docket.

Q. ON PAGE 12 OF HIS TESTIMONY, MR. DUNKEL MAINTAINS THAT QWEST'S COMPETITIVE ZONE PROPOSAL DOES NOT CONFORM

TO COMMISSION RULES FOR COMPETITIVE CLASSIFICATION. DO YOU AGREE?

A. No. Rule 14-2-1108(A) specifies the method a telecommunications company may follow to request classification of services as competitive:

> A telecommunications company may petition the Commission to classify as competitive any service or group of services provided by the company.

Rule 14-2-1102 defines competitive services as "any telecommunications service where customers of the service within the relevant market have or are likely to have reasonably available alternatives."

Within that same rule, relevant market is defined as:

> Where buyers and sellers of a specific service or product, or of a group of services or products, come together to engage in transactions. For telecommunications services, the relevant market may be identified on a service-by-service basis, a group basis, and/or by geographic location.

Qwest's competitive zone proposal, which requests competitive classification for groups of services within specified geographic relevant markets complies completely with Commission rules.

Q. IN FOOTNOTE 17 OF HIS TESTIMONY, MR. DUNKEL INDICATES THAT HE IS NOT IMPLYING OR CONTENDING THAT QWEST INTENDS TO DOUBLE ITS RATES. PLEASE COMMENT.

A. In several places throughout his testimony, Mr. Dunkel raises the issue of the price cap proposed in my Direct testimony. I proposed the price cap (doubling existing or proposed rates) as a means of addressing Commission and consumer concern about potential price increases if the competitive zone proposal is approved. It is not Qwest's intent to increase rates to the identified price caps – again, market forces will best determine appropriate prices – but the caps will provide an outside limit for any future price increases.

Q. MR. DUNKEL TERMS QWEST'S COMPETITIVE ZONE PROPOSAL AS "EFFECTIVELY PRICED DEREGULATION."[2] IS THAT A CORRECT ASSESSMENT?

A. No. Competitive zones will not deregulate any services offered by Qwest.

Q. MR. DUNKEL INDICATES THAT RESALE AND UNBUNDLED NETWORK ELEMENTS (UNE) SERVICES SHOULD NOT BE

[2] Dunkel Testimony, Page 16, Line 15.

CONSIDERED "EFFECTIVE" COMPETITION (PAGE 16, LINES 13-14). DO YOU AGREE?

A. No. Under the terms of the Act, Qwest and other incumbent local exchange carriers are required to resell retail services at wholesale rates and to furnish network elements on an unbundled basis to other telecommunications providers. Earlier in this testimony, I outlined the stated purpose of the Act as being, among other things, to promote competition. Resale, interconnection, and unbundling of network elements were defined by Congress as means to accomplish the Act's stated goals. They are all viable forms of competition.

Q. **MR. DUNKEL INDICATES THAT THE DATA QWEST HAS PROVIDED DOES NOT DEMONSTRATE THAT SUFFICIENT COMPETITION EXISTS TO WARRANT COMPETITIVE ZONE CLASSIFICATION OF SPECIFIED WIRE CENTERS. (PAGES 19 – 22) PLEASE COMMENT.**

A. Qwest's request for classification of specific wire centers as competitive zones was based solely on the presence of a facilities-based alternative provider. In other words, although Qwest proposed three criteria that could qualify a wire center as a competitive zone[3], it very conservatively based its competitive zone proposal on the existence of facilities-based

[3] Qwest proposed that before a competitive zone could 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

1 competition. The wire centers that have been proposed as competitive
2 zones are those wire centers where Qwest has identified the presence of
3 a facilities-based competitor. The information provided in data requests
4 and supplemental direct testimony relative to line loss, number of resold
5 lines, number of unbundled loops sold, etc. further substantiate the extent
6 of such competition.
7
8 **Q. ON PAGE 17, LINES 20-23, MR. DUNKEL STATES THAT THE**
9 **NUMBER OF PORTED LOCAL TELEPHONE NUMBERS IS ONE OF**
10 **THE BEST GAUGES AVAILABLE TO DETERMINE THE MAGNITUDE**
11 **OF LOCAL EXCHANGE COMPETITION. DO YOU AGREE?**
12 A. I agree that the number of ported telephone numbers can be used as one
13 indicator of the extent of local competition. The number of alternative
14 provider ported telephone numbers represents former Qwest customers
15 presently served by an alternative provider. Qwest has no specific
16 information on how the quantity of telephone numbers ported represents
17 the number of lines lost to competition. Qwest cannot quantify what
18 services or how many lines the customer now subscribes to from an
19 alternative provider. Qwest only knows that a customer who previously
20 purchased service from Qwest is now purchasing such services from an
21 alternative provider.

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with Qwest; 2) A reseller is marketing or offering service in competition with Qwest; or 3) A competitor is

1

2 **Q. WHY DOESN'T QWEST KNOW THE NUMBER OF LINES LOST TO**
3 **COMPETITIVE PROVIDERS?**

4 A. While the combination of resold lines and ported numbers represents the
5 best measure of competition loss information available to Qwest, it does
6 not fully capture the total competitive loss experienced by Qwest. For
7 example, when a business customer switches to a competitive provider, it
8 may port telephone numbers used externally with the public while
9 changing telephone numbers for lines that are only used internally. The
10 ported number count does not include telephone numbers associated with
11 new and/or additional lines purchased by customers from alternative
12 providers. It also does not include lines for new customers that were
13 never Qwest customers who do not require a number to be ported.

14

15 **Q. ON PAGE 24 OF HIS TESTIMONY, LINES 1-2, MR. DUNKEL**
16 **MAINTAINS THAT THE EXHIBITS YOU HAVE PROVIDED**
17 **DEMONSTRATING COMPETITION FOCUS PRIMARILY ON SERVICES**
18 **ALREADY DEEMED COMPETITIVE. PLEASE RESPOND.**

19 A. On this point Mr. Dunkel is simply wrong. Mr. Dunkel specifically cites two
20 exhibits to my Direct testimony – Exhibit 5 and Exhibit 17. He states that
21 Exhibit 5 contains competitive information relating to Centrex service

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marketing or offering services through the provision of unbundled network elements purchased from Qwest.

which is already classified as competitive. He neglects to mention that the Exhibit also demonstrates that AT&T is offering business access lines in competition with Qwest. He then points to Exhibit 17 which contains toll service advertisements, toll also being a service already deemed competitive by the Commission. He concludes by saying that "all this evidence supports is maintaining the current competitive classification of these services in Arizona which is not an issue."

Exhibit 17 was not provided in support of the competitive zone proposal. It was used in my Direct testimony to demonstrate the existence of dial-around providers, in support of the rate design I am advocating for toll services. Mr. Dunkel evidently has dismissed without merit the 14 exhibits attached to my Direct Testimony, the 44 exhibits attached to my Supplemental Direct Testimony, and the plethora of newspaper articles, trade journal articles, data pulled from Internet web sites, and other competitive intelligence provided in response to data requests[4] which demonstrate the extremely competitive environment in the Phoenix and Tucson areas. Qwest is not overstating the level of competition as Mr. Dunkel infers on Pages 24 and 25; if anything, the degree of competitive inroads I've outlined in my testimony is understated since competitors do not freely share sensitive marketing data.

[4] For example, see Qwest responses to RUCO 06-07, 06-08.

Q. ON PAGE 31 OF HIS TESTIMONY, MR. DUNKEL TAKES ISSUE WITH QWEST'S PROPOSAL THAT ALLOWS THE PRICE FOR A SPECIFIC SERVICE TO BE BELOW TOTAL SERVICE LONG RUN INCREMENTAL COST (TSLRIC). PLEASE COMMENT.

A. The competitive zone proposal would allow Qwest to package services in a manner similar to what its competitors are offering which may necessitate the pricing of a particular service below its TSLRIC. However, as long as the total revenue for the customer or group of customers is above its TSLRIC, this would be an acceptable pricing mechanism. This concept allows Qwest to compete on a level playing field with its competitors, as Mr. Dunkel points out on Page 30, Lines 12-15, of his testimony:

> 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 service to other carriers, etc.

The competitive zone would provide Qwest with this same flexibility in those areas where it is experiencing competition.

Q. MR. DUNKEL MAINTAINS THAT THE TIME FRAME PROPOSED FOR THE COMMISSION TO REACT TO A COMPETITIVE ZONE PROPOSAL IS UNREASONABLE. DO YOU AGREE?

A. No. The proposal outlined in my Direct testimony, whereby the Commission will respond to a Qwest request for competitive zone classification within 15 days of notification or the area automatically becomes a competitive zone is reasonable in light of the rapidity with which competition is advancing in the state. It also streamlines existing regulatory practices and removes administrative functions for the Commission which are unnecessary in a competitive environment.

Q. MR. DUNKEL OPPOSES QWEST'S PROPOSAL TO HAVE NEW SERVICES AUTOMATICALLY CLASSIFIED AS COMPETITIVE. PLEASE COMMENT.

A. The existing process for classifying new Qwest services as competitive on a product-specific basis is resulting in significant delays – at times over a year. This may translate to a delay in making new services available to Qwest customers, placing the company at a distinct competitive disadvantage, as Qwest's competitors have the freedom to have new services automatically classified as competitive upon introduction. For customers to realize the fruits of genuine competition, including

1 innovations in the market, Qwest must be afforded regulatory parity to its
2 competitors.
3
4 **Q. MR. DUNKEL ALSO OPPOSES RELAXATION OF REGULATORY**
5 **REQUIREMENTS FOR PROMOTIONS. IS THIS CONSISTENT WITH**
6 **FACILITATING A FULLY FUNCTIONING COMPETITIVE**
7 **TELECOMMUNICATIONS MARKETPLACE?**
8 A. No, it is not. Qwest is simply asking for the same flexibility its competitors
9 already enjoy relative to promotional offerings. Approval of Qwest's
10 proposal for promotions will eliminate costly regulatory oversight that is no
11 longer necessary or appropriate. If Qwest is allowed to make its
12 promotional offerings available to consumers on an equitable basis with
13 its competitors, competition will flourish and the benefits associated with
14 such competition will accelerate for Arizona consumers.
15
16 **Contribution Analysis**
17
18 **Q. HAVE YOU REVIEWED MR. DUNKEL'S "CONTRIBUTION ANALYSIS"**
19 **SUMMARIZED AT PAGE 45 OF HIS DIRECT TESTIMONY AND**
20 **OUTLINED IN DETAIL IN SCHEDULE WDA-19?**
21 A. Yes.
22

Q. IS THIS ANALYSIS A REASONABLE ASSESSMENT OF THE LEVEL OF CONTRIBUTION GENERATED BY RESIDENTIAL BASIC EXCHANGE SERVICES IN ARIZONA?

A. No. This analysis is founded entirely on the erroneous assumption that costs for the local loop can be shared among all services potentially using the loop. Dr. William Taylor and Mr. Jerrold Thompson discuss in their rebuttal testimonies on behalf of Qwest why the loop costs cannot be treated as shared costs.

Q. IF LOOP COSTS ARE TREATED AS DIRECT COSTS OF PROVIDING RESIDENTIAL BASIC EXCHANGE SERVICE, IS MR. DUNKEL'S "CONTRIBUTION ANALYSIS" VALID?

A. No. In this instance, the residential basic exchange service rate is substantially lower than the TSLRIC costs for this service filed by Mr. Thompson.

<u>Rate Design</u>

Q. AT PAGE 64, MR. DUNKEL OPPOSES QWEST'S REQUEST TO INCREASE RESIDENTIAL SERVICE PRICES DUE TO HIS VIEW THAT RESIDENTIAL LOOP COSTS SHOULD BE SHARED WITH OTHER SERVICES. WOULD YOU COMMENT?

A. Yes. As discussed in Mr. Thompson's testimony, the appropriate cost basis for basic exchange services is TSLRIC. Dr. Taylor discusses a variety of factors that render Mr. Dunkel's cost allocation arguments invalid. Qwest's proposal to increase residential basic exchange prices is in complete alignment with Commission, FCC and legislative directives to move below-cost prices toward cost and to make remaining implicit subsidies explicit.

Q. MR. DUNKEL SUGGESTS A REDUCTION IN THE BUSINESS BASIC EXCHANGE RECURRING RATE OF $2.00 IN ARIZONA.[5] IS THIS REDUCTION APPROPRIATE?

A. No. The proposal discussed in my direct testimony simply blends the Dial Tone Line and business local usage rate elements into a single price, with no net change in the price level. If business basic exchange prices are decreased, the burden will fall to residential basic exchange rates to absorb an additional rate increase to contribute to Qwest's revenue requirement.

Q. MR. DUNKEL COMPLAINS AT PAGE 71 THAT QWEST'S PROPOSAL TO ADJUST ZONE INCREMENT CHARGES CONFLICTS WITH PUBLIC POLICY REQUIREMENTS, AND CITES 254(b)(3) OF TA 1996,

[5] Dunkel direct, P. 78

WHICH REQUIRES THAT CONSUMERS IN RURAL AREAS HAVE SERVICES WITH SIMILAR FUNCTIONALITY AND PRICE AS SERVICES PROVIDED TO CUSTOMERS IN URBAN AREAS. WOULD YOU COMMENT?

A. Yes. The section of TA 1996 cited by Mr. Dunkel specifically states that prices for services in rural areas should be "...reasonably comparable to rates charged for similar services in urban areas." The term "reasonably comparable" is one which provides the Commission significant latitude in determining appropriate rate levels throughout the state. Additionally, TA 1996 and the FCC, as an agent of the Legislature, also require incumbent LECs to deaverage prices for loop-based services and to remove implicit subsidies between services. Unfortunately, Mr. Dunkel offers the Commission no guidance as to how the latter two requirements should be incorporated into its deliberations regarding Qwest's proposed zone increment structure. In reality, Qwest's zone increment proposal produces prices that are deaveraged, are cost-based and that remove implicit subsidies. This proposal is in complete alignment with state and federal guidelines.

Q. IF THE COMMISSION SHOULD FIND IN PENDING DOCKET NO. T-0000A-00-0194 THAT UNE LOOP PRICES SHOULD BE DEAVERAGED IN A MANNER OTHER THAN THE PROPOSED BASE

RATE/ZONE INCREMENT STRUCTURE, HOW WOULD YOU PROPOSE TO MODIFY THE RETAIL ZONE INCREMENT PRICING PROPOSAL?

A. Qwest believes its Base Rate/Zone Increment deavearaging proposal for both wholesale and retail services is appropriate, cost-based and in full compliance with regulatory requirements. However, if the Commission finds that another wholesale UNE loop deaveraging structure, such as grouping wire centers into defined rate groups, is appropriate, the retail zone increment proposal in my direct testimony must be modified to mirror the Commission-ordered structure. Contrary to Mr. Dunkel's arguments, the loop facility cost cannot be shared amongst multiple services, and retail and wholesale prices must continue to be set in reasonable relationship to one another. Failure to do so will result in pricing anomalies which will distort normal competitive growth in Arizona: competitors will be attracted to urban, low cost areas to take advantage of reduced deaveraged UNE prices available there, but will be driven away from rural areas due to the high UNE prices in those areas in relation to the low Qwest retail prices for basic exchange services. This outcome is certainly contrary to the vision of the FCC, Congress and this Commission toward stimulating viable competition in all areas of the state.

1 **Q. AT PAGE 80, MR. DUNKEL COMPLAINS THAT QWEST'S INCLUSION**
2 **OF TOLL PRICE CHANGES IN ITS RATE DESIGN IS**
3 **INAPPROPRIATE, SINCE TOLL SERVICES ARE FLEXIBLY PRICED IN**
4 **ARIZONA. WOULD YOU COMMENT?**
5 A. Yes. Mr. Dunkel has missed the point. Qwest has presented a well
6 supported, positive revenue requirement in this Docket. IntraLATA Toll
7 service revenue is still considered to be a part of Qwest's Arizona rate
8 base. It is not deregulated. Mr. Dunkel is correct: Qwest could have
9 reduced Toll prices during the pendency of this rate case without including
10 them in the overall rate design of this Docket. However, doing so would
11 have increased the revenue requirement by the precise amount I
12 identified in my direct testimony, creating a need to adjust prices for other
13 services to offset the Toll price reductions. Since the revenue
14 requirement effect of Toll price reductions is the same whether the
15 reductions are included in the overall rate case rate design or
16 accomplished separately, Qwest believes the customer impact of price
17 changes is the major consideration in including the Toll rate changes in
18 this Docket. Prices for various services will be increasing and decreasing
19 as a result of this rate case, and customer confusion and dissatisfaction
20 can be minimized by implementing all price changes concurrently.
21

1 Q. **AT PAGE 81, MR. DUNKEL ALLEGES THAT QWEST CAN EXPECT TO**
2 **REALIZE AN INCREASE IN TOLL REVENUES RESULTING FROM ITS**
3 **PROPOSED DECREASE IN TOLL PRICES. DO YOU AGREE?**
4 A. No. Qwest has not experienced Toll call volume increases in response to
5 Toll price decreases. In the past, prior to the myriad of Toll competitors
6 that now occupy the interLATA and intraLATA toll markets, the effects of
7 price elasticity could be seen in demand for Toll. If a Toll price was
8 reduced, an increase in calling volume would follow. However, the Toll
9 market is no longer a monopoly market. Not by a long shot.
10
11 Toll competitors are now offering prices as low as $0.05 per minute, and
12 new technologies, such as Internet Telephony, are introducing alternative
13 Toll services for prices even lower. For example, Microsoft and
14 Net2Phone, the country's leading Internet Telephony provider, are now
15 offering a promotion for free long distance calling over Net2Phone's
16 network. There is heavy advertising in the market for these attractive
17 offers, which has changed customers' expectations as to what reasonable
18 Toll prices should be. When Qwest reduces a Toll price, such as the
19 reduction in Residential Toll off-peak prices proposed in this Docket from
20 $0.15 to $0.10 (a 33% decrease) an economist would expect that a large
21 surge in demand would be the result. However, customers' price
22 expectations have changed. This price reduction will not generate new

demand for Qwest Toll, but will reduce the rate of erosion of Qwest Toll minutes to competitors. Mr. Dunkel's suggestion that price elasticity should be somehow factored into Qwest's Toll revenue impact calculations should be rejected.

Q. AT PAGE 88, MR. DUNKEL ALLEGES THAT QWEST HAS MISCALCULATED THE REVENUE IMPACTS ASSOCIATED WITH THE PROPOSED DIRECTORY ASSISTANCE PRICE CHANGES IN THIS DOCKET. DO YOU AGREE WITH HIS CONCLUSIONS?

A. No. There is no miscalculation. The revenue impact displayed in Exhibit 48 of my Supplemental Direct testimony is accurate, and is based upon the prescribed test period for this rate case of full year 1999. Contrary to Mr. Dunkel's allegations, the elimination of the free D.A. call allowance is accounted for in the revenue impact calculations. The net annual revenue impact of Qwest's D.A. proposal in this Docket is $19,743,296. These calculations are also contained in Qwest's response to data request WDA 33-5.

Q. AT PAGE 91, MR. DUNKEL RECOMMENDS THAT NON-PUBLISHED AND NON-LISTED RATES CONTINUE UNCHANGED AT CURRENT RATE LEVELS. DO YOU AGREE?

A. No. The price increases proposed in my direct testimony are appropriate and reasonable. These services are discretionary to customers, similar to prices for Custom Calling services, and have significant value to customers desiring the privacy these services afford. Revenues associated with the proposed price increases for these services contribute to Qwest's overall revenue requirement in Arizona. If the proposed price increases for these services are removed from the pricing proposal, the revenue shortfall must be shifted to other services remaining in the docket.

Q. AT PAGE 108 OF HIS DIRECT TESTIMONY, MR. DUNKEL SUGGESTS THAT "...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." DOES THIS ARGUMENT HARKEN TO A TIME WHEN TELEPHONE MONOPOLIES WERE STILL IN PLACE?

A. Yes. Mr. Dunkel seems to dismiss targeted assistance plans for customers with limited means, and instead, suggests that local exchange prices should be driven to very low levels to ensure affordability for all. This was a valid concept in the past, but no longer fits in the post-TA 1996 environment. All prices must now be moved toward cost. Implicit

subsidies must be identified and made explicit. Prices must be deaveraged and be cost-based. These things must be accomplished through a combination of rate rebalancing and High Cost Fund support, and Telephone Assistance and Link Up Plans will continue to be available to provide additional support to low income households to optimize universal service. Qwest agrees that residential basic exchange service must continue to be available at affordable rates, but the traditional, subsidy-laden model for accomplishing that goal is no longer viable.

Q. AT PAGE 110, MR. DUNKEL STATES "...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 TO ITSELF." IS HIS CONCLUSION ACCURATE?

A. No. Qwest is bound by the dictates of TA 1996 to open its markets to competition. This is to be accomplished by offering its network components to competitors on an unbundled basis, by adjusting prices to remove implicit subsidies and to deaverage. Qwest is precisely complying with these guidelines in its price design in this rate case. Competition has already entered the urban markets in Arizona, and will clearly enter the rural markets in the state once competitors have the

1 economic incentive to do so. It is irrelevant whether a price design
2 proposed by Qwest does or does not "attract competition to itself." The
3 fact is that Qwest is obligated to set forward a price design that complies
4 with legal and regulatory guidelines designed to promote competitive
5 growth throughout the state. Qwest has done exactly that in its proposal
6 in this docket.
7
8 **III. RESPONSE TO DR. FRANCIS COLLINS**
9 **Competitive Zones**
10
11 Q. **IN HIS TESTIMONY, IT APPEARS DR. COLLINS HAS RELIED UPON**
12 **DATA FURNISHED BY QWEST IN TESTIMONY AND DATA REQUEST**
13 **RESPONSES TO ESTABLISH QWEST'S MARKET SHARE. IS THIS**
14 **APPROPRIATE?**
15 A. No. In my Direct and Supplemental Direct testimony, as well as in
16 responses to data requests in this proceeding, I provided several statistics
17 to be used in documenting the presence of competition in the specified
18 wire centers I am proposing become competitive zones. Included were
19 access lines lost, number of resold lines, and number of telephone
20 numbers ported. I did not state nor intend that these figures should be
21 added together to compute a Qwest "market share" calculation, contrary
22 to Dr. Collins' claim on Page 3, Lines 13 – 18 of his testimony. Dr. Collins

came to that conclusion independently and then accused Qwest of inaccurate reporting. (Page 3, Lines 19-21) These statistics are simply individual metrics which substantiate that competitors are active in the Phoenix and Tucson markets. Any estimation of market share based on these figures will lead to inaccurate and misleading conclusions.

Q. WHY WILL USING THESE FIGURES RESULT IN AN INACCURATE DETERMINATION OF MARKET SHARE.

A. There are several reasons why one cannot simply compile the data cited and produce an accurate market share measurement. First, the count of access lines lost to competitors is understated, as the data relies on customers self-reporting that they are leaving Qwest for a competitor. Many customers may not freely share this information. Second, the data provided by Qwest does not represent the entire market. Qwest has no way of determining total number of lines served by facilities-based carriers, for example. Third, as I explained in my rebuttal of Mr. Dunkel, telephone numbers ported cannot be considered representative of all lines provided by a competitor. For these reasons, as well as those outlined in the previous answer, the individual components cannot be "summed" to arrive at an accurate market penetration or "share" figure.

1 **Q. DR. COLLINS DISCOUNTS RESALE AND THE PROVISION OF**
2 **UNBUNDLED NETWORK ELEMENTS AS FORMS OF TRUE**
3 **COMPETITION. (PAGE 3, LINES 27-28, - PAGE 4, LINES 1-18) WHAT**
4 **IS YOUR REACTION TO THIS?**
5 A. As I stated in my rebuttal to Mr. Dunkel on the same issue, resale and
6 UNEs are means designated by Congress to open the local exchange
7 market to competition. As such, resold lines and UNEs should be
8 considered when evaluating the competitiveness of a particular market.
9
10 **Q. DR. COLLINS INDICATES HE IS UNCLEAR AS TO WHY QWEST**
11 **DOES NOT USE PROCESSES ALREADY IN PLACE TO ACHIEVE**
12 **PRICING FLEXIBILITY FOR SERVICES SUBJECT TO COMPETITION.**
13 **COULD YOU BRIEFLY SUMMARIZE THE RATIONALE FOR YOUR**
14 **COMPETITIVE ZONE PROPOSAL?**
15 A. Yes. First, the existing process is lengthy and fraught with delays that are
16 untenable in a competitive environment. Second, competitors are not
17 entering markets one service at a time. They are targeting specific
18 geographic areas with a full menu of service options for consumers. The
19 competitive zone proposal I have advanced will enable Qwest to respond
20 to competition in a timely manner and will allow the company the pricing
21 flexibility it needs for all competitive services in an expeditious fashion.
22

1 Q. **DR. COLLINS CLAIMS THAT QWEST'S FACTS CONCERNING**
2 **COMPETITORS' ABILITY TO PICK AND CHOOSE CUSTOMERS IN**
3 **SERVICE AREAS ARE MISSTATED. IS HE CORRECT?**
4 A. No. Cox is an excellent example of a competitor picking and choosing
5 where it will serve. Cox originally rolled out telephone service in Chandler.
6 Once that deployment was complete, the company expanded service to
7 other selected areas of the city, e.g., northeast Phoenix, Scottsdale, etc.
8 Furthermore, contrary to Dr. Collins' understanding of the Phoenix market,
9 some competitors segregate at an even more finite level. For example,
10 One Point focuses primarily on residential apartment complexes while
11 NEXTLINK focuses largely on business complexes. It is apparent that Dr.
12 Collins does not have an accurate view of the manner in which
13 competition is approaching the market in Phoenix and Tucson. This is
14 precisely why Qwest has proposed competitive zone pricing flexibility at
15 the wire center level.
16
17 Q. **DR. COLLINS COMPLAINS AT PAGE 9 THAT YOU HAVE**
18 **APPARENTLY CONFUSED THE TERMS "WIRE CENTER" AND**
19 **"EXCHANGE" IN YOUR EXECUTIVE SUMMARY PRECEDING YOUR**
20 **DIRECT TESTIMONY IN THIS DOCKET. DO YOU CARE TO**
21 **COMMENT?**

A. Yes. I clearly understand the distinction between a wire center and an exchange. An exchange in a large metropolitan area, such as Phoenix, can be made up of several wire centers. In the more rural areas of the state, the wire center and exchange boundaries can be one and the same. It is not clear why Dr. Collins felt compelled to challenge my knowledge of telephony definitions, but he should rest assured that I comprehend the wire center/exchange distinctions.

Q. DR. COLLINS MAINTAINS THAT NEW MARKET ENTRANTS ARE NOT ENGAGED IN "CREAM SKIMMING." DO YOU AGREE?

A. No, I do not. While there are competitive alternatives for residential customers in Phoenix, and Cox is certainly a primary residential competitor, the number of companies vying for Qwest's business customers is far greater. There are currently no known competitors for residence customers in the Tucson area.[6] There is no doubt that most competitors are after the high margin business customer as a means of quickly recouping investment and maximizing profit margins.

Q. DR. COLLINS TAKES ISSUE WITH THE PRICE FLOOR AND PRICE CEILING PROPOSED FOR COMPETITIVE ZONES. PLEASE COMMENT.

A. Dr. Collins' has painted an unrealistic mischaracterization of Qwest's proposed pricing constraints within competitive zones. As I stated previously in my rebuttal of Mr. Dunkel's testimony, the proposed price ceiling was established as a reasonable limit on any future price increases. In terms of the price floor, Dr. Collins purports to define for the Commission – absent any basis in fact – how Qwest would utilize and administer its proposal to allow some services to be priced below TSLRIC as long as the revenue for the customer or group of customers was above TSLRIC. Dr. Collins uses extreme examples, none of which are realistically within the realm of possibility. Qwest will not price residential local exchange service at zero, as Dr. Collins suggests on Page 10 of his testimony. In fact, as Qwest stated in its response to a data request from Mr. Dunkel which was also furnished to Cox, residence basic exchange service would not be considered part of the price floor test because the service is already priced below cost.[7] Furthermore, under the competitive zone proposal, Qwest is not going to design a pricing scheme that will classify customers or groups of customers at the sub-wire center level. This would be virtually impossible to implement, much less track, and would place an extensive administrative burden on all involved. Qwest is interested in streamlining processes, rather than making them more

[6] However, Qwest has obtained competitive intelligence regarding Cox's plans to deploy telephone service in Tucson in 2001.
[7] Qwest response to WDA 04-007 in this proceeding.

complex. Dr. Collins' portrayals of what "could" happen under competitive zone pricing should be dismissed as alarmist and unrealistic.

Q. ON PAGE 13 OF HIS TESTIMONY, DR. COLLINS INDICATES YOU "INCLUDED STORIES ABOUT QWEST'S ACTIVITIES IN OREGON" IN YOUR SUPPLEMENTAL DIRECT TESTIMONY. IS THIS CORRECT?

A. No, I made no mention of Oregon in my Supplemental Direct testimony. I did, however, respond to a data request from Mr. Dunkel with information relative to the Oregon Commission's treatment of competitive zones.

Q. WOULD YOU PLEASE SUMMARIZE THE ACTIONS THE OREGON COMMISSION HAS TAKEN IN RECOGNITION OF COMPETITION IN THAT STATE?

A. Yes. Oregon allows the establishment of competitive zones upon a showing by Qwest that competitive local exchange carriers (CLECs) have certificates of authority to provide service in Qwest exchanges, Qwest has an approved interim local number portability tariff in effect, and there has been a mutual exchange of traffic between Qwest and a CLEC in the specific exchanges. Exhibit DLT-2 contains a copy of a March 28, 2000 memo from the Oregon Public Utility Commission Telecommunications Division notifying the Oregon Commission that the criteria for granting Qwest pricing flexibility in forty-nine additional exchanges in the state had

been met pursuant to ORS 759.050(5) and Order No. 96-021, dockets CP 1, CP 14 and CP 15.[8] "By this report staff notifies the Commission that a mutual exchange of traffic exists between USWC and an authorized CLEC in the above forty-nine exchanges. Therefore, USWC now gets pricing flexibility for switched service in those exchanges. No Commission action is required."[9] Fifty-seven Qwest exchanges in Oregon have thus been deemed competitive zones, leaving only seven exchanges in the state where Qwest does not have pricing flexibility.

Q. DR. COLLINS RECOMMENDS THIS COMMISSION DISREGARD INFORMATION ABOUT COMPETITIVE ZONE ACTIVITY IN OTHER STATES. IN YOUR OPINION, IS THIS WISE COUNSEL?

A. No. If the Commission is to fulfill its commitment to Arizona rate payers, it cannot operate in a vacuum. Arizona is experiencing significant local exchange competition. If other state commissions have taken steps to advance the benefits of competition to their constituents, it may be prudent for this Commission to apply what has worked elsewhere to the regulatory structure in Arizona. To do otherwise would be a disservice to Arizona consumers.

[8] Qwest had previously received approval to have eight exchanges classified as competitive zones. Copies of Oregon Public Utility Commission Orders and Rules pertaining to competitive zones was provided in response to Mr. Dunkel's twenty-fourth set of data requests in this proceeding, WDA-24-6.

Q. HAVE OTHER STATE COMMISSIONS OR LEGISLATORS ALSO TAKEN STEPS TO ESTABLISH COMPETITIVE ZONES?

A. The criteria for granting incumbent local exchange carriers (ILECs) pricing flexibility and reduced regulatory oversight on a geographical basis due to the existence of competition varies. Some states I am aware of have very specific criteria, others do not.

For example, Utah Code 54-8b-2.3 allows ILECs to petition the Utah Commission for pricing flexibility in defined geographic areas when the following conditions have been met:

- The Commission has issued a certificate to the competing telecommunications corporation;
- The competing telecommunications corporation has begun providing the authorized public telecommunications service in the defined geographic area;
- The incumbent telephone corporation, by written agreement, stipulation, or pursuant to an order of the Commission, has allowed the competing telecommunications corporation to interconnect with the essential facilities and to purchase essential services of the incumbent telephone corporation; and
- The incumbent telephone corporation is in compliance with the rules and orders of the Commission adopted or issued under Section 54-8b-2.2.

The Utah Commission approved Qwest's request for pricing flexibility in ten wire centers on August 1, 2000.

[9] Interoffice Correspondence, Public Utility Commission Telecommunications Division, March 28, 2000, Page 2.

In 1998, the South Dakota legislature passed into law House Bill 1160 which allows any telecommunications company to "grant discounts, incentives, services, or other business practices necessary to meet competition."[10]

Qwest currently has pricing flexibility similar to what it is seeking in this docket in Nebraska and Iowa and has filed for competitive classification of business services in specific geographic areas in Washington.

As these examples illustrate, state commissions and lawmakers have established various means of ensuring that the benefits of competition flow to consumers by granting Qwest the flexibility it needs to respond to direct competition.

Q. ON PAGE 14 OF HIS TESTIMONY, DR. COLLINS OPINES THAT QWEST'S COMPETITIVE ZONE PROPOSAL SHOULD BE DENIED BECAUSE "QWEST DOES NOT NEED ANOTHER ANTICOMPETITIVE TOOL." HE WAS REFERRING TO QWEST'S COMPETITIVE RESPONSE TARIFF. DOESN'T COX HAVE A SIMILAR TARIFF IN PLACE?

[10] § 49-31-44, Section 28.

A. Yes. Exhibit DLT-3 is a tariff, which became effective on December 9, 1999, Cox has on file with the Arizona Corporation Commission outlining the marketing program Cox currently offers customers to "win" them back or to retain existing customers who receive a solicitation from a Cox competitor. In fact, Cox's offering is called the "Competitive Response Program," and is available to residential and business customers. This is another example of where a competitive advantage enjoyed by Qwest's competitors is viewed as "anticompetitive" when it's employed by Qwest – in the eyes of Qwest's competitors.

This Commission should not be fooled by competitors who contend, as Dr. Collins does in his testimony, that competition is in the "embryonic" stage (Page 15) of development and any attempt by Qwest to gain competitive parity will stifle competition. Just the opposite is true – competition is thriving, consumers in Phoenix and Tucson have choices in telephone providers, and consequently, reduced regulation of Qwest's services in those areas targeted by competitors is an appropriate Commission response.

IV. RESPONSE TO DR. LEE SELWYN

Competitive Zones

Q. ON PAGES 8-10 OF HIS TESTIMONY, MR. SELWYN MAINTAINS THAT QWEST IS NOT EXPERIENCING SUFFICIENT COMPETITION TO JUSTIFY ITS REQUEST FOR PRICING FLEXIBILITY WITHIN COMPETITIVE ZONES. PLEASE COMMENT.

A. Mr. Selwyn relies a great deal on data published by the FCC in its most recent "Trends in Telephone Service" report. This report cannot be construed to reflect the entire scope of the competitive telecommunications market in Arizona, nor does it provide information specific to Phoenix and Tucson, the areas I have recommended be classified as competitive zones. The report provides certain statistics, such as the percent of ILEC lines being resold, that provide an indication of the competitive nature of a market, however, it does not provide state-specific or wire center specific information relative to facilities-based competition. In addition, the information in the March 2000 report reflects data that is over a year old. As is evidenced by this very proceeding, competition is advancing at such a rapid pace in the state that year-old data is obsolete and should not be used as the basis for decision-making by the Commission.[11]

[11] For example, I filed Direct testimony on January 8, 1999 in this docket, proposing three wire centers be classified as residential competitive zones in the Phoenix metro area, based on the existence of Cox facilities in those wire centers. By the time I filed Supplemental Direct testimony in this docket sixteen

I have submitted voluminous information in this proceeding through my Direct testimony and exhibits, Supplemental Direct testimony and exhibits, and in Qwest responses to data requests which illustrate, to a much greater degree than the FCC report referenced by Mr. Selwyn, the extent of competition in the Phoenix and Tucson markets. In addition, the CLECs file annual reports with this Commission that provide much more specific and relevant data than that included in the FCC report. That is the data that should be considered by this Commission when evaluating whether competition is present to the extent that pricing flexibility in specific geographic areas is warranted, as I have proposed.

Q. ON PAGE 10, LINES 13-14, MR. SELWYN STATES THAT COLLOCATION "PROVES VERY LITTLE ABOUT THE EXTENT OF LOCAL COMPETITION." DO YOU AGREE?

A. No, I believe collocation is another indicator of the inroads competition is making in local markets. Indeed, the FCC report that Mr. Selwyn references includes collocation as a measurement of competition. Although Mr. Selwyn neglects to provide Arizona-specific statistics on this particular measurement from the FCC report, it indicates that as of June 30, 1999, 52.8% of ILEC residential lines and 74.7% of other ILEC lines in the state are served by central office switches where competitors have

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months later on May 19, 2000, I proposed that an additional eighteen wire centers be classified as residence

1 collocated. Again, this data is over a year old so the percentages are
2 obviously understated. Also, the data is not wire center specific so it does
3 not reflect the situation in the Phoenix and Tucson wire centers I have
4 proposed become competitive zones.
5
6 **Q. ON PAGE 12, LINES 11-13 OF HIS TESTIMONY, MR. SELWYN**
7 **ALLEGES QWEST IS ATTEMPTING TO CIRCUMVENT EXISTING**
8 **COMMISSION RULES REGARDING COMPETITIVE CLASSIFICATION.**
9 **IS THIS TRUE?**
10 A. No. As I've explained in my rebuttal of Mr. .Dunkel, Qwest's competitive
11 zone proposal fully complies with Commission rules.
12
13 **Q. MR. SELWYN MAINTAINS THAT REGULATORY PARITY IS NOT**
14 **APPROPRIATE FOR QWEST BECAUSE THE COMPANY MAINTAINS**
15 **MARKET POWER. DO YOU AGREE?**
16 A. I would agree that Qwest retains market power in outstate Arizona, but
17 certainly not in the Phoenix and Tucson areas where competitors have
18 committed significant investment and are aggressively targeting and
19 winning Qwest residential and business customers. Dr. Taylor addresses
20 market power more fully in his testimony.
21

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competitive zones, based on Cox's expansion of its fiber facilities.

1 **Q. MR. SELWYN MAINTAINS THAT QWEST'S COMPETITIVE ZONE**
2 **PROPOSAL WILL HARM CUSTOMERS WITHOUT COMPETITIVE**
3 **ALTERNATIVES. (PAGE 13, LINE 7) DO YOU AGREE?**
4 A. No. In actuality, Qwest's customers in those areas without alternatives
5 will be harmed if the Commission does not allow Qwest to compete more
6 effectively. When it loses high revenue customers, Qwest must recover
7 its costs over a smaller customer base. As the rate of loss grows, and
8 support from high margin services is no longer available (as those are the
9 services initially targeted by most competitors), rate increases become
10 inevitable. If this Commission will allow Qwest to compete on equal
11 footing with its competitors, it will have the opportunity to retain some
12 proportion of those high revenue customers and avoid future rate
13 increases for those customers in areas competitors have chosen not to
14 serve.
15
16 **Q. MR. SELWYN ALSO DISCOUNTS RESALE AND UNE'S AS VIABLE**
17 **FORMS OF COMPETITION, AS DID DR. COLLINS. (PAGE 17). DO**
18 **YOU HAVE ANYTHING TO ADD TO WHAT YOU'VE ALREADY**
19 **PROVIDED IN RESPONSE TO THIS POSITION?**
20 A. Yes. The FCC report relied upon so heavily by Mr. Selwyn, reinforces
21 Congress' view of these alternatives:
22 The Telecommunications Act of 1996 contemplated three
23 *incrementally powerful vehicles* for entering local telephone

> service markets. First, CLECs may resell the services of ILECs. Second, CLECs may make use of ILEC facilities, for example, by leasing ILEC UNE loops to use in combination with the CLEC's own switching ability. Third, CLECs may build the complete set of facilities they need to compete. Individual competitors have used various combinations of these methods at different times.[12] (emphasis added)

As Congress envisioned, and the FCC reports, CLECs are using resale, UNEs and their own facilities as means to compete. The data submitted by Qwest in this proceeding demonstrates that CLECs are competing on all three levels in the Phoenix and Tucson areas.

Q. MR. SELWYN CONTENDS THAT IF A COMPETITOR WAS OFFERING A SERVICE TO A SINGLE CUSTOMER IN A WIRE CENTER, THAT COULD TRIGGER ESTABLISHMENT OF A COMPETITIVE ZONE. IS THIS ACCURATE?

A. No. For expansion of competitive zones in the future, Qwest would be required to notify the Commission that competition exists in the form of at least one of the three criteria specified in my Direct testimony in a particular wire center. This notification would certainly have to pass the "red face" test. It would be based on much stronger evidence than a competitor serving one customer in a wire center. That is not even reasonable.

[12] *Trends in Telephone Service*, March 2000, Industry Analysis Division, Common Carrier Bureau, Federal Communications Commission, Page 9-1.

1

2 **Q. ON PAGES 17-20, MR. SELWYN INDICATES THERE IS A RISK OF**
3 **CROSS-SUBSIDIZATION IF COMPETITIVE ZONES ARE APPROVED.**
4 **IS THIS A LEGITIMATE CONCERN?**

5 A. No. There are rules in place that prohibit cross subsidization between
6 regulated and deregulated products.[13] I am not proposing that the
7 services included in competitive zones be deregulated. They will remain
8 regulated but be afforded increased pricing flexibility. Hence, Qwest will
9 continue to adhere to existing rules prohibiting cross-subsidization if
10 competitive zones are granted.

11

12 **Q. AT PAGE 18, MR. SELWYN COMPLAINS THAT, IN RESPONSE TO**
13 **DATA REQUEST WDA 04-008, QWEST STATES THAT CERTAIN**
14 **SERVICES IN COMPETITIVE ZONES COULD BE PRICED BELOW**
15 **TSLRIC, IN VIOLATION OF PROVISIONS OF TA 1996 AND**
16 **COMMISSION RULES. WOULD YOU COMMENT?**

17 A. Yes. Qwest will violate no provisions of TA 1996 or any Commission rules
18 in its pricing of services within competitive zones. In its response to WDA
19 04-008, contrary to Mr. Selwyn's allegations, Qwest did not imply that it
20 would price services at levels that will fail an imputation test, nor did it
21 suggest that it would subsidize competitive services with revenues from

[13] R 14-2-1109 c prohibits cross subsidization.

1 non-competitive services. In responding to competition in a wire center
2 that has been classified as a competitive zone, Qwest will be prepared to
3 demonstrate that, even if a price of a non-competitive service in a bundle
4 of services is offered at a level below TSLRIC to respond to a particular
5 competitor's offering, the revenues for that bundle of service will pass an
6 imputation test, and by definition, exceed the combined TSLRIC cost for
7 that bundle of services.
8
9 **Q. MR. SELWYN MAINTAINS ON PAGE 23, LINES 3-5, THAT QWEST**
10 **SHOULD NOT BE ALLOWED TO RECLASSIFY A WIRE CENTER AS A**
11 **COMPETITIVE ZONE UPON 15 DAYS NOTICE AND WITHOUT**
12 **EXPLICIT COMMISSION ACTION AS PROPOSED. WHAT IS YOUR**
13 **REACTION TO THIS?**
14 A. Qwest's proposal to expand competitive zone designation to additional
15 wire centers based on the existence of competitive presence is intended
16 to streamline regulatory processes and facilitate bringing the benefits of
17 competition to consumers in a much more rapid fashion than has
18 previously been the case. Other state commissions have recognized that,
19 upon receiving documentation of the existence of competition, a lengthy
20 regulatory proceeding is not necessary or appropriate.[14]
21

Q. MR. SELWYN OPPOSES YOUR PROPOSAL FOR TREATMENT OF NEW SERVICES BECAUSE NEW SERVICES ARE NOT LIKELY TO BE DISCRETIONARY IN NATURE AS QWEST HAS CONTENDED, NOR, ACCORDING TO MR. SELWYN ARE NEW SERVICES LIKELY TO FACE COMPETITION. (PAGE 25) PLEASE COMMENT.

A. In my Direct testimony, I proposed that new services be automatically classified as competitive. I do not agree that most new services are not discretionary. Mr. Selwyn proposes a subjective test of how to determine that a service is discretionary, based upon how an end user may view the service or how the service may be priced. In R14-2-1307 (C), the Commission identified essential facilities or services as:

1. Termination of local calls
2. Termination of long distance calls
3. Interconnection with E911 and 911 services
4. Access to numbering resources
5. Dedicated channel network access connections, and
6. Unbundled loops.

New services that do not fall within these categories should be considered competitive.

Mr. Selwyn's comment about new services not necessarily facing competition appears to be a red herring. He makes that statement on Page 25, lines 18-20, then launches into a discussion of how Qwest and

[14] See previous rebuttal to Dr. Collins relative to procedures used by the Oregon Public Utilities

1 its predecessors have been regulated entities who have had their
2 networks subsidized by rate payers. I have two comments on these
3 arguments: One, Qwest's competitors employ the same switch
4 technology utilized by Qwest, consequently, they have the same ability to
5 offer new features and functionality that Qwest does. They may
6 differentiate products by unique branding but that is representative of the
7 choice a competitive market brings consumers. Two, my proposal for the
8 regulatory treatment of new services is based on today's
9 telecommunications environment. Today's consumers are demanding
10 choices, innovation, and instant availability. It is incumbent upon this
11 Commission to make the transition from the traditional regulatory
12 framework to a more streamlined process as competition dictates.
13 Classification of new services as immediately competitive, with the
14 resultant pricing flexibility, is one area where the Commission can be
15 responsive to Arizona consumers with minimal effort and maximum
16 impact. Furthermore, Mr. Selwyn's contentions that services and features
17 that have no independent existence and rely on a common infrastructure
18 should take the regulatory status of the core service flies in the face of
19 how this Commission has treated competitive services in the past. Mr.
20 Selwyn's comments should be dismissed as not being relevant to the
21 Arizona marketplace.

Commission.

1

2 **Q. AT PAGE 47, DR. SELWYN SUGGESTS THAT "...THE COMMISSION**
3 **SHOULD NOT BE CONCERNED THAT IT IS SOMEHOW PUTTING**
4 **U S WEST AT A COMPETITIVE DISADVANTAGE." WOULD YOU**
5 **COMMENT ON THIS PERSPECTIVE?**

6 A. Yes. Qwest must currently price its services in Arizona at statewide
7 average levels. It is unable to offer attractive prices, packages or bundles
8 to respond to competitive entrants, who typically target geographic areas
9 of the state with dense concentrations of customers who are relatively
10 inexpensive to serve. In this scenario, Qwest cannot compete on par with
11 either established or new competitors. Qwest does not seek in this docket
12 to establish a competitive advantage relative to its competitors. Rather, it
13 seeks the ability to respond appropriately and fairly to competition. This
14 is a characteristic of a free market, one in which all competitors creatively
15 and aggressively compete for the customer's business. In a free market,
16 it is the customer who ultimately receives the benefit of full competition.

17

18 **Rate Design**

19

20 **Q. DR. SELWYN, AT PAGE 29, COMPLAINS THAT QWEST'S**
21 **DIRECTORY ASSISTANCE PRICING PROPOSAL "...SHOULD BE**

CONSIDERED AS AN ADDITIONAL INCREASE IN RATES FOR BASIC RESIDENTIAL SERVICE..." IS THIS POSITION WELL FOUNDED?

A. No. Dr. Selwyn's position presumes that all residential customers typically utilize Directory Assistance (D.A.) service, that it is essentially a component of residential local exchange service and that there are no competitive alternatives for the service. These presumptions are all seriously incorrect. In fact, 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. service are available to each and every Arizona consumer.

Additionally, Qwest's primary D.A. competitors, AT&T and WorldCom, make no distinction between local and national D.A. service, and price their services significantly higher than the $0.85 level proposed by Qwest in this docket. These providers support the premium rate levels at which the service is offered by bundling in value-added attributes, such as call completion, reverse directory search and proximity searches (e.g., provide the telephone numbers of all Italian restaurants within five miles of Camelback Mountain). Customers clearly find value in these added D.A. features, as reflected in the continued decline in Qwest D.A. call volumes. The D.A. competitive paradigm has changed: this service is no longer viewed as the "model T" listing service, but has evolved to a service

utilizing advanced technology to provide value and convenience. As outlined in my direct testimony, Qwest will integrate the call completion feature with its D.A. service to add value commensurate with the $0.85 proposed price, and will continue to add features to differentiate this service in the competitive D.A. market.

V. RESPONSE TO DR. BEN JOHNSON

Competitive Zones

Q. **THROUGHOUT THE DISCUSSION OF QWEST'S COMPETITIVE ZONE PROPOSAL IN HIS TESTIMONY, DR. JOHNSON RELIES ON MARKET SHARE AS THE PRIMARY INDICATOR OF AN EFFECTIVELY COMPETITIVE MARKET. PLEASE COMMENT.**

A Dr. William Taylor provides extensive testimony regarding the manner in which market share should be viewed by the Commission in considering Qwest's competitive zones proposal. However, as I indicated in my rebuttal to Dr. Collins' testimony, market share is only one indicator the Commission should use in determining whether a market is subject to effective competition. I have provided previous testimony documenting the number of alternative providers offering services in the Phoenix and Tucson markets, including a description of the services offered by

1 competitors. In my testimony and in Qwest responses to data requests in
2 this proceeding, I've provided samples of competitors' marketing efforts,
3 including advertisements, door hangers, and direct mail correspondence.
4 I've provided in-depth information on technologies employed by
5 competitive providers to reach consumers in the wire centers I am
6 proposing be classified as competitive zones, to the extent that Qwest, as
7 a competitive entity, can identify and quantify such intelligence. However,
8 Dr. Johnson is correct when he states on Page 20, Line 29 – Page 21,
9 Lines 1-2 that Qwest has not provided market share information in this
10 docket.
11
12 Q. **WHY IS IT THAT QWEST HAS NOT PROVIDED MARKET SHARE**
13 **DATA IN SUPPORT OF ITS COMPETITIVE ZONE PROPOSAL?**
14 A. The answer is quite simple – Qwest does not have the data necessary to
15 quantify its market share, or the market share of any of its competitors –
16 because it does not have access to its competitors statistics that would
17 enable it to analyze the entire market. Highly sensitive competitive
18 intelligence, such as number of access lines served, location of fiber
19 facilities, number of customers served, competitive prices, etc. needed to

1 produce a true market share calculation, is not freely shared by Qwest's
2 competitors. Nor is it publicly available.[15]
3
4 **Q. DR. JOHNSON HAS COMPUTED QWEST MARKET SHARE FIGURES**
5 **BASED ON DATA FILED IN THIS PROCEEDING. ARE YOU SAYING**
6 **THOSE ARE NOT RELIABLE STATISTICS?**
7 A. Yes. I will examine in more detail Dr. Johnson's conclusions in the
8 testimony that follows, but one cannot determine market share information
9 by looking solely at one segment of the market (i.e., input from Qwest),
10 which is what Dr. Johnson has done. He has not accessed information
11 from each CLEC offering telecommunications services in the Phoenix and
12 Tucson areas which is necessary for an accurate assessment of the total
13 market. .
14
15 **Q. ON PAGES 22 AND 23 OF HIS TESTIMONY, DR. JOHNSON**
16 **"SUMMARIZES" YOUR SUPPLEMENTAL DIRECT TESTIMONY. HAS**
17 **HE ACCURATELY CAPTURED THE BREADTH OF THE DATA IN THE**
18 **TESTIMONY?**
19 A. No. Dr. Johnson's summary failed to include the data I provided on the
20 transition of Qwest's competitors to "full service providers" through which
21 they are providing a broad range of services directly substitutable to the

[15] The information may be provided in the annual reports filed by CLECs with this Commission, however,

1 services offered by Qwest. He also failed to reflect the updated
2 documentation which appeared in my Direct testimony illustrating the
3 expansion of competitive fiber facilities and switches in the Phoenix and
4 Tucson areas. Another key point missed by Dr. Johnson was the extent
5 competitors are partnering with other providers to allow them to reach
6 more customers with a wider variety of services. My Supplemental Direct
7 testimony included a comprehensive update of competitors' activities
8 which impact the Phoenix and Tucson markets.
9
10 **Q. DR. JOHNSON REACHED THE CONCLUSION THAT SERVICES**
11 **BEING PROVIDED BY COMPETITORS IN PHOENIX BUILDINGS ARE**
12 **HIGH CAPACITY SERVICES. IS THIS CORRECT?**
13 A. No. A review of my Direct and Supplemental Direct testimony and
14 exhibits, as well as Qwest responses to RUCO data requests will show
15 that competitors are offering a full menu of services in competition to
16 Qwest services. For example, Exhibit DLT-4 to my Direct testimony
17 demonstrates that AT&T is offering a number of switched services directly
18 substitutable for Qwest's business access line services, trunks, Centrex,
19 ISDN, and toll services. Exhibit DLT-5 to my Direct testimony is an ELI
20 advertisement which states that ELI offers business customers
21 voice/data/video solutions – with number portability. Exhibit DLT-8 to my

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such data is filed under protective seal and is not publicly available.

Direct testimony is a copy of correspondence Cox sent to a potential customer in the Phoenix area. It indicates residential customers can purchase primary and additional telephone lines, as well as features such as Caller ID, Voice Mail, and Call Waiting from Cox rather than Qwest.

My Supplemental testimony also included many examples of services competitors are offering beyond high capacity services. Exhibit DLT-1 includes a page from AT&T's Internet web site which describes why "AT&T local service is the best choice for businesses." Exhibit DLT-2 includes a description of WorldCom's "On-Net Service" which provides business customers the ability to "utilize a single access method for all voice, data, and Internet services..." Exhibit DLT-4 contains a listing of services available from ELI including Basic Business Lines, Business Trunks, Centrex, Foreign Exchange Services, ISDN, Voice Messaging, Custom Calling Services, etc.

The competitors Qwest is facing in the Phoenix and Tucson markets are offering much more than high capacity services, as Dr. Johnson has incorrectly concluded. They are aggressively competing for Qwest's core services – residential as well as business.

1 **Q. DR. JOHNSON DISAGREES WITH THE CRITERIA QWEST HAS**
2 **PROPOSED BE USED IN DETERMINING COMPETITIVE ZONE**
3 **CLASSIFICATION. HE INDICATES THAT UNDER THE PROPOSED**
4 **STANDARDS, A COMPETITOR COULD BE OFFERING ONE SERVICE**
5 **TO ONE CUSTOMER – OR ADVERTISING THAT THE SERVICE IS**
6 **AVAILABLE, AND THAT WOULD TRIGGER COMPETITIVE ZONE**
7 **CLASSIFICATION. PLEASE RESPOND.**
8 A. Under Qwest's proposal, the Commission will be notified that competition
9 in the form of the presence of a reseller, a facilities-based provider, or a
10 provider utilizing UNEs exists in a particular wire center. (The wire centers
11 I proposed be classified as competitive zones in my Direct and
12 Supplemental Direct testimony were based on the existence of facilities-
13 based providers.) Nowhere in Qwest's proposal does it indicate that the
14 offering of service to a single customer will trigger competitive zone status.
15 Qwest will have the burden of demonstrating to the Commission that
16 competition exists based on one of the above three criteria. The
17 Commission will have the opportunity to object to Qwest's proposal and
18 initiate a formal investigation. The process Qwest has proposed for
19 establishment of future competitive zones was designed with the intent to
20 streamline the process, similar to that currently employed by the Oregon
21 Public Utilities Commission (described in my rebuttal to Dr. Collins'
22 testimony). The Company is seeking a means of being able to effectively

respond to competition without subjecting the Arizona Commission and ratepayers to a lengthy regulatory proceeding. A one to two year proceeding to determine if a particular geographic area is subject to competition is the antithesis of a competitive environment. A more rapid means of bringing the benefits of competition to Arizona consumers is warranted. The proposal outlined in my Direct testimony will accomplish that.

Q. DR. JOHNSON OBJECTS TO THERE NOT BEING ANY DISTINCTION IN DETERMINING WHETHER A PARTICULAR AREA IS COMPETITIVE BASED ON WHETHER THE COMPETITOR IS A RESELLER. IN YOUR OPINION, IS SUCH A DISTINCTION APPROPRIATE?

A. No. The end user who is approached by an alternative provider makes no such distinction, the market makes no such distinction, therefore, the regulatory process governing the market should make no such distinction. As I've stated previously in this testimony, the FCC and Congress have identified resale as a viable, meaningful form of local competition. The Arizona Commission should also.

Q. IN HIS DISCUSSION OF COMPETITIVE ZONES (PAGE 25, LINES 14-15), DR. JOHNSON REFERS TO THE DEREGULATION OF SERVICES

WHICH WILL RESULT WITH COMPETITIVE ZONE CLASSIFICATION. IS THIS CHARACTERIZATION ACCURATE?

A. No. Services offered within a competitive zone will continue to be regulated by the Commission.

Q. DR. JOHNSON REFERENCES A QWEST RESPONSE TO RUCO DATA REQUEST 30-001 WHICH PROVIDED A STATE-WIDE RESIDENTIAL "MARKET SHARE" STATISTIC. (PAGE 27, LINES 12-14) CAN THIS BE CONSIDERED AN ACCURATE ASSESSMENT OF MARKET SHARE?

A. No. Dr. Johnson neglected to include the entire response. Qwest also stated in its response to this data request:

> This estimate is based on public information available to U S WEST; however, the figure is likely <u>overstated</u> since the company does not have access to competitors' actual share or customer counts. (emphasis added)

As I indicated earlier, without having facts and data on the complete universe, an accurate assessment of market share cannot be determined.

Q. ON PAGE 28, LINES 3-4, OF HIS TESTIMONY, DR. JOHNSON STATED THAT THE COMPETITIVE INFORMATION PROVIDED BY QWEST IN THIS DOCKET "ISN'T SUFFICIENT TO CONCLUDE THAT

COMPETITIVE PRESSURES ARE SIGNIFICANTLY GREATER IN THESE WIRE CENTERS THAN IN OTHER PARTS OF THE STATE," REFERRING TO THOSE WIRE CENTERS QWEST IS PROPOSING BECOME COMPETITIVE ZONES. IS THIS AN ACCURATE CONCLUSION?

A. No, it is not. Qwest's confidential response to data request WDA 02-39 (Attachment B) lists the total quantity of each USOC for each class of service in each exchange in the state for each CLEC resold during the month of April 1999. This data shows that resale, just one indicator of a competitive market, is extremely more prevalent in Phoenix and Tucson exchanges than it is in the rest of the state. For example, there were XX residence access lines resold in Bisbee, contrasted to XX residence access lines resold out of the Chandler Main wire center during this time period. (See Proprietary Exhibit DLT-4 for figures.) The difference is even more pronounced for business. A review of Attachment B will substantiate that Qwest is experiencing a much greater degree of competition in Phoenix and Tucson than it is in outlying areas of the state. Dr. Johnson's conclusion is incorrect.

Q. ON PAGE 29, LINES 12-13, DR. JOHNSON INDICATES THAT "THE TREND TOWARDS INCREASED COMPETITION IS STILL IN ITS INFANCY." DO YOU AGREE WITH HIS ASSESSMENT?

A. No. Dr. Johnson is basing this statement on a partial review of a subsegment of the total market. His analysis focused solely on the residential market and he did not obtain data from competitive carriers directly. Qwest is certainly experiencing competition in the residential market, primarily from Cox and a limited number of providers focusing on apartment complexes; however, the competition it is facing for business customers is much more extreme. Furthermore, Qwest does not purport to have data that represents the entire competitive telecommunications market in the Phoenix and Tucson areas. Some information is only available from the competitors themselves. Dr. Johnson's sweeping statement that competition is in its infancy must be rejected as based on incomplete evidence.

Q. DR. JOHNSON ATTEMPTS TO FURTHER SUPPORT HIS CLAIM THAT THE EXTENT OF COMPETITION IN THE PHOENIX AND TUCSON MARKETS IS NOT DEVELOPED SUFFICIENTLY TO WARRANT APPROVAL OF QWEST'S COMPETITIVE ZONE PROPOSAL ON PAGES 30-31. PLEASE COMMENT ON HIS OBSERVATIONS.

A. On Page 30, Lines 22-24, Dr. Johnson states that "until customers actually change carriers, *and are satisfied with the service provided by new entrants*," the market cannot be considered effectively competitive. (emphasis added) Qwest has provided a significant amount of data in this

1 proceeding that demonstrates customers are changing carriers, at an
2 increasing rate. However, I know of no economic or regulatory mandate
3 that makes customer satisfaction a requirement for effective competition.
4 If a market is competitive, and customers are not satisfied, they have
5 alternatives. Customer satisfaction is not a prerequisite to an effectively
6 competitive market – it is an end result. Furthermore, he has provided no
7 facts or data to illustrate whether customers are satisfied. He infers that
8 they are not, but provides no support for his position. These ambiguous
9 contentions should be dismissed as irrelevant to the issues addressed in
10 this proceeding.
11
12 On Page 31, lines 3-4, Dr. Johnson states "very few customers
13 have ever seriously contemplated changing their local carrier." He
14 provides no information to illuminate how he arrived at such a
15 conclusion. Consequently, the statement can be lent no credence,
16 and it, too, should be dismissed.
17
18 He also concludes that Qwest's request for competitive zone pricing
19 flexibility should be denied because the total number of competitive local
20 exchange carriers operating in Arizona is much lower than the number of
21 competitive long distance carriers. (Page 31, Lines 5-6) Long distance
22 competition has been prevalent for decades – local competition was

initiated four years ago. The number of long distance carriers has absolutely no impact on the competitiveness of the local market and Dr. Johnson's attempt to derail the Commission's attention from the true issues of this proceeding should be dismissed without merit.

Q. ON PAGE 33 OF HIS TESTIMONY, LINES 1-4, DR. JOHNSON MAKES A STATEMENT INDICATING THAT IF CHOICES WERE TRULY PREVALENT IN THE PHOENIX MARKET, HIS MARKET SHARE CALCULATION SUPPOSEDLY REPRESENTING QWEST'S MARKET SHARE WOULD BE LOWER. DO YOU AGREE?

A. No. As I indicated above, Dr. Johnson's market share calculation is flawed and based on incomplete data. Furthermore, it is not appropriate to use a residence figure to represent the degree of competition in the entire market. Business competitors have been much more aggressive in pursuing Qwest customers for a longer period of time. I do not agree with Dr. Johnson's assessment of the competitive alternatives which exist in the Phoenix market. The documentation I've provided in testimony and through Qwest responses to data requests demonstrates otherwise.

Q. DR. JOHNSON TAKES ISSUE WITH THE PROPOSED PRICE CEILINGS FOR SERVICES WITHIN COMPETITIVE ZONES. ARE PRICE CEILINGS UNIQUE TO QWEST?

A. No. Qwest's competitors have identified maximum rates for their services, some of which are much higher than existing rates. The effect of this is that competitors are able to increase rates up to the filed price ceiling without seeking and obtaining Commission approval. Qwest is asking for that same latitude – in those areas where it is experiencing competitive pressure.

Q. WILL QWEST LOWER ITS RESIDENTIAL ACCESS LINE RATE TO MEET OR BEAT THE PRICE OF COX'S RESIDENCE SECOND LINE, AS DR. JOHNSON ON PAGE 39, LINES 8-14?

A. No. Qwest's residential access lines are already priced below cost. Qwest will not lower them in response to competitive pressure.

Q. DR. JOHNSON ALSO SURMISES THAT QWEST COULD RAISE PRICES FOR SOME CUSTOMERS AND LOWER PRICES FOR OTHERS. IS THIS PART OF THE FLEXIBILITY YOU ENVISION FOR COMPETITIVE ZONES?

A. Yes. However, I must clarify this response because it can easily be misconstrued, as is evidenced by the testimony that has been filed by Qwest's competitors in this case. Within a competitive zone, i.e., wire center, Qwest will have the ability to respond to market demands by adjusting rates below the specified price ceiling. Rates for like customers

within a competitive zone may be increased in response to competition – to the maximum rate – or they may be decreased in response to competition. Rates for customers in other competitive zones may be unaffected, unless Qwest is experiencing the same type of competition which would generate the same competitive response. However, rates for customers who do not reside within a competitive zone will be unaffected by any such price changes. In other words, those customers without competitive alternatives will not be affected by rate changes made in response to competition and those customers within a competitive zone who are impacted will obviously have choices if they do not agree with Qwest's new rates. Rates for customers outside of competitive zones cannot be increased outside of a rate case; therefore the Commission will continue to have the final say in the rates that are charged to customers with no competitive alternatives. Qwest simply desires to compete on a level playing field with its competitors in those geographic locations where competition is prevalent.

Q. DR. JOHNSON ALLEGES THAT QWEST WILL USE COMPETITIVE ZONE FLEXIBILITY TO "LOCK IN" CUSTOMERS TO LONG TERM CONTRACTS. WHAT IS YOUR REACTION TO THIS?

A. Approval of competitive zone pricing flexibility will have absolutely no impact on Qwest's contracting ability. Qwest already has the ability to

contract with customers, absent competitive zone approval. In fact, Qwest currently contracts with customers for services already deemed competitive by the Commission. In addition, Qwest's competitors utilize contracts to secure customers. This is another red herring argument by Dr. Johnson that should be dismissed as irrelevant.

Q. DESPITE HIS OBJECTIONS TO COMPETITIVE ZONES, DR. JOHNSON CONCLUDES THAT QWEST IS CONSTRAINED FROM COMPETING IN THE CURRENT TELECOMMUNICATIONS ENVIRONMENT, ISN'T THAT CORRECT?

A. Yes. I quote Dr. Johnson from Page 43 of this testimony, Lines 7-8:

> While I strongly disagree with U S WEST's proposal, I don't believe the existing rules are adequate to deal with changing competitive conditions.

Q. DR. JOHNSON PROPOSES A CHANGE TO EXISTING COMMISSION RULE 14-2-1108(A) WHICH HE INDICATES WILL PROVIDE QWEST WITH THE PRICING FLEXIBILITY IT NEEDS. IS DR. JOHNSON'S PROPOSED CHANGE EVEN NECESSARY TO ACCOMPLISH HIS INTENT?

A. No. Dr. Johnson adds verbiage to specify that the Commission may classify a service or group of services competitive "within a specified relevant market." (Page 43, Lines 15, 19). The existing rules already

provide for the Commission to classify any "service or group of services" as competitive within the relevant market.

As I've pointed out previously in this testimony, Commission rules define relevant market as:

> Where buyers and sellers of a specific service or product, **or of a group of services or products**, come together to engage in transactions. For telecommunications services, the relevant market may be identified on a service-by-service basis, **a group basis**, and/or by **geographic location**. (R-14-2-1102, A.A.C., emphasis added)

Dr. Johnson's revision to Rule 14-2-1108(A) is already considered in Rule 14-2-1102. His suggested changes add no clarity and certainly will not result in affording Qwest the pricing flexibility it needs to respond to competition where it is occurring.

Rate Design

Q. AT PAGE 77 OF HIS DIRECT TESTIMONY, DR. JOHNSON STATES "...THE UNDERLYING RATIONALE FOR THESE INCREASES-THAT LOCAL SERVICE IS "SUBSIDIZED" BY OTHER SERVICES-IS INVALID..." IS DR. JOHNSON CORRECT?

A. No. He is entirely incorrect. When Qwest's residential local exchange rates are compared to the correct cost basis, as discussed in detail by Dr. Taylor and Mr. Thompson on behalf of Qwest, residential local service rates are clearly subsidized.

Q. IF DR. JOHNSON'S PRESUMPTIONS REGARDING COST ALLOCATION AND ABSENCE OF RESIDENTIAL LOCAL EXCHANGE SUBSIDY ARE INCORRECT, ARE THE REMAINDER OF HIS ARGUMENTS RELATIVE TO LOCAL EXCHANGE PRICING VALID?

A. No.

Q. BEGINNING AT PAGE 84, DR. JOHNSON COMPLAINS THAT QWEST'S ZONE INCREMENT PROPOSAL IN THIS DOCKET GENERATES PRICES THAT ARE INAPPROPRIATELY HIGH. WOULD YOU COMMENT?

A. Yes. Qwest's zone increment proposal establishes rate levels that are appropriately in alignment with Qwest's pending proposal regarding deaveraged UNE loop prices. Failure to align the retail and wholesale prices outside the Base Rate Area in Arizona will create significant pricing anomalies and potential for rate arbitrage. Qwest's proposal is entirely reasonable.

Q. AT PAGE 97, DR. JOHNSON ASSERTS THAT PRICE ELASTICITY OF DEMAND SHOULD BE CONSIDERED IN CALCULATING THE REVENUE IMPACTS ASSOCIATED WITH QWEST'S INTRALATA LONG DISTANCE PRICE PROPOSALS. DO YOU AGREE?

A. No. Please see my rebuttal comments to Mr. Dunkel's positions regarding the lack of price elasticity in Qwest's intraLATA long distance services.

VI. RESPONSE TO MS. ARLEEN STARR

Q. AT PAGE 7 OF HER DIRECT TESTIMONY, MS. STARR COMPLAINS THAT QWEST'S PROPOSAL IN THIS RATE CASE "...IS AN ATTEMPT TO INCREASE MONOPOLY REVENUES WHILE MAINTAINING THE VERY BARRIERS TO COMPETITIVE MARKET ENTRY THAT WILL SUSTAIN THE MONOPOLY." IS SHE CORRECT?

A. No. On the contrary, Qwest's proposal strikes an appropriate balance between several objectives: adjustment of prices to minimize implicit subsidies, alignment of retail and wholesale prices, establishment of a pricing flexibility framework to facilitate competitive parity between Qwest and its competitors, maintenance of affordable prices for consumers and attainment of Qwest's defined revenue requirement in Arizona. Ms. Starr's complaints are clearly off the mark.

1 **Q. AT PAGE 9, MS. STARR MAKES THE FOLLOWING ALLEGATION:**
2 **"...ACCESS REDUCTIONS WILL ALSO LIMIT U S WEST'S ABILITY**
3 **TO ENGAGE IN ANTI-COMPETITIVE PRICING STRATEGIES IN THE**
4 **TOLL MARKET, WHICH WOULD IMPEDE COMPETITION." PLEASE**
5 **RESPOND.**
6 A. Qwest has not engaged in "anti-competitive pricing strategies" in the toll
7 market, nor do we intend to do so. The Commission currently has
8 regulatory guidelines in place that govern the manner in which wholesale
9 and retail prices should be set. Qwest is in full compliance with those
10 guidelines. Additionally, I am unaware of any complaints AT&T has filed
11 with the Commission concerning any instance of inappropriate toll pricing
12 in Arizona. Ms. Starr's allegations are long on rhetoric and short on
13 factual support.
14
15 **Q. AT PAGE 31, MS. STARR SEEMS TO IMPLY THAT QWEST'S**
16 **EVENTUAL ENTRY INTO THE INTERLATA LONG DISTANCE MARKET**
17 **WILL SOMEHOW HAVE A DETRIMENTAL EFFECT ON COMPETITION,**
18 **UNLESS THE COMMISSION TAKES ACTION TO REDUCE QWEST'S**
19 **INTRALATA SWITCHED ACCESS RATES. WOULD YOU COMMENT?**
20 A. Yes. I honestly do not understand the connection Ms. Starr is attempting
21 to make in these comments. Qwest's intraLATA long distance
22 competitors are enjoying tremendous success in capturing market share

from Qwest: since the advent of intraLATA long distance dialing parity, Qwest's intraLATA long distance share in Arizona has continued to trend sharply downward. Eventual Section 271 relief will enable Qwest to strongly compete with AT&T and other interexchange carriers for the interLATA market. At that time, it is likely Qwest will win a portion of the interLATA long distance market share AT&T now holds. Perhaps that eventuality is the "detrimental effect on competition" Ms. Starr alludes to. If so, that issue is well beyond the scope of this docket.

Q. AT PAGE 32, MS. STARR PROVIDES ILLUSTRATIONS OF HOW AT&T IS UNABLE TO COMPETE EFFECTIVELY WITH QWEST IN THE INTRALATA LONG DISTANCE MARKET, AND GOES ON TO INFER THAT QWEST HAS A MONOPOLY IN THE INTRALATA LONG DISTANCE MARKET. WOULD YOU COMMENT?

A. Yes. Ms. Starr omits several facts from her analysis which alter the conclusion. First, her analysis assumes that AT&T must pay Qwest switched access charges for each and every intraLATA minute of use an AT&T customer originates or terminates in Arizona. This is simply a false assumption. AT&T provides intraLATA long distance service via a variety of alternative means that are not assessed switched access charges, including AT&T-owned dedicated facilities, purchase of special access dedicated services from other carriers and purchase of special access

1 services from Qwest. In addition, AT&T has recently taken an equity
2 stake of approximately 40% in Net2Phone, the nation's largest internet
3 protocol (IP) telephony provider. At this time, interLATA or intraLATA
4 long distance calls placed via IP telephony are not assessed switched
5 access charges. Second, AT&T is able to average its costs of providing
6 long distance across interstate and intrastate jurisdictions. In many
7 instances, AT&T's calling plans require the customer to subscribe to
8 AT&T service for all long distance calling, both interstate and intrastate.
9 In this scenario, AT&T's average cost of providing long distance service is
10 well below the revenues it receives for that service. The margin for the
11 long distance minute of use, when considering long distance in the holistic
12 sense, is substantially greater than that displayed in Ms. Starr's analysis.
13
14 **Q. AT PAGE 36, MS. STARR SUGGESTS THAT QWEST'S CURRENT**
15 **SWITCHED ACCESS CHARGES ARE "...AN ENORMOUS ECONOMIC**
16 **BARRIER FOR COMPETITORS TO OVERCOME." IS THIS**
17 **CORRECT?**
18 A. No. The competitive intraLATA long distance market in Arizona is
19 thriving, even in view of the current level of Qwest's intraLATA switched
20 access prices. However, as discussed by Mr. McIntyre, Qwest is
21 proposing substantial reductions to its switched access prices in this
22 docket. Switched access charges are not a barrier to competitive entry

now, and the proposed price reductions should stimulate even more competitive entry.

Q. AT PAGE 38, MS. STARR STATES: "ARIZONA CUSTOMERS WILL SUFFER IN THE LONG RUN BECAUSE U S WEST WILL HAVE THE ABILITY TO RAISE ITS PRICES ONCE COMPETITIVE PRESSURE ON ITS TOLL SERVICES IS REDUCED OR ELIMINATED." WOULD YOU COMMENT?

A. Yes. I find Ms. Starr's comments somewhat surprising in view of AT&T's recent attempt to increase interstate long distance rates, which was subsequently withdrawn only after strong expression of concern by the FCC. Clearly, AT&T's price increase strategy was not related to elimination of competition in the hotly competitive interstate long distance market. Nevertheless, Qwest believes that intraLATA long distance competition will intensify in the near future in Arizona, as CLECs continue to capture local exchange market share and ramp up their efforts to provide full service local and toll services to their customers. Coupled with continued creative packaging and bundling of services by interexchange carriers, rapid growth of IP telephony and increased substitution of wireless services for traditional landline services, it is not reasonable to assume that competition in the intraLATA long distance market will diminish in the foreseeable future. Rather than suffering,

Arizona consumers will enjoy an ever expanding array of competitive long distance alternatives.

VII. CONCLUSION

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. A variety of parties, including Mr. William Dunkel, Dr. Francis Collins, Dr. Lee Selwyn, Dr. Ben Johnson and Ms. Arleen Starr have filed testimony in this docket suggesting Qwest's proposals regarding Competitive Zone classification and rate design are inappropriate in Arizona. A common thread runs through the parties' complaints around Qwest's Competitive Zone proposal: Qwest should continue to be constrained from competing on par with its competitors in the same manner in which these competitors target their services. The parties are wrong. Qwest's proposal is entirely consistent with the objectives and guidelines of the Telecommunications Act of 1996 (the Act), the FCC's subsequent rulings in support of the Act and prevailing ACC rules. The overarching goal of the Act is to open markets to competition and to establish an environment in which telecommunications competitors may compete vigorously, creatively and on equal footing. Qwest's Competitive Zone proposal establishes a mechanism to promote fair competition in geographic areas in which competitors have chosen to offer alternatives to Qwest's services. If the

Commission approves Qwest's Competitive Zone proposal, Arizona consumers will be the ultimate beneficiaries of the fruits of full, open and fair competition.

The parties have also chosen to oppose Qwest's rate design for retail services, which was proposed to support the positive revenue requirement in Arizona identified by Qwest witness Mr. George Redding. Again, the parties are wrong. Qwest's proposal strikes an appropriate balance between multiple objectives: the need to begin to remove implicit subsidies from Qwest's rate structure pursuant to the mandates of the Act, the need to establish cost-based prices to enable economically efficient competition to enter all markets throughout Arizona, the need to align "deaveraged" wholesale and retail pricing structures to avoid creation of pricing anomalies and opportunity for rate arbitrage, the need to simplify and streamline traditional rate structures, the need to comply with existing ACC pricing rules and the need to minimize the overall impacts of rate changes on Arizona customers to the extent practicable. A major recurring theme in the parties' testimony in opposition to the retail pricing design in this docket is that the loop cost should be treated as a cost to be shared among virtually all retail services Qwest offers in Arizona. As discussed in the testimonies of Mr. Jerrold Thompson and Dr. William Taylor, this "cost allocation" concept is not valid. When

Qwest's retail pricing proposal is viewed in the context of TSLRIC as the proper cost basis, the proposal is in full alignment with the policy objectives outlined above.

In view of the body of evidence supplied in my direct, supplemental direct and rebuttal testimonies in this Docket, I respectfully urge the Commission to approve Qwest's Competitive Zone and retail rate design proposals as filed.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF QWEST CORPORATION, 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-01051B-99-0105

EXHIBITS OF

DAVID L. TEITZEL

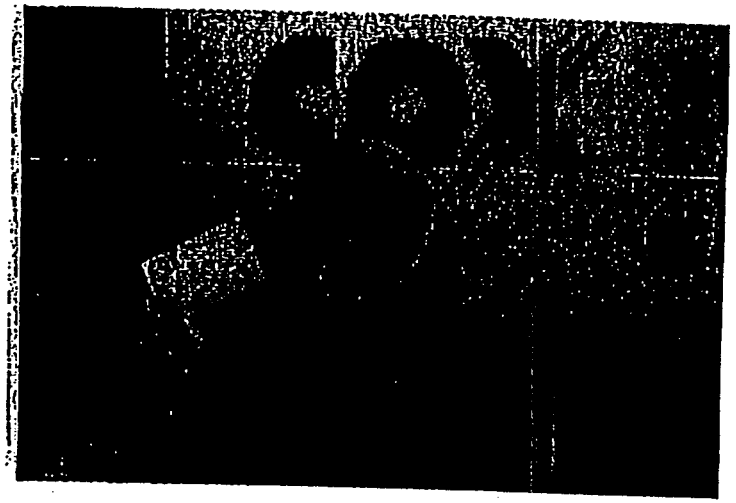
QWEST CORPORATION

AUGUST 21, 2000

INDEX OF EXHIBITS

DESCRIPTION	EXHIBIT
Cox Bundling Strategy	 1
Oregon PUC Memo – Competitive Zones	 2
Cox Win Back Tariff	 3
Proprietary Information	 4

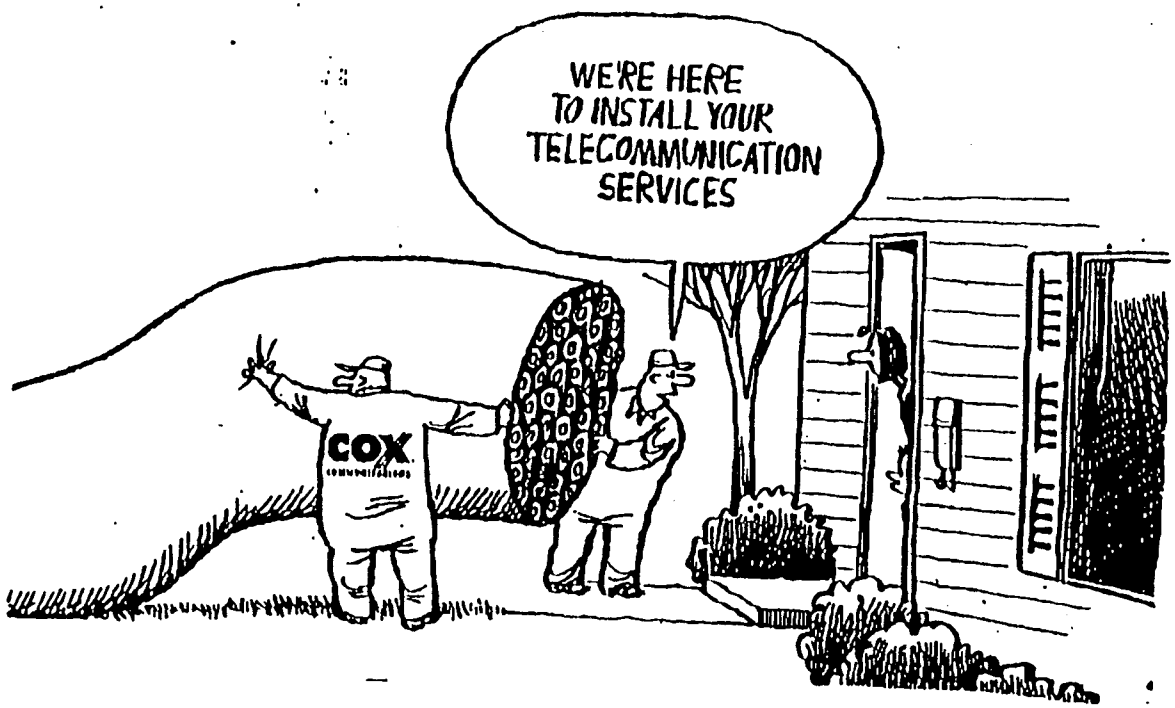
Bundling Strategy Development



"One Company, One Bill, One Step at a Time"

COMMUNICA
Now you're

The Bundles are Coming...



Bundling vs. One Stop Shopping

- Bundling is adding one product to either one or two other products to create a new, multi-category product under the Cox Brand.
- One Stop Shopping is Simply providing a Single location (Retail, Call Center, Direct Sales) which allows customers to obtain multiple category products/services. However, these products/services are not necessarily provided under the same brand

What Bundling is Not

- Bundling **is not** about *creating* extensive choices for the customer and therefore the creation of unmanageable operational complexity.

- Bundling **is about** *simplifying* choices for customers and creating preassembled target groups of services which can be easily purchased.

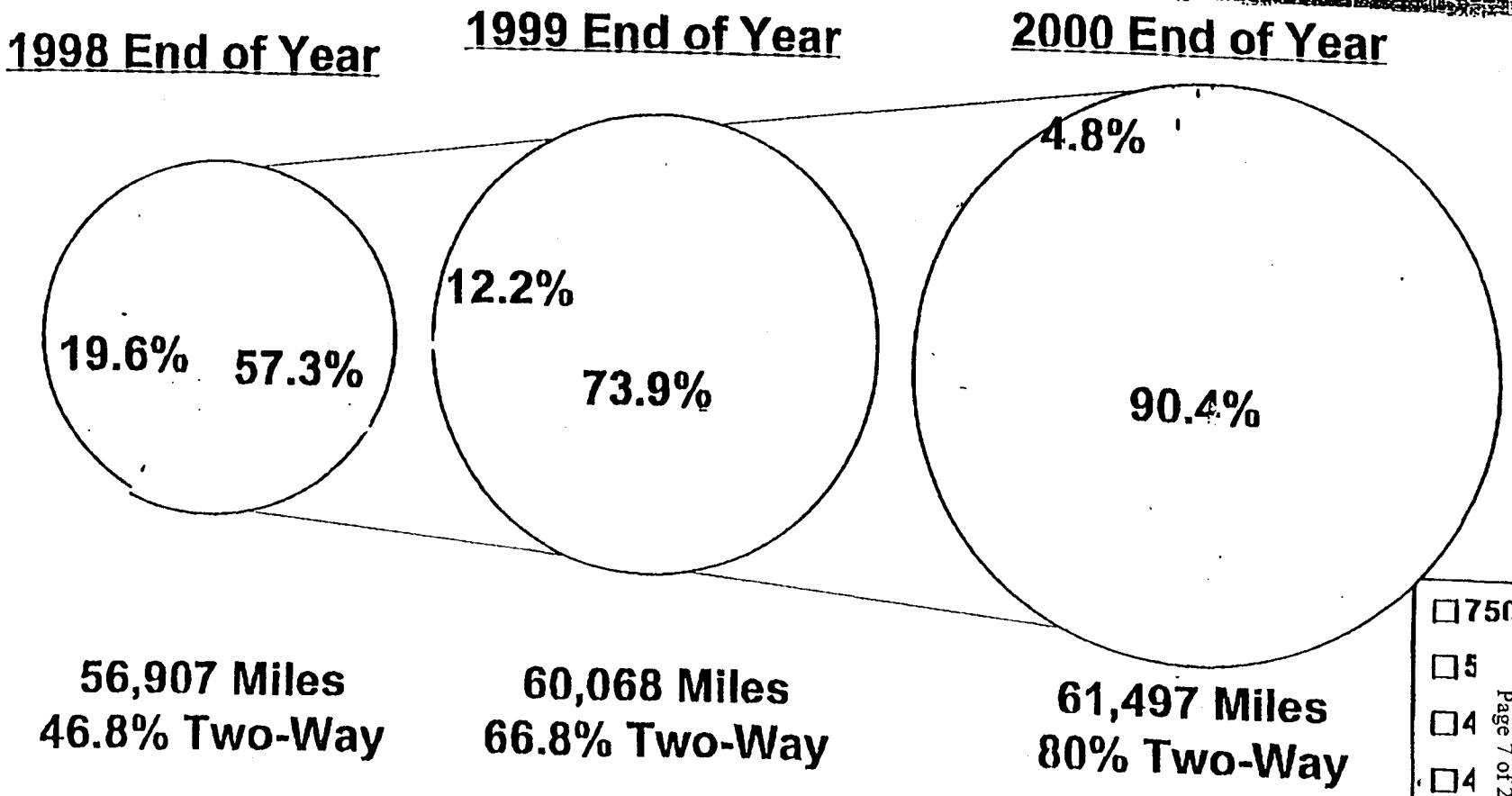
What is a Cox Bundle?
What is a Cox Package?

- **Cox Bundle: A combination of two or more product categories (video, voice, data) conveniently sold and serviced by Cox.**
  - Cox Digital Cable, Cox@Home, Cox Digital Telephone
  - Cox Digital Cable & Cox@Home
  - Cox Cable & Cox Digital Telephone
- **Cox Package: A combination of two or more elements within a single product category.**
  - Cox Digital Telephone & Solutions Package
  - Cox Cable & Premium Channels

The Steps We are Taking

- Network Upgrades

New Service Network Readiness is Job One!



New Service Deployment

Data		Telephony		Digital Cable	
Orange County	12/96	Orange County	9/97	Orange County	10/97
San Diego	5/97	Omaha	11/97	Omaha	12/97
Phoenix	6/97	New England	12/97	New England	12/97
Omaha	8/97	San Diego	5/98	New Orleans	2/98
New England	8/97	Phoenix	10/98	Hampton Roads	4/98
Hampton Rds.	11/97	*Oklahoma City*	*3Q99*	Tucson	6/98
Oklahoma City	2/98			San Diego	1Q99
New Orleans	10/98			Phoenix	1Q99
Las Vegas	10/98			Oklahoma City	1Q00
Ft. Walton	*4Q99*			*Las Vegas*	
				Ft. Walton	

What it Will Require

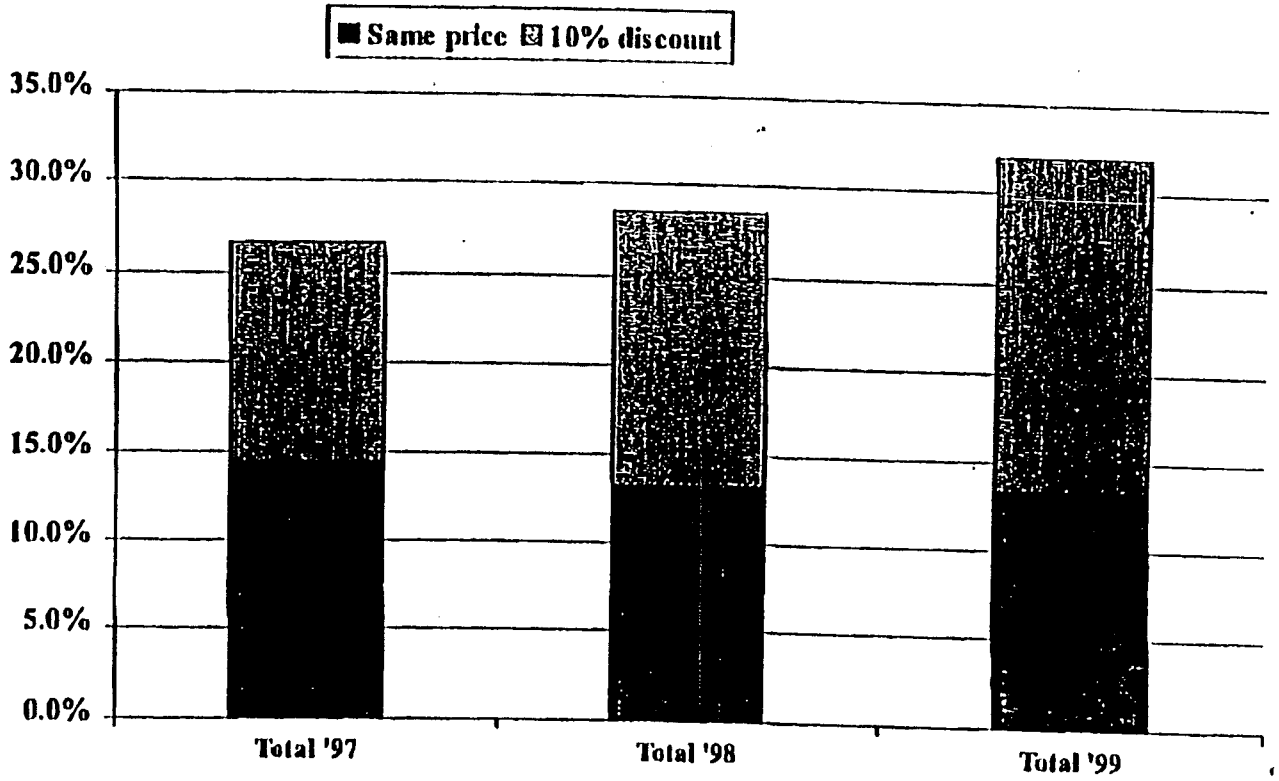
- Network Upgrades
- Brand Expansion

Continued Brand Strength

"This company values its customers and strives to provide them the best product and service at a fair price."

% who agree	1998	1997
CABLE COMPANY	74.1	+0.7PT
LOCAL PHONE CO.	66.3	- 3.7
LONG DISTANCE CO.	65.5	- 5.4
ELECTRIC CO.	67.1	+3.0

Interest In Cox Digital Telephone Continues to Grow



We Are Delivering...

- *"Customers who have jettisoned their local telephone company in favor of service from their cable TV operator rank the quality of the service higher than the bulk of local telephone subscribers, according to a study released by J. D. Power and Associates."*

What it Will Require

- Network Upgrades
- Brand Expansion
- Operational & Financial Flexibility

Simple Objectives

- Make it Easy and Rational to Buy Video, Voice, and Data Services From Cox Rather Than From Up to 3 Separate Providers
- Make it More Difficult/Painful to Downgrade
- Determine Whether Customers Will Make Multiple Purchase Decisions Simultaneously or Whether They Prefer Serial Purchases.

Overall Goal

Utilize our ability to offer integrated bundles of services as a competitive advantage to drive incremental customer profitability.

- ***Drive Incremental penetration***
- ***Improve retention***
- ***Enhance competitive position***
- ***Reduce customer acquisition, upgrade & retention costs***

- In general, the challenge is to de-emphasize specific product price, and build loyalty on a multiproduct level

Progress to Date:

- Extensive Review of Existing Industry Research and Analysis (Forrester, IDC, Yankee, and others).
- Qualitative Research Among Current 1, 2 and 3 Product Customers in Diverse Markets.
- Bundling Summit Held Incorporating Input/Experiences of Several Field Locations.
- Development of GO TO MARKET Plan.
- MIS Walk-Through of Requirements.

Current Situation

- Large Video Customer Base Coupled with Telephone's Natural Deep Penetration Represents Large Target Opportunity for Bundled Services.
- New Services and Associated Value Proposition are Generally Achieving Penetration Targets, Therefore Current 2 Service Bundles (Video/Phone, Video/Data, and Data/Phone) are Plentiful.
- Although 3 Product Bundle Customers Exist, We have Identified the Need for Additional Economic Benefit or Retentive Element for These Bundles.

Overall Game Plan

- ✓ Build Cox Brand as a Viable Provider of Video, Voice & Data Services - "Now you're living."
- ✓ Evaluate Extension of 2 Tier Pricing Structure to Video Products.
- ✓ Identify Which Bundles Appeal to Cox, Customers, and Can be Offered, Provisioned, and Serviced.
- ✓ Identify Which Target Households These Bundles Appeal to.
- ✓ Creation of a New Level Of Recognition of Highest Value Cox Customers
- ✓ Test & Retest. Measure & Closely Monitor

Short Term Strategy

- Bolster the Sell-in of Current 2 Product Bundles and Maintain Associated "Preferred Customer Discounts"
  - **Vigorously Reinforce Current 2 Product Discount & Reinforce in Bill**
- Develop Target Bundles for Prospective 3 Product Customers
- Profile Current 2 & 3 Product Customers
- Manage CPNI Issues
- Define Entire Customer Experience and Develop Special Level Customer Care

** TOTAL PAGE.21 **

Long Term Strategy

- Billing - Choice of single bill or separate statements
  - Monthly Reinforcement of Status, Value Received
  - Direct Debit
- Customer Service - Special Number with Quick Access to Subject Matter Experts
  - Priority Queuing
  - Empowered to Satisfy
- Sales Process - Simple, Easy, One Call
- Install - 1 truck roll or customer choice
- Rate Guarantees
- Time Specific Appointments or Shorter Time Windows

** TOTAL PAGE.02 **

David Pugliese
Executive Director, Voice & Data Marketing

David Pugliese joined Cox Communications in Atlanta, Georgia in February 1996 as Executive Director of Voice & Data Marketing. In this role, David was accountable for the development of Cox's marketing strategy and tactics associated with several planned new voice & data services including Cox Digital Telephone-*the better choice in local telephone service*, Cox @Home-*the High Speed Internet Service*, and Cox Long Distance by Frontier. Currently, David has overall responsibility for product management & marketing of Cox Digital Telephone service, the key initiative of bundling of video, voice, and data services, and also competitive intelligence.

Prior to joining Cox and the cable industry, David developed extensive telecommunications industry marketing expertise through a number of positions with Frontier Corporation and AT&T. While at Frontier from 1994-1996, David held key positions of General Manager-Consumer Marketing and Vice President of Marketing for Frontier Cellular, a joint venture between Frontier Corporation and Bell Atlantic/NYNEX Mobile Communications. At AT&T from 1982-1994, David held a number of positions within the Business and Consumer Marketing & Sales organizations.

PUBLIC UTILITY COMMIS
Telecommunications Divisio
Interoffice Correspondence

DATE: March 28, 2000

TO: Commissioners Eachus, Smith, and Hamilton
Through Dave Booth and Phil Nyegaard

FROM: Marlene Gorsuch

SUBJECT: U S WEST Communications – Pricing Flexibility

The purpose of this report is to notify the Commission that the criteria have been met for U S WEST Communications to receive pricing flexibility, pursuant to ORS 759.050(5), in forty-nine additional telephone exchanges.

The Commission first set criteria for GTE Northwest (GTE) and U S WEST Communications (USWC) to receive pricing flexibility in Order No. 96-021, dockets CP 1, CP 14, and CP 15. The criteria have been repeated since January 1996 in orders by which the Commission granted authority to competitive providers to provide local exchange service in competition with the incumbents. USWC has met the criteria for pricing flexibility for switched service in several exchanges, as summarized here:

1. Many competitive local exchange carriers (CLEC's) have certificates of authority to provide service in all USWC exchanges.

2. USWC has filed a tariff for interim local number portability, and the Commission has approved the tariff.

3. Staff has notified the Commission that a mutual exchange of telephone traffic exists between USWC and a CLEC in each of several exchanges.

We use different criteria for dedicated transmission service, i.e. private line service. On several occasions, the Commission has granted to USWC, as well as GTE, Sprint/United, and CenturyTel, pricing flexibility for dedicated transmission throughout their service areas.

USWC advised the PUC staff by letter dated March 8, 2000, that a mutual exchange of traffic exists in forty-nine exchanges:

Albany	Grants Pass	Pendleton
Ashland	Hermiston	Phoenix/Talent
Astoria	Independence/Monmouth	Prineville
Athena/Weston	Jacksonville	Rainier
Baker	Jefferson	Redmond
Bend	Junction City	Rogue River
Blue River	Klamath Falls	Roseburg
Camp Sherman	Lapine	St. Helens
Central Point	Leaburg	Seaside
Corvallis	Lowell	Siletz
Cottage Grove	Madras	Sisters
Culver	Medford	Stanfield
Dallas	Milton-Freewater	Toledo
Falls City	Newport	Umatilla
Florence	Oakland/Sutherlin	Veneta
Gold Hill	Oakridge	Warrenton
		Woodburn/Hubbard

Staff contacted the competing CLECs: ATI, BG ENTERPRISES, FRONTIER (GLOBAL CROSSINGS), RIO COMMUNICATIONS, STERLING INTERNATIONAL (1-800-RECONEX), SUNRIVER TELCOM, TELNET, and UNITED COMMUNICATIONS. They confirmed USWC's information.

By this report staff notifies the Commission that a mutual exchange of traffic exists between USWC and an authorized CLEC in the above forty-nine exchanges. Therefore, USWC now gets pricing flexibility for switched service in those exchanges. No Commission action is required.

On the attached pages are shown the exchanges where USWC and GTE have pricing flexibility pursuant to ORS 759.050 and Order No. 96-021. There are now only seven exchanges where USWC does not have pricing flexibility: Cannon Beach, Harrisburg, Mapleton, Marcola, Sumpter, Walla Walla (Stateline), and Westport.

cc: Mike Weirich, Assistant Attorney General
Don Mason, U S West Communications
Kay Barley, U S West Communications

Pricing Flexibility

U S WEST Communications has pricing flexibility in the following exchanges pursuant to ORS 759.050 and Order No. 96-021, dockets CP 1, CP 14, and CP 15.

U S WEST

Albany
Ashland
Astoria
Athena/Weston
Baker
Bend
Blue River
Burlington
Camp Sherman
Central Point
Corvallis
Cottage Grove
Culver
Dallas
Eugene/Springfield
Falls City
Florence
Gold Hill
Grants Pass
Hermiston
Independence/Monmouth
Jacksonville
Jefferson
Junction City
Klamath Falls
Lake Oswego
Lapine
Leaburg
Lowell
Madras
Medford
Milton-Freewater
Newport
North Plains
Oak Grove/Milwaukie
Oakland/Sutherlin
Oakridge
Oregon City
Pendleton
Phoenix/Talent
Portland
Prineville
Rainier
Redmond
Rogue River
Roseburg
Salem
St. Helens
Seaside
Siletz
Sisters
Stanfield
Toledo
Umatilla
Veneta
Warrenton
Woodburn/Hubbard

Pricing Flexibility

GTE Northwest has pricing flexibility in the following exchanges pursuant to ORS 759.050 and Order No. 96-021, dockets CP 1, CP 14, and CP 15.

GTE Northwest

Bandon
Beaverton
Brookings
Coos Bay
Coquille
Cove
Elgin
Enterprise
Forest Grove
Gold Beach
Gresham
Hillsboro
Hoodland
Imbler
Joseph
La Grande
McMinnville
Murphy/Provolt
Newberg
Scholls
Sherwood
Stafford (Wilsonville)
Tigard
Union
Wallowa

Arizona Corporation Commission
Docket No. T-1051B-99-105
Qwest Corporation – DLT-3
Exhibits of David L. Teitzel
Page 1 of 2 August 21, 2000

SECTION 4 - Promotional Offerings

ORIGINAL

4.1 Promotional Offerings

The Company, from time to time, may make promotional offerings of its services which may include waiving or reducing the applicable charges for the promoted service. The promotional offerings may be limited as to the duration, the date and times of the offerings and the locations where the offerings are made.

4.2 Competitive Response. (N)

A. Residence Competitive Response Program

1. Description:

The Residence Competitive Response Program is an offering to residence customers who have left Cox for another telecommunications provider, for their local exchange service, or for their intraLATA and interLATA MTS services, or to those who choose to stay with Cox after a solicitation from a competing local service provider. In accordance with the terms of this Residence Competitive Response Program Cox may offer incentive(s) to such residential customers.

2. Terms and Conditions:

a. This competitive response offering may be offered to customers returning to Cox from a competing telecommunications provider, or those who choose to stay with Cox after a solicitation from a competing local service provider.

b. Periods and provisions of this offer will be determined by Cox.

c. Cox reserves the right to discontinue this offer, without further proceedings or approvals, upon fourteen (14) days' notice to the Arizona Corporation Commission.

d. Qualifying residential customers are required to have a satisfactory credit rating with in accordance with Section 2.5 above.

e. Cox shall use reasonable business efforts so that similarly situated customers are offered similar incentive credits in similar circumstances.

f. The Residence Competitive Response Program is a competitive response only and is not available for resale.

3. Rates and Charges:

a. Customers who qualify under the Terms and Conditions of this tariff may receive either a waiver of the current nonrecurring charge, up to two months of recurring rates, or both, on selected services determined by the Company. Amounts and types of the waivers will vary. In addition, residential Customers may be eligible for waivers of intraLATA and interLATA MTS charges.

b. Total local exchange service charges waived will not exceed $100.00 per customer location. (N)

Issued By: Martin Corcoran
Director, Tariff Development
Cox Communications, Inc.
1400 Lake Hearn Drive,
Atlanta, GA 30319

ADMINISTRATIVELY
APPROVED FOR FILING

Arizona Corporation Commission
Docket No. T-1051B-99-105
Qwest Corporation – DLT-3
Exhibits of David L. Teitzel
Page 2 of 2 August 21, 2000

ORIGINAL

4.2 Competitive Response, contid.

B. Business Competitive Response Program:

1. Description:

The Business Competitive Response Program is an offering to business customers who have terminated or canceled all or part of their Cox services and established service with another telecommunications provider, or to those who choose to stay with Cox after a solicitation from a competing local service provider. In accordance with the terms of this Business Competitive Response Program, Cox may offer incentive(s) to such business customers.

2. Terms and Conditions:

a. The Business Competitive Response Program may be offered to business customers returning to Cox from a competing telecommunications provider, or to those who choose to stay with Cox after a solicitation from a competing local service provider.

b. The Company may offer qualifying business customers incentives in the form of credits on the business customers' bills after those business customers actually establish the agreed upon service with Cox.

c. Business customers may receive the incentive credit(s) only in connection with services that are established with and provided by Cox.

d. On contractual services, business customers are required to sign a contract in order to receive the incentives described below.

e. Business customers who receive the Competitive Response Program credit(s) are required to remain with Cox for a minimum of one year or be billed all of the nonrecurring charge(s) and monthly rate(s) waived.

f. Cox reserves the right to discontinue this offer, without further proceedings or approvals, upon fourteen (14) days' notice to the Arizona Corporation Commission.

g. Periods and provisions of this offer will be determined by Cox.

h. Qualifying business customers are required to have a satisfactory credit rating with in accordance with Section 2.5 above.

i. Cox shall use reasonable business efforts so that similarly situated customers are offered similar incentive credits in similar circumstances.

j. The Business Competitive Response Program is a competitive response only and is not available for resale.

3. Rates and Charges:

a. Business customers who qualify for this tariff under the Terms and Conditions above may receive a maximum of either a waiver of the current nonrecurring charge(s), or up to two months of the current monthly rate(s), or both, on selected services as determined by Cox. In addition, business customers may be provided waivers of intraLATA and interLATA MTS charges.

b. Incentive amounts are calculated on the first month's nonrecurring charge(s) and monthly rate(s). The total credit amount will not exceed the total nonrecurring charge(s) plus two months service of the monthly rate(s).

(N)

ADMINISTRATIVELY
APPROVED FOR FILING

PROPRIETARY INFORMATION

Page	Line	Proprietary Information
58	22	**Redacted** Residence Resold Access Lines – Bisbee
58	23	**Redacted** Residence Resold Access Lines – Chandler Main

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF QWEST CORPORATION, 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-1051-B-99-105 AFFIDAVIT OF DAVID L. TEITZEL
STATE OF WASHINGTON	)	
COUNTY OF KING	)	
	)	SS

I, David L. Teitzel, of lawful age being first duly sworn, deposes and states:

1. My name is David L. Teitzel. I am Directory, Product and Market Issues for Qwest Corporation, formerly known as U S WEST Communications, Inc., in Seattle, Washington. I have caused to be filed written rebuttal testimony and exhibits in support of Qwest Corporation in Docket No. T-01051-B-99-105.

2. Attached hereto and made a part hereof for all purposes is my rebuttal testimony.

3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct to the best of my knowledge and belief.

Further affiant sayeth not.

David L. Teitzel

SUBSCRIBED AND SWORN to before me this 16th day of August, 2000.

ANGIE LEIFER
COMMISSION EXPIRES
NOTARY PUBLIC
8-08-02
STATE OF WASHINGTON

Notary Public

My Commission Expires:
8/8/02

EXHIBIT
Q-29
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 RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES	)	DOCKET NO. T-01051B-99-0105

REBUTTAL TESTIMONY OF

JERROLD L. THOMPSON

EXECUTIVE DIRECTOR- SERVICE COST INFORMATION

QWEST CORPORATION

AUGUST 21, 2000

REBUTTAL TESTIMONY OF JERROLD L. THOMPSON

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IDENTIFICATION OF WITNESS

Q. PLEASE STATE YOUR NAME, OCCUPATION AND BUSINESS ADDRESS.

A. My name is Jerrold L. Thompson. I am employed by Qwest Corporation (formerly U S WEST Communications, Inc.), (Qwest) as Executive Director - Service Cost Information. My business address is Room 4400, 1801 California Street, Denver, CO.

Q. HAVE YOU PREVIOUSLY FILED TESTIMONY IN THIS PROCEEDING?

A. Yes. I provided Direct Testimony on January 8, 1999 and Supplemental Direct Testimony on May 19, 2000.

PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. My testimony rebuts the testimonies of Mr. William Dunkel representing the staff of the Arizona Corporation Commission, Dr. Ben Johnson representing RUCO staff, Dr. Michael Ileo representing the Arizona Payphone Association, and Ms. Arlene Starr of AT&T. I provide a background for the Total Service Long Run Incremental Cost (TSLRIC) studies that have been filed in this proceeding[1]. My rebuttal testimony provides an overview of the economic principles considered in the studies, describes the cost calculation procedures followed in the studies, and responds to the various erroneous statements made and conclusions reached by the aforementioned parties.

Q. HOW IS YOUR TESTIMONY ORGANIZED?

A. My testimony is organized into four major sections. First, I describe the cost principles used in Qwest's TSLRIC studies. Second, I describe the

[1] TSLRIC studies were updated with my Supplemental Testimony.

categorization of costs within the studies. Third, I discuss the appropriate uses of TSLRIC data. Finally, I address the testimony of the witnesses listed above and explain why their testimony is incorrect and provide misinformation to the Commission.

TSLRIC PRINCIPLES

Q. PLEASE SUMMARIZE THE ECONOMIC PRINCIPLES THAT ARE APPLIED IN QWEST'S TSLRIC STUDIES.

A. Qwest's Total Service Long Run Incremental Cost (TSLRIC) studies identify the *forward looking, long run* incremental costs that are *directly caused* by offering a service or group of services. The description used in Qwest's cost studies for TSLRIC is *Total Direct* costs. The assumptions, methods, and procedures used in Qwest cost studies are designed to yield the long run forward-looking *replacement* costs of reproducing the telecommunications network, considering the most efficient *least cost* technologies currently available.

Q. DO THE QWEST STUDIES FOLLOW THE FUNDAMENTAL PRINCIPLE OF COST CAUSATION?

A. Yes, as discussed in the testimony of Dr. William E. Taylor[2], Qwest TSLRIC studies follow the important principle of cost causation. If the establishment of a service causes an investment to be made, or an expense to be incurred, these costs are included in the study for the service. When costs are incurred because of a service they are considered to be caused by the service.

[2] Rebuttal Testimony of Dr. William E. Taylor at 15.

TSLRIC COST CATEGORIES

Q. HOW ARE COSTS DISPLAYED IN THE TSLRIC STUDIES THAT QWEST IS FILING IN THIS PROCEEDING?

A. The Qwest TSLRIC studies filed in this proceeding identify costs on a unitized basis (e.g., per minute of use, or per circuit) and disaggregate the cost results into the following cost categories: Total Direct Costs, and Network Support Costs[3].

Q. PLEASE DEFINE "TOTAL DIRECT COSTS."

A. *Total Direct Costs* are the forward-looking costs that are caused by offering the service in the long run. These costs would not be incurred if the service were not offered. *Total Direct Costs* reflect the per-unit forward looking cost associated with providing the entire service in the most efficient manner, holding constant the production of all other services produced by the firm. In a recurring cost study, *Total Direct Costs* include the capital costs (e.g., depreciation, cost of money, income taxes) and maintenance costs associated with the investment required to provision a service, along with other service-specific costs such as product management expense.

Total Direct Costs are equivalent to the Total Service Long Run Incremental Cost (TSLRIC) of a service.

[3] The cost studies also include categories of "Attributable" and "Common"that are provided as comparative information to TELRIC studies that have those additional indirect allocations. The term "Fully Allocated" is used to describe the summation of Direct, Network Support, Attributable, and Common costs.

Q. PLEASE DEFINE "NETWORK SUPPORT COSTS."

A. *Network Support Costs* include network administration and engineering costs. These costs are not directly associated with a single service, but are generally caused by the provision of a group of services.

USE OF TSLRIC DATA

Q. HOW SHOULD TSLRIC DATA BE USED?

A. The information provided in the Qwest TSLRIC studies should be used as one input in the pricing process. For example, as discussed in the testimony of Dr. Taylor, a service is considered as not *receiving* a subsidy, if the price of the service is at or above its Direct Cost, or TSLRIC. Therefore the Direct Cost should be used as a *price floor* of a service. On the other hand, from the perspective of Qwest's long term financial viability, all costs- incremental and historical, need to be recovered.

While the TSLRIC may be useful in determining whether the direct revenues from a service cover the direct costs, TSLRIC by itself does not provide any information as to whether the service covers its proportionate share of shared costs (i.e., network support), or the contribution required from services to allow a fair return on its fair value rate base. The level of recovery of these costs should be based upon market demand and other factors, as discussed by other Qwest witnesses, in determining actual prices.

Q. WOULD YOU PLEASE CLARIFY THE PURPOSE OF THE TSLRIC STUDIES?

A. The purpose of TSLRIC studies is to provide information to be used as a price floor for retail services. My earlier testimony discussed the use of TSLRIC to avoid cross-subsidies. Said a different way, in a competitive environment, if one provider were to price its retail services below TSLRIC for a substantial period of time, other providers could find it difficult to compete. Therefore, the TSLRIC of the services provides the minimum level that prices should be set in a competitive market.

REBUTTAL OF MR. DUNKEL

A. COST VS. COST RECOVERY

Q. DO YOU HAVE SOME GENERAL OBSERVATIONS ABOUT MR. DUNKEL'S TESTIMONY?

A. Yes. *Costs* are the cash outlays Qwest incurs to provide a service. *Cost recovery* or price is the cash inflow Qwest receives for providing the service. Mr. Dunkel frequently confuses these two simple concepts. With a normal commercial transaction, customers are charged a price for *what* they use, not *how* they choose to use it. *What* price they are charged is based on the supplier's cost of providing the service. My expectation as a consumer, is that if I purchase a service I expect to be charged based on the supplier's cost, not

charged based upon how I choose to *use* the service. For example, I buy gasoline at a given price regardless of whether I have a compact car or a sport utility vehicle, regardless of whether I use the fuel to commute to work or to go on a vacation. Mr. Dunkel's view is apparently that prices should be based not on what customers receive when they are provided access to the network, but rather on how customers choose to use that access.

It is generally accepted that the ***cost*** of the loop does not vary with the ***use*** of the loop (i.e., using it to place local calls, intrastate long distance calls, or interstate long distance calls does not change the cost of the loop). If the cost does not change based upon usage, it is illogical to have the rate design based on prices that recover the non-usage based cost on usage services. To do so creates numerous economic disincentives and practical problems, as explained in the testimony of Dr. Taylor.

Q WHAT ARE THE DETERMINANTS OF THE COST OF THE LOOP?

A. Loop costs do vary. They vary by the number of customers and the location of the customers. In other words, loop costs are determined by (1) the length of the loop from the central office to the customer location; and (2) the number of customers that are located in proximity with one another. In industry terminology these two determinants are referred to as distance and density. The common characteristic of these two determinants is that they are related to where **customers** are, not how the customers use the loop.

B. THE COST OF THE LOOP IS NOT A SHARED COST

Q. MR. DUNKEL DISCUSSES HIS VIEW THAT THE COST OF THE LOOP IS A SHARED COST. IS THIS VIEW CORRECT?

A. It is not correct. As Dr. Taylor explains, economically proper cost analysis attributes the costs ***caused*** by the service to that service. Causation of costs must be viewed from the perspective of the supplier, (in this case Qwest), not viewed from the perspective of the consumer. Mr. Dunkel's conclusion that the loop is "shared" comes from the perspective of the consumer. Mr. Dunkel's view of the loop cost as "shared" is based on the faulty notion that because customers may ***use*** the loop for multiple services, the loop facility should be considered a shared cost. In fact, when Mr. Dunkel uses the term "shared", he really means "shared *use*"[4].

As explained by Dr. Taylor, *Service-specific fixed costs* are those associated with the supply of a particular service. A firm supplying *any* level of that service would incur these costs, but would avoid those costs altogether by ceasing production of the service. TSLRIC studies include service-specific fixed costs. The loop is a service-specific fixed cost. The cost of the loop is associated with the service of supplying network access to the customer. Access to the network is the first service generally provided to Qwest's customers. Once a customer has access to the network, the customer has the choice of how to use the network, when to use the network, or whether to not use the network.

The customer's request, or anticipated request, for ***access*** to Qwest's network is the reason that Qwest incurs the cost of constructing and placing the loop[5].

[4] See Dunkel Rate Design; Direct, p.40, Line 10.
[5] Mr. Dunkel's view is that the investment decision "...was directly made by a telephone executive"(Direct, p.47, l.

Regardless of the intent of the customer to use the line only for incoming calls, only for outgoing calls, only for Internet access, or only in case of emergencies, the cost is not attributable to other actions of the customer, or **shared** by other services. For example, Customer A could use the loop for all of these services and Customer B could only use it for only incoming calls, and the cost of their respective loops would not change. Since Qwest would not incur any more loop cost for Customer A, nor any less loop cost for Customer B, attributing the cost of the loop to the customer's usage based services is not cost causative and should not be treated as such in TSLRIC studies.

Q. MR. DUNKEL APPEARS TO BELIEVE THAT THE COST OF THE LOOP SHOULD BE RECOVERED FROM VARIOUS USAGE BASED SERVICES AS A SHARED COST. WOULDN'T THE EFFECT OF THIS VIEW HAVE THE SAME RESULT AS ALLOCATING THE LOOP COST TO VARIOUS USAGE BASED SERVICES?

A. Yes. Arbitrary recovery of the loop cost from usage based services has the same result as arbitrary allocation of the loop cost to, and recovering it from, those services. Either way, it is economically incorrect. As explained in Dr. Taylor's testimony, allocation of the loop cost (or cost recovery) would not appropriately reflect cost-causation of the services. Because it does not properly reflect cost-causation it would provide improper cost floor information for the Commission. As I have said, the fundamental principle that is used in TSLRIC studies is to base the costs on cost-causation.

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9), based on a desire to obtain revenues. If there was no expectation of the executive to obtain revenue from the customer, the cost would not have been incurred.

Q. IN ELABORATION OF THE ECONOMIC CONCERNS, IS THERE A PRACTICAL EXAMPLE OF THE PROBLEM WITH RECOVERING A SIGNIFICANT NON-USAGE COST ON A USAGE BASIS?

A. Yes. When a significant non-usage cost such as the loop is recovered primarily from usage based services, high usage customers could easily pay more than the cost Qwest incurs to provide them the loop. This creates the perception by the customer that his cost is higher than it actually is. In a competitive market, an alternative facility based supplier of loops could propose a cost to the customer that appears to be lower, but in actuality, may be higher than the cost Qwest incurs to provide the loop for that customer. Because the customer is charged on a usage basis for the loop from Qwest, the customer may make the choice to move his service to Qwest's competitor, thereby stranding the loop originally provided. If this customer choice were made because the competitor's loop was actually less costly, the result is expected and reasonable in a competitive market. However, if the competitor's loop was more costly and the decision was made solely on the customer's perception of the usage price, then the result is improper and should not occur.

C. NETWORK ACCESS IS A SEPARATE SERVICE BUNDLED WITH BASIC SERVICE USAGE

Q. HOW SHOULD THE COSTS OF BASIC SERVICE BE VIEWED?

A. The costs of Basic Service should be viewed as consisting of two services, access and usage. The act of providing access to the customer is the cause of

the loop cost, so that cost should be attributed to network access. Network access is an element of basic service, residential and business. Flat rated basic residential service bundles network access with an assumed level of local usage. Therefore, while not always obvious, residential basic service is comprised of network access and local usage. An examination of the current local business service tariff and the Low Use Option clearly identify these two components and are good illustrations of the true nature of local service.

Qwest's Exchange and Network Services Tariff, 5.2.3 Dial Tone Line provides the following description:

> The term "dial tone line" applies to certain individual business lines. This service entitles customers to **access** the telecommunications network for a stipulated monthly charge. (Emphasis added.)

The business customer is charged the dial tone rate plus an additional rate for usage[6]. This structure represents the true nature of the basic service when it is bundled as network access plus local usage. Qwest's TSLRIC studies reflect these same components for basic service. The Low Use Option has a similar rate structure to basic business. There is a flat monthly charge plus a charge per message completed. The monthly charge is related to the network access provided to the customer, and the message charge is related to the use of the network.

The "network access plus usage" view of basic service is comparable to the view of network access plus Qwest's long distance usage. The customer pays for

[6] This tariff structure is proposed to be collapsed into one rate element in this proceeding, but nevertheless illustrates the concept of two separate services that are bundled together for residential service.

access to the network, and then chooses to make long distance calls on the network.

Staff, as represented by Mr. Dunkel, has accepted the proposal to bundle network access and usage for business rates.[7] In addition, Mr. Dunkel has endorsed the "network access plus usage" view of basic service for Low Use customers.[8] By endorsing these rate structures, Mr. Dunkel has endorsed the "network access plus usage" view of basic service. It is inconsistent for Staff to endorse the "network access plus usage" view as appropriate for rate design, but disagree when that same view is used in Qwest's TSLRIC studies.

Q. HAS THE FCC PROVIDED SUPPORT FOR THE ISSUE OF VIEWING LOCAL SERVICE AS COMPRISED OF THE TWO COMPONENTS OF NETWORK ACCESS AND LOCAL USAGE?

A. Yes. In its First Report and Order on Universal Service the FCC examined the services eligible for federal universal service support. The FCC took this same view of **access to** and **use of** the network in its decision on Universal Service[9]. The FCC stated, "We find that both access to and use of the public switched network at rates that are 'just, reasonable and affordable,' are necessary to promote the principles embodied in section 254(b)(1)[10]" [of the Telecom Act of 1996].

In addition, in its First Report and Order the FCC states:

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[7] Dunkel, page 78.
[8] Dunkel, pages 67-69.
[9] Although the FCC calls access to these Technically,
[10] First Report and Order, CC Docket 96-45, Released May 8, 1997, at 66.

> Incremental costs are the additional costs (usually expressed as a cost per unit) that a firm will incur as a result of expanding the output of a good or service by producing an additional quantity of the good or service. Incremental costs are forward-looking in the sense that these costs are incurred as the output level changes by a given increment. The costs that are considered incremental will vary greatly depending on the size of the increment. For example, the incremental cost of carrying an additional call from a residence that is already connected to the network to its end office is virtually zero. **The incremental cost of connecting a new residence to its end office, however, is the cost of the loop....**[11] (Emphasis added.)

D. FLAT RATE RECOVERY OF LOOP COSTS

Q. WHY IS IT APPROPRIATE TO RECOVER THE COST OF A LOOP FROM BASIC EXCHANGE SERVICES?

A. As has been discussed, the cost of a loop does not change with usage. Qwest incurs the cost to construct a line or loop and connect it to the customer. Once this is done, except for maintenance, there is no additional cost. However, Qwest is entitled to recover its investment in providing this connection. Traditional cost studies use an amortization method of recovering the loop cost over its depreciable life, and earn a fair return on the un-depreciated investment and other related costs until the investment is recovered. This amortization, not unlike a payment on a loan, results in a constant amount of cost recovery per month. Appropriate recovery of this flat-per-month cost is through a flat-charge to the customer per-month. This is the cost recovery method that is used for local service and other basic services. For example, if a customer subscribes to

[11] First Report and Order, CC Docket 96-98, 95-185, Released August 8, 1996, at 675.

Low Use Option service, the customer is charged a flat-rate per month plus a charge per message[12] for the use that is made of the network. If the customer subscribes to flat residence exchange service, an assumed level of use is charged, along with per-line-per-month charge for the loop. The cost related to both Low Use service and flat basic service is nearly identical except for usage quantity. There is no *allocation* of the loop to basic exchange service, the cost of the loop is the entire direct cost of providing network access that is bundled into basic residential exchange services.

Q. HAS THE FCC PROVIDED INFORMATION THAT SUPPORTS FLAT RATE RECOVERY OF THE LOOP COST?

A. Yes. In its First Report and Order, the FCC stated:

> Most loop costs are associated with a single customer. Outside plant between customer's premises and ports on incumbent LEC switches is typically either physically separate for each individual customer, or has costs that can easily be apportioned among users. **We therefore conclude that costs associated with unbundled loops should be recovered on a flat-rated basis.** Usage-based rates for an unbundled loop would most likely translate into usage-based rates for new entrant's retail local customers. **A retail usage-based rate would distort incentives for efficient use.** Customers that had to pay a usage charge would have an incentive not to use the network in situations where the benefit of using the network exceeds the true cost of using the network. Usage-based loop prices would put an entrant at an artificial cost disadvantage when competing for high-volume customers.[13] (Emphasis added.)

[12] The message charge is proposed to change to a per minute charge, but is still usage based.
[13] First Report and Order, at 789.

Recovering the cost of the loop from usage based services, as proposed by Mr. Dunkel[14], has the same effect as having usage-based loop prices, putting Qwest at an artificial cost disadvantage, especially when competing for high-volume customers.

E. INTERSTATE RATE BASE ALLOCATIONS

Q. DO YOU AGREE, AS MR. DUNKEL STATES, THAT THE SUPREME COURT AND THE FCC REQUIRE JURISDICTIONAL ALLOCATION OF THE LOOP FOR SEPARATIONS PURPOSES?

A. Yes. U. S. Supreme Court decisions and FCC rules require that under rate base rate-of-return, accounting revenue requirements need to recognize the two separate regulatory jurisdictions (interstate and intrastate). Qwest has followed those requirements in its revenue requirement filed in this proceeding. For the historical loop investment, 25% has been allocated to the interstate jurisdiction pursuant with the FCC's rules. This 25% has been subtracted from Qwest's total historical accounts leaving the intrastate accounting amounts for consideration by this Commission.

Q. SHOULD THE SAME 25% ALLOCATION PROCESS BE USED FOR TSLRIC STUDIES?

A. No. The Separations process is a mechanism to determine historical costs for each of the two jurisdictions that regulate Qwest's prices: interstate-FCC and intrastate-ACC. Economic costs are determined independently of the regulatory

[14] See for example, Mr. Dunkel's discussion of IntraLATA toll service, p. 84.

jurisdiction in which the service happens to fall. Prices for interstate services provide recovery for the interstate revenue requirements, as I have explained above. This regulatory mechanism for recovery of interstate revenue requirements should not be confused with the identification of economic forward looking costs. Certain interstate rates can be viewed as providing contribution toward recovery of the economic cost of the loop and should be considered in a contribution analysis to properly reflect cost recovery and thereby address the issue of "double recovery" raised by Mr. Dunkel.

F. STATE COMMISSION DECISIONS

Q. MR. DUNKEL QUOTES SEVERAL STATE COMMISSIONS THAT HAVE FOUND THAT THE LOOP COST SHOULD BE ALLOCATED TO USAGE SERVICES. SHOULD THE ARIZONA CORPORATION COMMISSION BE SWAYED BY THESE DECISIONS?

A. No. The state commission decisions quoted by Mr. Dunkel, with one exception[15], were all rendered prior to the Telecom Act of 1996: Utah – 1995, Iowa – 1989 and 1994, Washington – 1995, Colorado – 1987, and New Hampshire - 1991. The significance of these pre-Telecom Act decisions is that they were made in an environment that was more of a monopoly than today. The FCC quotes the Joint Explanatory Statement of the Committee of the Conference, explaining the intent of Congress in the Telecom Act, where "any support mechanisms continued or created under new section 254 should be explicit, rather than implicit as many

[15] The exception is Washington, April 1996 shortly after the passage of the Act. Another quote from the Indiana commission, October 1998, appears to address "takings" issues related to the 5th Amendment to the Constitution, rather than rate making issues as in this proceeding.

support mechanisms are today."[16] These pre-Telecom Act decisions have in common their reliance upon the notion of ***use*** of the loop as a basis for an equitable allocation of the loop cost.[17] The intent in each of these past decisions was to continue the universal service implicit subsidies in intrastate rates that rely upon a usage based allocation of the **non-usage** cost of the loop. Because of the changes required and created by the Telecom Act, these past views of recovery of the loop cost are antiquated.

REBUTTAL OF DR. JOHNSON

Q. DOES DR. JOHNSON DISAGREE WITH QWEST'S TSLRIC STUDIES FOR BASIC SERVICE?

A. Yes, Dr. Johnson takes the same view of the loop and port costs as Mr. Dunkel. He states that he believes that those costs are shared and should not be included 100% in TSLRIC studies for basic services.[18] He provides a discussion of this view and offers calculations that allocate the loop to services. The rebuttal testimony I provide for Mr. Dunkel's testimony is equally applicable in response to the testimony of Dr. Johnson on this subject and it is not necessary to repeat it.

[16] FCC Universal Service, First Report and Order, at 9.
[17] Utah "...use of toll services", Iowa "...which rely upon it", Washington "...use of that facility", Colorado "...used by all of these users".
[18] Dr. Johnson Rebuttal, page 50.

Q. DR. JOHNSON MAKES A POINT THAT THE TSLRIC STUDIES NEED TO BE COMPARED TO THE PROPER TYPES OF REVENUE. WHAT IS YOUR RESPONSE TO THIS PERSPECTIVE?

A. Dr. Johnson states that it is misleading to compare Qwest's TSLRIC study for basic exchange service to only basic exchange rates.[19] Based on Dr. Johnson's view of the loop as a shared cost, he disagrees with the fact that Qwest's TSLRIC studies did not "assign" loop costs to "other services that use the loop." As Dr. Taylor testifies, this proposed assignment is economically incorrect. In addition, since many of the services identified as "benefiting" from network access, are usage based services, Dr. Johnson's view of assigning the non-traffic sensitive cost of the loop to these services results in the incorrect matching of costs and cost recovery I discussed earlier in my testimony.

Q. IN HIS DISCUSSION OF SUBSIDY, DR. JOHNSON DESCRIBES A TSLRIC ANALYSIS THAT INCLUDES THE COST OF THE LOOP AND THE PORT. IS HIS DESCRIPTION CONSISTENT WITH THE DEFINITION OF TSLRIC?

A. No. As discussed by Dr. Taylor, TSLRIC is a study of an incremental cost where the increment of output in question is the total volume of a service, hence the first two words of the TSLRIC acronym are "Total Service".[20] Dr. Johnson states, "For example, one can meaningfully compare the incremental 'costs' of adding another residence customer to the network (including the cost of the loop and port) with the incremental revenues that will be generated by the presence of that customer." This is not a description of a TSLRIC study. TSLRIC quantities are

[19] Johnson page 52.

[20] This definition is also used by the Arizona Corporation Commission's Rules and Regulations, Section R14-2-1102 (17), "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."(Emphasis added.)

for the total volume of a service, not for one customer. His example is not useful and only acts to confuse the reader.

Q. DOES DR. JOHNSON APPEAR TO AGREE WITH THE VIEW THAT BASIC SERVICE IS A BUNDLE OF NETWORK ACCESS AND USAGE?

A. Yes. He appears to agree with that view, although he disagrees with the comparison of those costs to only exchange service revenue.[21] If my reading of his testimony is correct, then it seems that his issue is not necessarily with Qwest's TSLRIC studies, but rather with its comparison of revenues to the TSLRIC results. In essence, restated in my words, he seems to be emphasizing that the contribution from other services, (i.e., the excess of price over TSLRIC for those other services), be considered as recovering the cost of the loop. If this is an accurate portrayal of his view, I would not disagree that this is the current state of cost recovery for Qwest in Arizona. However, in the emerging competitive market, historic contribution levels from these services are at risk and are unlikely to be sustainable in the long run.

For example, retail prices for many long distance services have declined in the last few years.[22] All indications are that they will continue to decline rather than increase in the future. To the extent loop costs are expected to be recovered from long distance services, that expectation is unlikely to be sustainable for very long. For example, in this proceeding, AT&T is vigorously arguing for switched

[21] Dr. Johnson Direct, page 56.
[22] For example, see David L. Teitzel, Supplemental Direct Testimony page 42.

access rates that do not include any contribution toward recovery of the cost of the loop.[23]

REBUTTAL OF DR. ILEO

Q. DR. ILEO'S TESTIMONY STATES THAT QWEST'S PROPOSED RATES FOR PUBLIC ACCESS LINES ARE UNLAWFUL. DO YOU AGREE?

A. I do not agree. Like Dr. Ileo, I am not an attorney and the conclusion Dr. Ileo has reached is a legal conclusion for which I am unqualified to assess. However, I cannot find any evidence provided by Dr. Ileo that demonstrates how Qwest's rates for Public Access Line (PAL) services violate the law. He states that the PAL rates violate Section 276 of the Telecom Act, but I do not see any evidence presented by Dr. Ileo that supports that legal conclusion.

Q. HAS QWEST PROVIDED EVIDENCE THAT ITS PRICING PROPOSALS FOR PAL SERVICES COMPLY WITH SECTION 276 OF THE TELECOM ACT?

A. Yes, as discussed in the testimony of Mr. McIntyre, Qwest's proposed PAL rates fully comply with Section 276 of the Telecom Act and FCC Orders. Because Dr. Ileo did not provide specifics on how he thinks Qwest's rate proposals are unlawful, it is impossible for me to address his accusations. However, the primary issue raised by Dr. Ileo appears to center around the nature of subsidies because of his often used terms "unlawful subsidies".

[23] See Arlene Starr Direct Testimony pages 19-21.

Q. CAN YOU DETERMINE WHAT DR. ILEO BELIEVES IS A "SUBSIDY"?

A. Although I disagree that subsidy is an issue with PAL, from the context that Dr. Ileo's testimony is framed, it appears that he believes that any price above a TSLRIC plus common cost level is a "subsidy". I base this conclusion on the level of rates that he proposes, which is his version of TSLRIC plus common costs.

Q. IS THERE DISAGREEMENT WITH DR. ILEO'S APPARENT DEFINITION OF A "SUBSIDY"?

A. My understanding of the test of whether a service is *the source* of a subsidy is when a service is priced above its Stand Alone Cost (SAC). This view is discussed by Staff Witness Thomas Regan.[24] Mr. Regan states: "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." (Emphasis added). He further states: "Demonstrating that a service is priced above TSLRIC does not provide sufficient evidence of that service providing a subsidy to other services. Rather, a service must be demonstrated to be priced above its properly calculated Stand-Alone Cost, in order to demonstrate that the service is providing a subsidy to another service...". There appears to be significant disagreement between Mr. Regan and Dr. Ileo on this issue.

[24] Thomas Regan Direct Testimony pages 6-8.

Q. HAS DR. ILEO PRESENTED A STAND-ALONE COST STUDY TO DEMONSTRATE THAT PAL RATES PROVIDE A SUBSIDY?

A. He has not. While I have not had time to examine the adjustments he has proposed to Qwest's TSLRIC study for PAL,[25] nothing he has done could be described as a Stand-Alone Cost study.

Q. DO THE FCC'S RULES REQUIRE QWEST TO UNDERTAKE A STAND-ALONE COST STUDY?

A. No, on the contrary the FCC's rules only require that Qwest pass the FCC's "new services test"as its rules relate to PAL services. Dr. Taylor provides background on this issue. Mr. McIntyre's testimony provides details on Qwest's analysis of this test, but testimony provided by Staff witness Steven V. Le in Docket No. T-01051B-97-0024 ET AL stated:

> As discussed earlier, the FCC's later Orders interpreting the new services test appear to indicate that a range of rates would meet the test. The FCC in its Orders has approved rates under the test between and including zero times direct cost and 4.8 times direct cost as "reasonable".

Q. DOES QWEST'S RATE PROPOSAL FOR PAL SERVICE IN THIS PROCEEDING MEET THIS RANGE OF REASONABILITY?

A. Yes. Based on the information provided by Mr. McIntyre, Qwest's price proposal for PAL services meet this test.

Q. SO, DR. ILEO HAS NOT PROVIDED ANY EVIDENCE THAT QWEST'S PAL RATES ARE UNLAWFUL, HE HAS NOT SUPPORTED HIS INTERPRETATION

[25] Due to the short interval between receipt of Dr. Ileo's Direct Testimony and the date this testimony is required to be filed, I was unable to assess the validity or reasonableness of Dr. Ileo's adjustments. I reserve the opportunity to comment on those adjustments in later rounds of testimony.

OF THE TELECOM ACT REQUIREMENTS, HE HAS PROVIDED NO EVIDENCE OF A SUBSIDY IN THE PROPOSED PAL RATES, AND HE HAS NOT DEMONSTRATED THAT THE PROPOSED RATES FAIL TO MEET THE FCC'S NEW SERVICES TEST. WHAT THEN IS LEFT FOR DR. ILEO TO ARGUE?

A. All that is left is that his clients appear to believe that their rates are too high and that their rates should not be set to recover levels of direct, common, shared and embedded costs that are comparable to that provided by other retail services. Even though the ratio of proposed PAL rates to TSLRIC plus common costs is far less than half of some other services such as Caller ID- Number or Last Call Return, Dr. Ileo proposes rates equal to direct costs or below. The argument presented by Dr. Ileo is that PAL rates should be given preferential treatment over other retail services by dramatically reducing (if not eliminating) contributions over direct cost for PAL services. This is not good public policy and could potentially result in accusations of discrimination by consumers of other services.

Q. DR. ILEO REQUESTS THAT THE COMMISSION CLARIFY THE CALCULATION OF ITS DECISIONS IN THE GENERIC COST DOCKET. IS THERE ANY REASON THAT THE COMMISSION SHOULD DO WHAT DR. ILEO REQUESTS?

A. No. Dr. Ileo has not demonstrated any reason that the Commission should go to through this burdensome task. The information he hopes to attain from this obtrusive investigation would only allow him to further adjust Qwest's TSLRIC studies. There is no reason for these adjustments. There is already evidence

that Qwest has passed the test. The Generic Cost Docket took months to complete with hundreds, if not thousands of pages of testimony, with multiple cost analyses, and exhibits. It would unjustly delay this proceeding for the Commission to put together this information, then require Qwest to attempt to re-create the Commission's decision using its cost models only to provide Dr. Ileo with information that is irrelevant.

REBUTTAL OF MS. STARR

Q. MS. STARR CRITICIZES QWEST FOR OVERSTATING ITS COST STUDIES. ARE HER CRITIQUES VALID?

A. Ms. Starr faults Qwest's Switched Access cost study for several reasons. None of these reasons are valid. Ms. Starr points out that the cost of money used in Qwest's cost studies is higher than what the Commission ordered in its last rate case. This should hardly be a surprise to Ms. Starr due to the fact that Qwest is proposing a new forward-looking cost of money in this proceeding. This proceeding is the appropriate place for Qwest to recommend a different cost of money. If the Commission selects a different cost of money than that proposed by Qwest, then a different cost of money may be appropriate in Qwest's TSLRIC studies. Ms. Starr criticizes the use of Annual Cost Factors. Annual Cost Factors are commonly used to apportion indirect costs. They are justly intended to increase costs and are most often applied to investment determined costs as those costs are primarily direct costs. Ms. Starr's criticism is misdirected. Another criticism is that Qwest's cost studies have not excluded exchanges that it has proposed to sell to Citizens Utilities. The sale of these exchanges has not been approved by the Commission or the FCC. Until the sale is closed and final

it would be inappropriate for Qwest to reflect the sale of the exchanges and potentially lower its price floor for its retail services prematurely.

Ms. Starr states that "the most disconcerting issue" she has with Qwest's switched access cost studies is that the difference between Qwest's proposed price and its costs is too high. Technically this is not a criticism of Qwest's costs as it is a complaint about its proposed prices. However, Ms. Starr recommends that no mark-up over TSLRIC be allowed by the Commission. It is unclear whether this recommendation is for all services or just switched access – which is the set of services referenced in her testimony. Nevertheless, this is a reckless recommendation at worst, and a self-serving recommendation at best. If it is a recommendation for all of Qwest's services, then there would be little hope for Qwest to even come close to achieving a reasonable return on its fair value rate base from this proceeding, because forward-looking theoretical costs are not a surrogate for Qwest's fair value rate base. If, on the other hand, Ms. Starr is recommending that Qwest's rates for switched access recover no mark-up for shared, common, or embedded costs, then that recommendation is unreasonable and self-serving. Switched access rates should provide a reasonable level of recovery of direct, shared, common and embedded costs like any other service provided by Qwest.

CONCLUSION AND RECOMMENDATION

1 **Q. WHAT IS YOUR CONCLUSION AND RECOMMENDATION TO THE**
2 **COMMISSION?**
3 A. The testimony and analysis of Qwest's cost studies by the various parties are
4 incorrect and misleading. The loop provides a customer access to Qwest's
5 network. The customer may or may not use the loop for other services offered
6 by Qwest. Regardless of how the customer uses the loop, the cost of the loop
7 does not change. This fact is agreed upon in the industry, and is consistent with
8 mainstream economic principles. The cost of the loop is insensitive to usage.
9 The loop cost is incurred when and if the customer requests service. If the
10 customer chooses not to have access to the telephone network, Qwest would not
11 incur the cost of the loop. Mr. Dunkel's testimony attempts to refute these very
12 simple facts. He attempts to confuse the Commission by saying that if the
13 customer uses the loop for other services then the cost of the loop is a joint cost
14 that should be shared among services. This is incorrect. Services are not
15 allocated among other services. The cost of network access is the cost of the
16 loop. Network access, with local usage, is bundled in the service known as basic
17 exchange service.
18
19 Mr. Dunkel and Dr. Johnson believe that the loop cost is shared and recommend
20 that the cost of the loop be recovered from all services such as long distance,
21 switched access and public access lines. In contrast, Dr. Ileo believes that the
22 loop is not shared but recommends that public access line rates make no
23 contribution to Qwest's overall revenue requirement above his version of forward-
24 looking costs. Likewise, Ms. Starr believes the loop is not attributable to

switched access and recommends that switched access make no contribution to Qwest's revenue requirement above forward-looking costs.

Alternatively, Qwest recommends that its TSLRIC studies are reasonable estimates of its price floors for its services. As my rebuttal testimony reflects, none of these parties has proven their cases and therefore their recommendations should be disregarded. My recommendation to the Commission is to accept Qwest's revised costs as listed in my Supplemental Testimony for consideration of price floors for rates considered in this proceeding.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

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 APPPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN.	)	**DOCKET NO. T-1051B-99-105**
STATE OF COLORADO	)	**AFFIDAVIT OF Jerrold L. Thompson**
COUNTY OF DENVER	)	**ss**

I, Jerrold L. Thompson, of lawful age being first duly sworn, depose and states:

1. My name is Jerold L. Thompson. I am the Executive Director-Service Cost Information for Qwest Corporation ("Qwest") (formerly U S WEST Communications Inc.) in Denver, Colorado. I have caused to be filed written testimony and exhibits in support of Qwest in Docket No. T-01051B-99-0105

2. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct to the best of my knowledge and belief.

Further affiant sayeth not.

Jerrold L. Thompson

SUBSCRIBED AND SWORN to before me this 17th day of August, 2000.

Maija Beck
Notary Public residing at
Denver, Colorado

My Commission Expires: May 8, 2004

BEFORE THE ARIZONA CORPORATION COMMISSION

EXHIBIT

Q-30
Admitted

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-01051B-99-0105

REBUTTAL TESTIMONY OF

GEORGE REDDING

QWEST CORPORATION

AUGUST 21, 2000

REBUTTAL TESTIMONY OF GEORGE REDDING

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SUMMARY OF REBUTTAL TESTIMONY

With the number of adjustments and issues raised in any general rate case, it is easy to become so involved in the details that the primary purpose of the revenue requirement requested is overlooked or ignored. The purpose of any properly adjusted test period is to produce a revenue requirement that will allow the Company the opportunity to achieve the requested rate of return in the future when rates from the proceeding will be in effect.

Qwest has tested the validity of this purpose by overlaying the suggested revenue requirements of the Company and Staff and the deficiency of RUCO on future results based on actual year to date May 2000 results. The revenue requirement developed by the Company will yield almost exactly the requested return, while those of Staff and RUCO miss the mark completely.

My rebuttal testimony then addresses the individual adjustments proposed by Staff, RUCO, AT&T and DOD/FEA. Chief among these is the end of period annualization adjustment. Staff and RUCO spend a great deal of time attempting to show that the Company's adjustments are unreasonable. My response is the same as for the overall revenue requirement; test the adjusted results against the future. I have done this and again show that Staff and RUCO miss the mark.

I then discuss other adjustments, including the proposed treatment of software capitalization, out of period wages, removal of access line sales and image advertising. All of these adjustments are significant and in error for various reasons that I discuss in detail. I also discuss a number of other adjustments and their rationale. Finally, I discuss the adjustments proposed by AT&T and DOD/FEA, which are ill conceived.

After my review of all of the proposals of the other parties, my conclusion remains the same; the Company has an approximate $200M revenue requirement over and above that produced by current operations. My test of this requirement against 2000 results only confirms the appropriateness of this request. With a few exceptions, the adjustments of the other parties should be set aside and the Company position accepted.

IDENTIFICATION OF WITNESS

Q. PLEASE STATE YOUR NAME, TITLE, EMPLOYER AND ADDRESS.

A. My name is George Redding. I am employed by Qwest Corporation as Director-Regulatory Finance. My address is 1801 California, Denver, Colorado.

Q. ARE YOU THE SAME GEORGE REDDING WHO FILED DIRECT AND SUPPLEMENTAL TESTIMONY IN THIS PROCEEDING?

A. Yes, I am.

Q. U S WEST HAS UNDERGONE A NAME CHANGE SINCE YOU LAST FILED TESTIMONY IN THIS PROCEEDING. HOW WILL YOU REFER TO THE FORMER U S WEST IN YOUR REBUTTAL TESTIMONY?

A. The regulated telecommunications subsidiary of Qwest Communications International, Inc. (formerly U S WEST, Inc.) is now Qwest Corporation. Qwest Corporation is the new name of the former U S WEST Communications, Inc. In my testimony I will refer to the former U S WEST Communications, Inc. as Qwest or the Company.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. My rebuttal testimony will clearly show that the positions taken by other parties in this case do not achieve the purpose of a properly constructed test period. Their suggestions of a revenue requirement or deficiency will not allow Qwest to earn the rate of return that they suggest is appropriate in the development of their revenue requirement or deficiency. The fault in their reasoning is their misguided approach to the determination of a revenue requirement through the use of imputations, improper adjustments, overly detailed dissection of the Company's adjustments and losing sight of the purpose of the test period. I will discuss all of these matters.

Q. HOW IS YOUR REBUTTAL ORGANIZED?

A. First, I will review the purpose of an appropriately adjusted test period. Then, I will demonstrate that the suggested revenue requirement proposed by Staff and the deficiency proposed by RUCO will not achieve the purpose of the test period. Then, I will discuss many of the adjustments proposed by Staff and RUCO in detail. Finally, I will rebut the revenue requirement testimony of AT&T witness Gately and DOD witness Lee.

PURPOSE OF THE TEST PERIOD

Q. WHY ARE YOU REVIEWING THE BASIC THEORY OF THE DEVELOPMENT OF THE TEST PERIOD?

A. In the flurry of activity to understand the myriad adjustments and differing views regarding those adjustments, it is easy to overlook the fundamental purpose of the test period and whether the revenue requirement satisfies that purpose. If the test period is properly developed, then the resulting revenue requirement, when applied to the period when rates from the case will be effective, should produce approximately the same rate of return as that found appropriate. I will test for this expected outcome by overlaying the revenue requirements of the Company, Staff and RUCO on that future period when rates would go into effect. However, I think it is first essential to review authoritative literature regarding the purpose of the test period.

Q. WHAT IS THE BASIC REGULATORY THEORY OF THE RATEMAKING PROCESS?

A. In a nutshell, it is the process under rate of return regulation through which the cost of providing service is established to properly set rates for the future. It is <u>prospective</u> in nature. New rates can only be set for the future. The objective is that the rates granted in a case will permit the Company to cover its cost of service in the future and allow an opportunity to earn a fair rate of return in the future.

Q. WHAT ARE THE BASIC FINANCIAL ELEMENTS USED TO DEVELOP A REVENUE REQUIREMENT?

A. As stated, the purpose of the ratemaking process is to set rates for the future. With this in mind, the first, and most important, financial element is the selection of the test year and its development into a test period.

Q. UNDER TRADITIONAL RATE OF RETURN REGULATION, WHAT IS THE PURPOSE OF THE TEST PERIOD?

A. The purpose of the test period is to estimate, to the best extent possible, the conditions that will exist when rates from this proceeding will go into effect.

Q. YOU SAY ESTIMATE. ISN'T THE TEST PERIOD BASED ON ACTUAL RESULTS?

A. Yes, it is. However, since the test period is attempting to simulate conditions that will exist when rates go into effect, it is also a forecast. As so succinctly stated by Hahne & Aliff in their text, Accounting for Public Utilities: "[T]he test period necessarily assumes the posture of a projection of future events when it is used to set future rates."[1] The authors go on to state:

> The idea that historic data express factual conditions has sometimes led to the conclusion that those data are the most reliable data available for estimating future conditions. The factual nature of the events as recorded has apparently imbued the data with a degree of soundness and quality that appears to exceed a forecast approach for test year purposes. When conditions are in a state of change, historic results are likely to be the most unreliable of the sources of test period data as a basis for measuring future rate needs.[2]

[1] Robert L. Hahne & Gregory E. Aliff, Accounting for Public Utilities 7-4 (1995).

In a 1975 article, while serving as Chairman of the New York Public Service Commission, Dr. Alfred Kahn wrote:

> No tradition in public utility regulation is more sanctified than the use of an historic test period. Since the purpose of the exercise is to set rates for the future, the parties try in various ways to adjust the 'test year' experience for later, 'known changes' . . . . The system works moderately well, as long as the period during which the new rates are in effect is not dramatically different from the test period. . . . The fact is . . . regulatory commissions have always been in the business of projecting, whether they knew it or not. When they used historic test year statistics, fully verifiable and verified, graven in stone, as the basis of future rates, they were in fact projecting. They were assuming that the future would be similar to the past. It is no more speculative, then, to make the best possible estimate of future costs when setting future rates; and honesty compels it.[3]

Q. IN ADDITION TO SELECTION OF THE TEST YEAR, WHAT ARE THE OTHER ASPECTS OF CREATING A TEST PERIOD?

A. As stated in the definition of the test period earlier in my testimony, the test year provides the foundation. The next step is to restate the test year data to be reflective of the conditions when new rates are expected to be in effect. This is accomplished through the test period adjustment process.

Q. WHY ARE ADJUSTMENTS SO IMPORTANT?

A. Again I refer to Hahne & Aliff:

> Even in stable conditions, historic data will likely require restatement for actual occurrences not expected to recur or for events that are expected to occur but did not exist (in whole or in part) in the test year.[4]

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[2] *Id* at 7-5.
[3] Alfred Kahn, *Between Theory and Practice: Reflections of a Neophyte Public Utility Regulator*, Public Utilities Fortnightly 29 (Jan 2, 1975), quoted in Hahne & Aliff, *supra* at 7-3.
[4] *Id.* at 7-7.

Q. WHAT TYPES OF ADJUSTMENTS DID YOU MAKE TO THE TEST YEAR IN THIS CASE?

A. I made three types of adjustments. They were accounting adjustments, commission adjustments and pro forma adjustments.

Q. PLEASE DESCRIBE ACCOUNTING ADJUSTMENTS.

A. Accounting adjustments are entries made during the test year that apply to other periods, or entries made outside the test period which affect the test year. The classic example of an accounting adjustment is a tax true-up, which is booked in one period, but is applicable to a prior period. These adjustments are made to reflect the test period as it would have been in a perfect world. Due to Qwest's use of an end of period annualization adjustment of revenues and expenses, there were relatively few of these adjustments that were made outside the normalization and annualization method used in this filing.

Q. WHAT ARE COMMISSION ADJUSTMENTS?

A. They are adjustments made by the Commission in prior rate cases.

Q. COULD YOU PLEASE TURN TO PRO FORMA ADJUSTMENTS AND DESCRIBE THEM?

A. Certainly. Pro forma adjustments are known and measurable changes that occur either within the test year or outside of it. The purpose of pro forma adjustments is to make the test period more representative of the future when the new rates determined in a proceeding will be in effect. Garfield & Lovejoy in their book Public Utility Economics, have the following to say regarding pro forma adjustments:

> The commission, in making rates, presumably does so for an indefinite period into the future. However, in order to do so, the commission must rely upon the record of costs of service in a 'test period' . . . which is usually the latest 12 months for which there are complete data. Consequently, future rates are made on the basis of past costs. Of course, 'known changes' - occurring after the test period - usually are taken into consideration by commissions in order to make the test year data as representative as possible of the cost situation that is apt to prevail in the future.[5]

Other authors, such as Hahne & Aliff, make similar points regarding pro forma adjustments. For example, they state:

> For many years, regulators relied primarily upon historic test year data with proforma adjustments to recognize known and measurable changes in the events as recorded . . . . They have recognized that test period data must be structured to accommodate the future, because the future will not develop to accommodate test period assumptions.6

Charles Phillips adds:

> Philosophically, the strict test year assumes the past relationship among revenues, costs, and net investment during the test year will continue into the future. To the extent that these relationships are not constant, the actual rate of return earned by a utility may be quite different from the rate allowed by the commission. For many years, commissions have adjusted

[5] *Id.* at 45-46.
[6] Hahne & Aliff, *supra* at 7-4.

test-year data for "known changes:", i.e., a change that actually took place during or after the test period.[7]

Q. DO THE PRO FORMA ADJUSTMENTS REFLECTED BY QWEST FOLLOW THESE GUIDELINES?

A. Yes, they do. And, as I will demonstrate in my next section, the adjustments to the test year chosen by Qwest will allow the test period to fulfill its purpose.

THE FAILURE OF STAFF AND RUCO TO ACHIEVE THE PURPOSE OF THE TEST PERIOD

Q. WHAT WILL YOU ADDRESS IN THIS SECTION?

A. I will test the revenue requirements set forth by the Company and Staff and the deficiency set forth by RUCO against 2000 actual results to see if they fulfill the purpose of a properly adjusted test period. Again, if these revenue requirements were properly developed they should allow the Company an adequate rate of return when overlaid on 2000 actual results.

Q. HOW WILL YOU CONDUCT YOUR TEST?

A. I have received 2000 actual intrastate results through May. I will test the adequacy of the revenue requirements by adding the net operating income

[7] Charles F. Phillips, Jr., The Regulation of Public Utilities 182 (1985)

value of the parties' revenue requirement/deficiency to the year to date May 2000 results which I have annualized. If the recommended revenue requirement is adequate it should produce a return on investment similar to the return being advocated by the parties.

Results of the test are as follows:

$(000)	Qwest	Staff	RUCO
Net Operating Income (NOI) (YTD May 2000 Annualized)	$61,973	$61,973	$61,973
NOI Value of Revenue Requirement/Deficiency	117,976	4,261	(16,490)
Adjusted NOI	$179,949	$66,234	$45,483
Avg. Net Investment (May 2000)	$1,630,392	$1,630,392	$1,630,392
Return on Avg. Net Investment	11.04%	4.06%	2.79%
Recommended Rate of Return	10.86%	9.68%	9.51%

As the above charts show, the proposed effective net operating income proposed by Staff and RUCO would completely miss the mark of approximating the conditions that will be in effect when rates from this proceeding would go into effect. They will not provide sufficient revenues to generate the required rate of return.

Q. WHAT CONCLUSIONS DO YOU DRAW FROM THIS COMPARISON?

A. The Net Operating Income shown above demonstrates clearly that the Company needs the opportunity to achieve the full revenue requirement from

its filing to earn at adequate levels. Without any relief the Company is currently earning only a 3.8% return on its average net investment, which is inadequate. The revenue requirement proposed by Staff and RUCO's deficiency will clearly not bring the Company up to reasonable levels. If inadequate opportunity to achieve adequate levels of additional revenues are granted in this case, the Company will have to evaluate all of its options, including the possibility of another case. However, as the chart above demonstrates, this situation can be put to rest in this case by granting the opportunity to achieve additional revenues close to the Company's request.

DISCUSSION OF INDIVIDUAL ADJUSTMENTS

A. OVERVIEW

Q. HOW WILL YOU ORGANIZE YOUR DISCUSSION OF THE INDIVIDUAL ADJUSTMENTS?

A. I will first discuss the adjustments proposed by Staff and RUCO. Unlike DOD/FEA and AT&T, they engaged in a fairly rigorous development of a revenue requirement or deficiency. DOD/FEA and AT&T used a much more generalized approach which should be accorded less weight than Staff & RUCO.

Q. WILL YOU ADDRESS ALL OF THE FINANCIAL ADJUSTMENTS?

A. No. Ms. Ann Koehler-Christensen will address directory imputation. Mr. Dennis Wu will address depreciation issues. Mr. Phil Grate will address the pension asset and incentive compensation. I will address all remaining financial areas.

B. STAFF & RUCO

END OF PERIOD ANNUALIZATION

Q. WHAT IS YOUR OVERALL REACTION TO STAFF'S AND RUCO'S COMMENTS REGARDING THE COMPANY'S END-OF-PERIOD ANNUALIZATION METHODOLOGY?

A. My general reaction is that Staff and RUCO witnesses do not accurately portray the thoroughness of the Company's method and seem to avoid describing the multiple steps included in the method in an understandable manner. While these witnesses do eventually get around to acknowledging each of the steps at varying places in their testimony, they fail to describe the complete methodology employed by Qwest in any coherent, concise manner. Even an informed reader could misinterpret the Company's end-of-period methodology by reading only the statements of Staff and RUCO.

Q. COULD YOU PLEASE REVIEW THE PURPOSE OF AN END OF PERIOD ANNUALIZATION ADJUSTMENT?

A. The purpose is to remove some of the lag inherent in the use of a historic test year by, in essence, moving the historic test year forward by six months. Another purpose, in Arizona specifically, is to synchronize the test year. The rate base, due to the "fair value" requirement, is necessarily an end of period rate base. The end of period adjustment proposed by Qwest brings the revenues, expenses and taxes into line with the rate base.

Q. WOULD YOU PLEASE REVIEW THE COMPANY'S METHODOLOGY IN A SUMMARY MANNER?

A. Certainly. First, the Company's adjustment was not simple. As described below, it took a great deal of time and analysis.

The adjustment was performed in several steps. I will outline them again here:

- December results, by income statement line item, were first reviewed for any out of period, one time or other adjustments that would make the month of December abnormal. These items were then removed. In simple terms, December was adjusted to reflect normal recurring operating results.

- The normalized December, again by line item, was compared to the trend of that line item over the period of October 1999 to February 2000. If the normalized December results were out of line with this trend, then a trended value for that line item was developed and substituted for the normalized December.

- Finally, either the normalized December or the trended value was then multiplied by twelve to achieve an annualized result.

Q. PLEASE ADDRESS THE END OF PERIOD ANNUALIZATION AND THE COMMENTS MADE BY MR. BROSCH, MR. CARVER, MR. LARKIN AND MR. SMITH.

A. Certainly. Mr. Smith of RUCO removes the non-labor expense annualization with only a comment that it is not consistent with past Commission practice. Mr. Larkin, Mr. Brosch and Mr. Carver attempt to discredit the methodology used by the Company by glossing over the annualizations as merely taking the last month in the test year times twelve.

Both Mr. Brosch and Mr. Carver used phrases like "indiscriminate multiplication" (Brosch page 11) and "global end-of-period annualization" (Carver page 9) to mischaracterize the thoroughness of the Company's end-of-period annualization methodology.

However, both Mr. Carver and Mr. Brosch then acknowledge later in their arguments that Qwest's method of annualization does indeed involve more than a simple multiplication of December results times twelve.

Q. SEVERAL OF THE OPPOSING WITNESSES, MOST NOTABLY MR. BROSCH AND MR. CARVER, IMPLY OR DIRECTLY STATE THAT

QWEST'S ADJUSTMENT WAS PERFORMED AT TOO HIGH A LEVEL. HOW DO YOU ANSWER THAT CRITICISM?

A. An end of period annualization, by necessity, is an estimate. Estimates are not made more meaningful or accurate by being more "detailed" or "precise". In fact, the opposite can hold true. By digging into the detail it is easy to obfuscate the main purpose of estimating a reasonable test year revenue requirement. This fogging of the main point of the annualization adjustment by picking and choosing what to annualize and what to leave at average test year levels is exactly what has happened here.

Further, this picking and choosing destroys the synchronization of the test period. The Company, to the extent practicable, brought all elements of the test year into synchronization at end of period levels. Proper synchronization requires that all elements be stated on the same basis.

Finally, Qwest is not asking the Commission to just "trust us" that our annualizations are appropriate. 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.

Q. ON PAGES 11 TO 28 OF HIS TESTIMONY, MR. CARVER SEEMS TO BE ATTEMPTING TO MAKE SOME FORM OF COMPARISON OF THE COMPANY'S ADJUSTED RESULTS WITH ACTUAL REVENUES AND EXPENSES. DO YOU AGREE WITH HIS CONCLUSIONS?

A. No, I do not. First, Mr. Carver has made an apples and oranges comparison between the historic, recorded results of operations and the Company's estimated, end-of-period proforma level for the test year. Obviously, the adjustments to the test year are not included in the historical results. As I just mentioned, a more appropriate way to measure the reasonableness of adjusted test year results is to compare them with the future. Such a comparison will show the Company's adjusted results to be reasonable and clearly demonstrates that drawing conclusions by comparing pro forma adjusted results with historical results is misleading and inappropriate.

Q. HAVE YOU PREPARED COMPARISONS FROM WHIICH THE COMMISSION CAN DRAW APPROPRIATE CONCLUSIONS ABOUT THE TEST YEAR ESTIMATES FOR INTRASTATE REVENUES AND EXPENSES?

A. Yes. My Rebuttal Exhibits GAR-R1, R2 and R3 show graphical representations of Revenues, Expenses Other than Depreciation and Depreciation, respectively. These charts reflect the historical monthly results from January 1997 through May 2000. Each chart also shows a trend of the

actual results. Finally, the Company's, Staff's and RUCO's pro forma levels for each item have been superimposed upon the actual results. I have excluded deregulated results, directory imputations and all adjustments by the Company, Staff and RUCO related to the exchanges to be sold from these comparisons. The deregulated results were excluded as all parties have proposed adjustments that will negate to some degree the impacts of these results. I have excluded directory imputations as these adjustments are not included in actual results. Finally, I excluded the exchange sale adjustments as these results are still included in actual results at this time. With these three adjustments, the actual results and the pro forma adjusted results of the Company, Staff and RUCO are on a comparable basis.

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. Although different rates are used, the Company and Staff are quite close on the total amount of Depreciation (Rebuttal Exhibit GAR-R3) included in the revenue requirement. These graphs demonstrate that the Company's method, which was done at an overall level is not improved by digging around in the details.

Where the comparison between the parties really falls apart is on Expenses Other Than Depreciation (Rebuttal Exhibit GAR-R2). There, Staff's and RUCO's recommended expense levels are significantly below actual levels currently being incurred. This is why their suggested revenue requirements are sorely deficient as demonstrated on my test of the revenue requirements in Section I of my rebuttal testimony. It is difficult to understand how Mr. Carver can make the statement on page 20 of his testimony that, "...it is notable that even dramatic post-test year increases in intrastate operating expenses do not reach the extraordinarily high proforma level included in USWC's proposed revenue requirement." My Exhibits demonstrate just the opposite.

Q. BOTH STAFF AND RUCO POINT OUT INSTANCES WHERE CERTAIN INDIVIDUAL ITEMS AT A LOWER THAN INCOME STATEMENT LINE ITEM LEVEL MAY NOT BE REPRESENTATIVE. HOW DO YOU REPLY TO THESE COMMENTS?

A. My answer is to look at the results shown on my Rebuttal Exhibits GAR-R1, R2 and R3. The method the Company employed did not, and need not, have looked at the sub-account level of each income statement line item. This is because the Company method focused on estimating end of period cost levels at the line item level of detail and included normalizing adjustments for

unusual events and trending. To cite some examples, the Company made normalizing adjustments to December 1999 specifically for both product and brand advertising. Additionally, the Company performed a trending adjustment to normalized December 1999 to further reduce Corporate Operations expense to the trend at year end. The mere fact that Staff and RUCO do not like the Company's method does not make it wrong. The real test is to evaluate the results as shown on my Exhibits. These results validate the Company's methodology.

Q. PLEASE SUMMARIZE YOUR CONCLUSIONS RELATED TO THE END OF PERIOD ANNUALIZATIONS.

A. The end of period annualization proposed by Qwest is appropriate, viable and produces results that are comparable to the levels actually being incurred by the Company in 2000. The Company's adjustment, therefore, is a major element in fulfilling the purpose of a test period. The Commissions should accept Qwest's annualization adjustments.

SOFTWARE CAPITALIZATION

Q. WHAT IS THE STAFF'S AND RUCO'S PROPOSED ADJUSTMENT RELATED TO SOFTWARE CAPITALIZATION?

A. In this adjustment, both Staff and RUCO recommend adoption of Statement of Position (SOP) 98-1, "Accounting for the Costs of Computer Software

Developed or Obtained for Internal Use," for Arizona intrastate ratemaking purposes.

Q. DO YOU AGREE WITH THIS ADVOCACY?

A. No, I do not. As I stated in the responses to several Interrogatories, most notably UTI13-021, it makes no sense to adopt this particular change for ratemaking under rate of return regulation. The FCC adoption had no impact on interstate rates because interstate services are price cap regulated.[8] The most compelling reason for not adopting this change for intrastate ratemaking purposes is that there is no change in cash flows coupled with the short lives.

Q. PLEASE EXPLAIN FURTHER.

A. This accounting change is fairly unique among accounting changes due to the short life - in this case five years. The Company has, in the past, asked for state adoption of a number of accounting changes. They were detailed by Mr. Carver at page 63 of his testimony. Those changes had a much longer lives, ranging from 7 years to 20 years.

[8] In the FCC order, at para. 45, footnote 13, "Joint petitioners [Bell Atlantic and BellSouth] claim that good cause exists for the grant of a waiver [of the requirement to provide a revenue requirement study] because the Commission has modified the price cap rules to exclude exogenous treatment for accounting changes that have no cash flow impact. Therefore, because the accounting change has no impact on rates, a revenue requirement study would serve no useful purpose." [Report and Order in CC Docket No. 98-81, Order on Reconsideration in CC Docket No. 96-14150, Fourth Memorandum Opinion and Order in AAD File No. 98-43, Adopted May 18, 1999 and released June 30, 1999]

This change, on the other hand, produces huge swings in revenue requirement over a very short time frame. If it were to be adopted for ratemaking purposes today, the Company would have to come back in a very short timeframe to recover the revenue requirement shortfall. However, that would be inconsistent with the Staff testimony of Mr. Shooshan, who is recommending adoption of price cap regulation with an initial term of five years. If his recommendations are adopted, it would make recovery of the shortfall produced by this adjustment impossible.

Q. SO WHAT IS THE BEST SOLUTION?

A. The best solution is to ignore this accounting change for ratemaking purposes.

Q. WHY IS THAT?

A. When an accounting change occurs, there is often an initial "shock" to the revenue requirement, followed by a move toward a stable condition as the accounting process reflects more and more business in the "new" manner. In the first year of this accounting change, at a total company level, Qwest realized approximately $420M in reduced software expense, which is accounted for as an intangible asset under the new rules. Using the same information source as Mr. Carver (the response to UTI request 64-4S1) and the same assumptions of a 5-year amortization period, the amortization of

that asset amounts to only $42M in the first year. The net cost reduction of over $375M ($420M-$42M) reduces revenue requirement significantly. Then, in the second year, the company expects to capitalize an additional $511M, and the amortization rises to approximately $180M. This continues until the fifth year, when the ongoing expense level catches up to the expense level prior to capitalization, and the revenue requirement associated with the change becomes stable. However, because there is now a stable new *incremental* element of rate base, the revenue requirement actually rises above the level that prevailed before the accounting change, because of the return on the investment. This calculation is shown on Exhibit GAR-R4.

Q. WHAT HAS MR. CARVER DONE?

A. He has taken the first year impact, which is now behind us, and uses that level of expense as if it were permanent to arrive at his adjustment. This means that he has taken the year of the maximum change and proposes to embed that maximum change into the revenue requirement. He has also ignored the fact that this accounting change, by itself, is not cash impacting. Finally, he has completely ignored the fact that the financial impact of this change will dissipate rapidly.

Q. PLEASE ELABORATE.

A. Certainly. The first point is that Qwest still has to pay for the programming work or software purchases, regardless of accounting treatment. Mr. Carver's adjustment takes away the cash to pay for these costs, forcing the Company to get it from other sources. This reduction in cash flow also decreases the Company's incentive to provide capital investment.

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.

Q. YOU MENTIONED THAT MR. CARVER'S ADJUSTMENT WILL MAKE THE FIRST YEAR IMPACT PERMANENT, AND THAT, IF A PRICE CAP PLAN WERE ADOPTED, QWEST WILL NOT HAVE THE OPPORTUNITY TO RECOVER THE IMPACTS OF THIS ACCOUNTING CHANGE WHEN IT TURNS AROUND. IS THERE AN ALTERNATIVE?

A. Yes. If the Commission is to adopt this adjustment it should also provide an automatic rider to reflect the revenue requirement change that will occur over the next five years if this accounting change is adopted.

Q. PLEASE EXPLAIN.

A. The revenue requirement impact of this accounting change over the next several years is as follows:

1999	$(36)
2000	(31)
2001	(14)
2002	(1)
2003	11
2004	13

This means that a $(36)M decrease in year one should be followed by an automatic increase of $5M in year two, $17M in year three, $13M in year four, $12M in year five and a final increase of $2M in year six. These automatic rider adjustments would make the Company whole as the revenue requirement impact of the software capitalization changes in the future.

Q. IS THERE PRECEDENT FOR A RATE RIDER SUCH AS THIS?

A. Yes. In 1996 the Arizona Court of Appeals decided that Qwest was entitled to certain additional revenues resulting from the decision of the Company's rate case in Docket No. E-1051-93-183. Qwest was granted a rate rider in 1997 to recover the refund portion of the decision. This rider continued until 1999 when the entirety of the refund had been collected.

Q. IS A RIDER THE BEST OPTION?

A. No, it is not. The best option is the one set forth by the Company, namely, not to adopt this accounting change for ratemaking purposes. Adoption of this accounting change for ratemaking purposes will cause rate shock of its own. Customers will be delighted with the first year decrease, but will be less enthusiastic about the yearly increases that would follow and the permanent rate level that will be higher than if the Commission ignored the accounting change. In total those increases would total $49M to enable the customers to enjoy a first year decrease of $(36)M.

Q. WOULD THE COMMISSION HAVE TO ADOPT THE AUTOMATIC INCREASES?

A. Yes, it would. If this change is adopted for ratemaking purposes and the Commission adopts a price cap plan, the revenue requirement will automatically increase each year by the mechanics of the change itself. In other words, the future impacts will occur without any action by the Company. Since adoption of a price cap plan would end rate of return regulation, at least for the term of the plan, the Company could never recover these future cost increases without an automatic rider. Coincidentally, the term of the proposed price cap plan exactly parallels the period when the future cost increases would occur. To fail to provide for these future increases would not only be one sided, it would be confiscatory, as the changes will occur without action on the Company's part. As I stated earlier, the best solution is for the

Commission to ignore Mr. Carver's adjustment and not adopt this accounting change for ratemaking purposes.

Q. IS RUCO'S PROPOSED ADJUSTMENT ANY BETTER?

A. No, it is not. While it does average the impact of the first three years, it suffers from the same infirmities of Staff's proposed adjustment. It would still require a future rate case or, if a price cap plan is adopted, an automatic recovery mechanism to make the Company whole. It would still create a large revenue requirement swing over a short period of time. It would still take away, at least in the early years, valuable cash flow that the Company needs for investment. My recommendation to the Commission is still the same; do not adopt this accounting change for regulatory purposes. This achieves the best result for both the Company and its customers.

POST TEST YEAR WAGE & SALARY INCREASES

Q. WHO IS PROPOSING AN ADJUSTMENT TO ELIMINATE POST TEST YEAR WAGE INCREASES?

A. Only Mr. Carver for Staff proposes elimination of the post test year wage and salary adjustments. Mr. Larkin of RUCO also makes adjustments to the post test year wage and salary adjustments, but he does not eliminate them.

Q. DO YOU AGREE WITH ANY OF THESE ADJUSTMENTS?

A. Yes. Mr. Larkin is correct in his adjustment to the occupational wage increase effective in August 2000. The Company applied an incorrect factor for this wage increase. The factor should have been 3.5% instead of the 4.02% used in the original calculation.

Q. MR. CARVER OF STAFF PROPOSES TO ELIMINATE ALL POST TEST YEAR INCREASES ON THE BASIS THAT ONLY WAGE AND SALARY CHANGES WITHIN THE HISTORICAL TEST YEAR SHOULD BE RECOGNIZED. DO YOU AGREE?

A. Absolutely not. First, it has been the policy of this Commission in the past to recognize out of period wage and salary changes. They were recognized in the last case, albeit with an offset for falling employee levels at that time. That same condition does not prevail now. Based on past practice, the full out of period increases should be allowed. Furthermore, the Staff is inconsistent on the point of reaching out beyond the test year. They appropriately go outside of the test year with regard to the access line sales. While I do not agree with their adjustment, I do agree with addressing the subject matter of the access line sales, which is outside the test year.

Q. HAVEN'T THESE INCREASES ALREADY TAKEN EFFECT?

1 A. Yes, they have. Mr. Carver acknowledges as much on page 66 of his
2 testimony. However, he then goes on to make the incredible statement that
3 "[i]n a sense, the update of the test year from June 1998 to calendar year
4 1999 is an exercise encompassing an 18 month known and measurable
5 period update."
6
7 Nothing could be farther from reality. When an entire test year is updated
8 based on actual results, that is not what is traditionally recognized as a known
9 and measurable change. This is pure obfuscation on Mr. Carver's part. A
10 "known and measurable change" is one that occurs within or outside of the
11 test year that is the basis for a pro forma adjustment. Normal examples are
12 wage and salary changes, rate changes, tax rate changes, etc.
13
14 **Q. ARE OUT OF PERIOD CHANGES APPROPRIATE?**
15 A. Yes they are. In fact, Mr. Carver is inconsistent with another Staff witness,
16 namely Mr. Brosch, when he claims that Staff has made no out of period
17 adjustments. The access line sale is not yet completed as of the date of this
18 rebuttal. Clearly, any adjustment for this sale is outside the test period. Yet,
19 all parties acknowledge that an adjustment for this item should be made to
20 produce a properly adjusted test year.
21

Q. MR. CARVER WOULD HAVE ONE BELIEVE THAT NO ADJUSTMENT BASED ON CHANGES OUTSIDE OF THE TEST YEAR IS WARRANTED. IS THAT CORRECT?

A. No, it is not. In a current New Mexico case, Mr. Carver contradicted his own position wherein he quoted *The Regulation of Public Utilities*, page 196 in an interrogatory response which stated in part "... commissions have adjusted test-year data for 'known changes'; that is, a change that actually took place *during or after* the test period (such as a new wage agreement ....)" (emphasis added). Other scholars, such as Garfield & Lovejoy in their book Public Utility Economics, state that "[o]f course, 'known changes' - occurring after the test period - usually are taken into consideration by commissions in order to make the test year data as representative as possible of the cost situation that is apt to prevail in the future." Both of these quotes merely restate the primary purpose of a test period – to be as representative as possible of the period when new rates will be in effect.

Q. DO OUT OF PERIOD WAGE AND SALARY ADJUSTMENTS QUALIFY AS KNOWN AND MEASURABLE CHANGES?

A. They certainly do. They are known (the date of the increase is certain) and they are measurable (both increases have already taken effect).

Q. MR. CARVER'S OTHER POINT IS THAT QWEST MADE NO ADJUSTMENTS FOR ITMES SUCH AS "GROWTH IN REVENUE LEVELS" ON PAGE 65 OF HIS TESTIMONY. IS HE CORRECT?

A. This comment makes it clear that Mr. Carver has an improper conception of the test period. While it is true that the Company, and to some degree Staff and RUCO, have adjusted the test period for volume levels, none of the parties adjusted for volume level changes outside of the test year. Volumes can be adjusted outside of a historic test period, but then the test year becomes a forecasted test year. This is not an improper method for ratemaking purposes, but Arizona has traditionally used a historic test year. All parties have presented their recommendations using a historic test year.

Under the historic test year concept, volume adjustments are not made outside the confines of that historic period, but price level changes are. That is exactly what Public Utility Economics and Garfield & Lovejoy meant in the earlier quotes. Qwest has made such price level changes outside the test year for known and measurable changes such as the wage and salary increases.

Had there been rate changes, or other changes in price levels that occurred outside the test year, the Company would have included them. It is the Company's practice to scan the period outside the test year and include any

price level changes that meet the known and measurable test. In this case, the only changes meeting the test were the wage and salary increases.

Q. WHAT IS THE PURPOSE OF MAINTAINING TEST YEAR VOLUMES?

A. Whether the test year volumes are stated at average or end of period levels, the purpose of maintaining test year volume levels is to maintain the relationship among revenues, expenses, taxes and investment. The out of period wage and salary adjustments are stated on the same volume basis as the in period wage and salary adjustments so that this relationship is maintained.

Q. PLEASE SUMMARIZE YOUR POSITION RELATING TO OUT OF PERIOD WAGE AND SALARY ADJUSTMENTS.

A. The out of period wage and salary adjustments are known and measurable changes that should be recognized. The rate increase error pointed out by Mr. Larkin should be corrected. The adjustments have been stated at test year volume levels to maintain the proper relationship among test period revenues, expenses, taxes and investment. Consistent with the past practice of this Commission, these adjustments should be allowed.

ACCESS LINE SALES

Q. BOTH STAFF AND RUCO ADDRESS VARIOUS ISSUES RELATED TO THE COMPANY'S PROPOSED SALE OF ACCESS LINES IN ARIZONA. WHAT ARE YOUR COMMENTS?

A. Qwest's filing removed the revenues, expenses, taxes and investment related to the access lines to be sold. The basis used to develop the financial quantification for this removal was the same as the financial presentation used in the actual sale transaction. As stated in several interrogatories, such as UTI 51-003 & 004 and UTI48-015, this basis was reviewed and approved by the Company's independent auditors.

Mr. Brosch of Staff and Mr. Smith of RUCO both propose further adjustments to the sale of access lines. I would like to address Mr. Smith's adjustment first.

Q. PLEASE PROCEED.

A. Qwest has appropriately removed the revenues, expenses, taxes and investment related to the proposed sale. Both Mr. Smith and Mr. Brosch acknowledge that these revenues and costs should be removed. However, Mr. Smith proposes to inappropriately address the disposition of the gain in this case rather than in the access line sale docket. Testimony related to the gain has been and is being presented in the access line sale docket and that

is where the disposition of the gain should be decided. There has been no testimony, other than Mr. Smith's brief discussion, on the disposition of the gain in this case. The disposition of the gain should remain in the access line sale docket and be decided there.

Q. MR. BROSCH ONLY DISPUTES THE METHODOLOGY OF HOW MUCH REVENUE AND COST RELATED TO THE ACTUAL OPERATIONS OF THE EXCHANGES TO BE SOLD SHOULD BE REMOVED. ISN'T THAT CORRECT?

A. Yes, it is. I disagree with his adjustments and would like to address each of them.

Q. PLEASE PROCEED.

A. His first adjustment is to allocate corporate operations expense to the costs to be removed. The adjustment for sale of exchanges should reflect reality rather than guesses or wishful thinking by Mr. Brosch. Per Qwest's Financial Planning and Analysis (FP&A) organization there are no budgeted reductions for corporate operations expense associated with the sale of exchanges. The bottom line is that Qwest will not have reductions in corporate operations expenses as a result of exchange sales.

Q. ARE THERE OTHER REASONS THAT NO CORPORATE OPERATIONS EXPENSE SHOULD BE ALLOCATED TO THE REMOVAL OF COSTS RELATED TO THE PROPOSED SALE?

A. Yes, there are. 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.

Mr. Brosch characterizes his proposed 1% corporate operations expense cut as conservative. Qwest characterizes his proposal as unrealistic. Mr. Brosch talks in generalities about cutting corporate operations expenses, but does not offer any specific reasoning or support for his statement.

Q. WHAT IS MR. BROSCH'S NEXT ADJUSTMENT?

A. Mr. Brosch made a pro rata assignment of marketing costs to the exchanges being sold based on relative revenues. By contrast, Qwest assigned marketing costs to those exchanges in the context of where and how its marketing dollars are actually spent. 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.

The Company's adjustment to the marketing expense allocator was not arbitrary. USWC did a high level analysis of advertising expenditures in 1997 and 1998 and found that approximately 45% of expenditures were for campaigns primarily directed at urban areas, while the remainder could potentially reach both urban and rural areas. The methodology utilized was reviewed and accepted by Arthur Andersen, Qwest's independent outside auditors.

Q. DOESN'T MR. BROSCH ALSO MAKE AN ADJUSTMENT RELATED TO DEPRECIATION?

A. Yes, he does.

Q. DOES THE COMPANY AGREE WITH THIS PORTION OF THE ADJUSTMENT TO ACCESS LINE SALES?

A. In principle, yes. In fact the Company acknowledged the correctness of such an adjustment in its response to Data Request UTI 52-014. I do not agree

with the rates used by Mr. Carver in his adjustment, but I do agree that an adjustment should be made.

IMAGE, OLYMPIC & SPORTS ADVERTISING

Q. HAVE YOU REVIEWED THE ADJUSTMENTS FOR IMAGE ADVERTISING AND OLYMPIC/SPORTS SPONSORSHIP RECOMMENDED BY STAFF AND RUCO?

A. Yes.

Q. WHAT IS MR. CARVER'S ARGUMENT REGARDING IMAGE ADVERTISING.

A. The heart of Mr. Carver's argument is contained on page 102 of his testimony where he states:

> USWC has not demonstrated that promoting its imagery in a favorable light will influence growth in business or residence access lines or customer decisions to purchase other discretionary services such as call waiting. While individual customers might be receptive to and express awareness of the Company's branding efforts, this type of image building is not cost free and does not directly support the development of new products or promote the sale of specific existing products.

Q. WHAT IS YOUR RESPONSE TO THIS ARGUMENT?

A. Mr. Carver has based his disallowance of image advertising on an incomplete chain of logic. The piece he is missing is that image advertising supports the sale of *all* products. Image and product-specific advertising are

complementary. Image advertising develops awareness of the Company and product-specific advertising then builds on that awareness at the more specific level of individual products. In other words, product-specific advertising is incomplete without the complementary image advertising. And, as competition grows and the public hears more brand names associated with telecommunications, image advertising becomes increasingly important to build the awareness of the company so that the product-specific advertising can effectively promote the various products.

Q. DO YOU HAVE INFORMATION THAT SUPPORTS THE IMPORTANCE OF BRAND OR IMAGE ADVERTISING?

A. Yes, I do. Tom Peters recently published "The Circle of Innovation" and discusses brand advertising in chapter 10. There he states:

> The market is hopelessly crowded. As a result: BRANDING IS MORE--NOT LESS--IMPORTANT THAN EVER ... if you want to stand out ... even a little bit ... in that insanely crowded/ever more crowded marketplace.[9] (emphasis in the original)

He goes on to say,

> No room for new brands? Exactly Wrong! It's the age of message glut ... and never has there been more room for/need for new brands/aggressive branding. Lobbing it [product or service] out there ... even if it's terrific and perfectly homed in on a particular consumer ... ain't going to get you very far. (Sorry.)

[9] "The Circle of Innovation", Tom Peters, Vintage Books, June 1999, page 337.

BEFORE THE ARIZONA CORPORATION COMMISSION

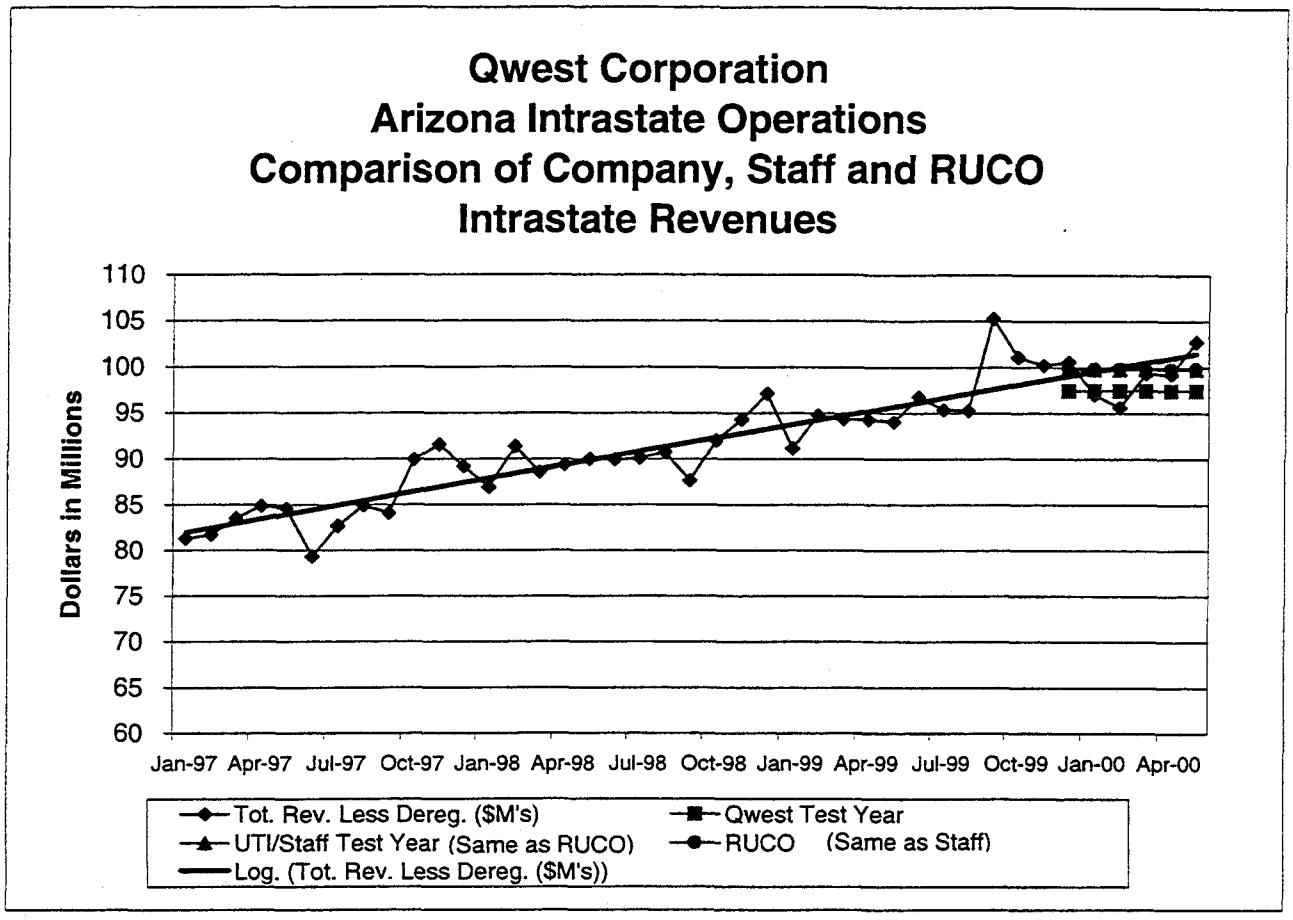
IN THE MATTER OF THE APPLICATION OF U S WEST COMMUNICATIONS, INC., A COLORADO CORPORATION, FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY, THE FAIR VALUE OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN	)	DOCKET NO. T-01051B-99-0105

EXHIBITS OF

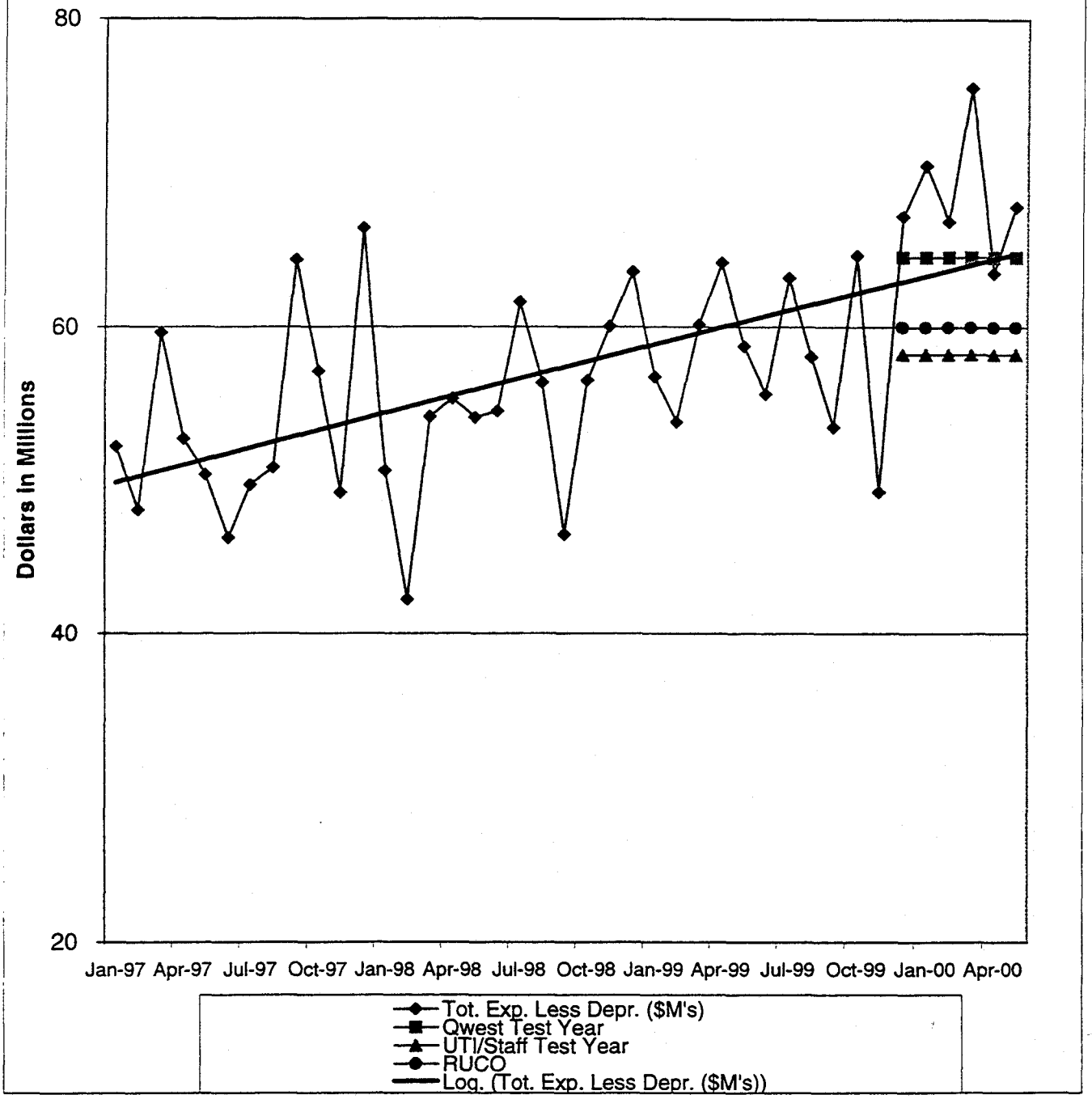
GEORGE REDDING

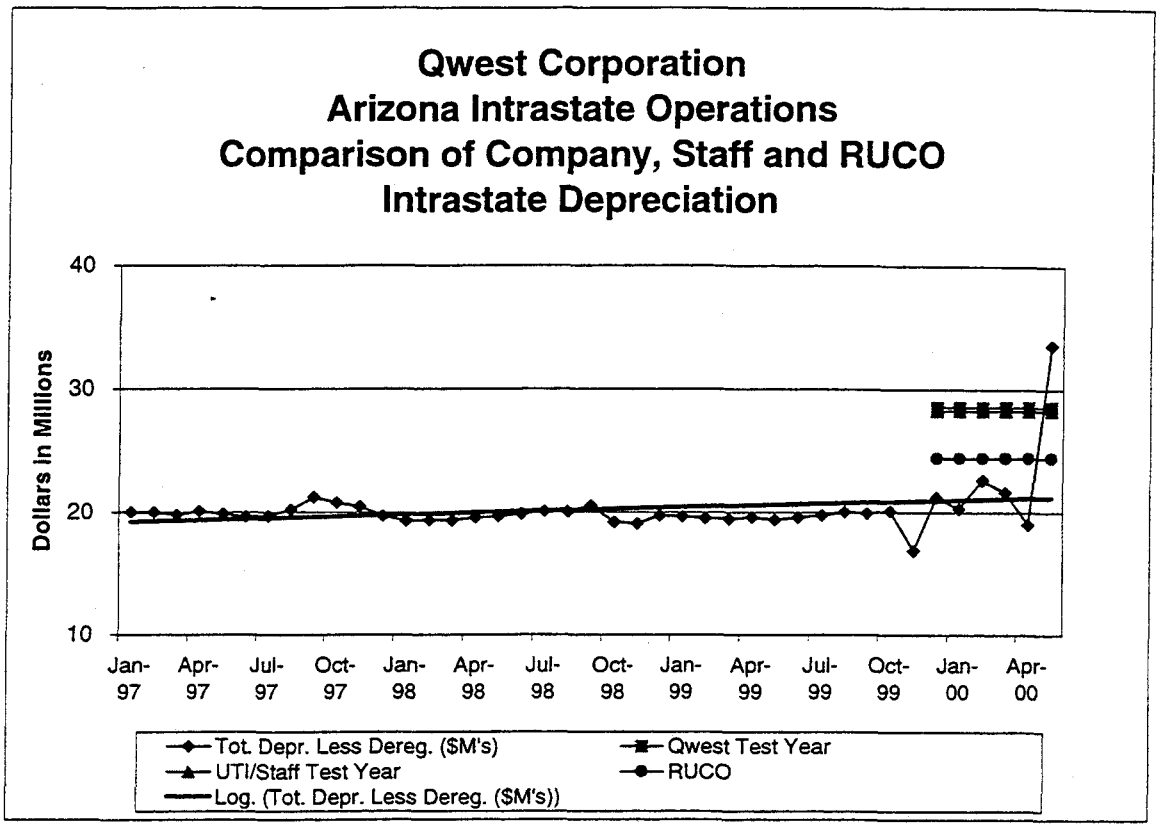
QWEST CORPORATION

AUGUST 21, 2000


Qwest Corporation
Arizona Intrastate Operations
Comparison of Company, Staff and RUCO
Intrastate Revenues
Dollars in Millions
110
105
100
95
90
85
80
75
70
65
60
Jan-97
Apr-97
Jul-97
Oct-97
Jan-98
Apr-98
Jul-98
Oct-98
Jan-99
Apr-99
Jul-99
Oct-99
Jan-00
Apr-00
Tot. Rev. Less Dereg. ($M's)
Qwest Test Year
UTI/Staff Test Year (Same as RUCO)
RUCO (Same as Staff)
Log. (Tot. Rev. Less Dereg. ($M's))

Qwest Corporation
Arizona Intrastate Operations
Comparison of Company, Staff and RUCO
Intrastate Expenses less Depreciation




Qwest Corporation
Arizona Intrastate Operations
Comparison of Company, Staff and RUCO
Intrastate Depreciation
Dollars in Millions
40
30
20
10
Jan-97
Apr-97
Jul-97
Oct-97
Jan-98
Apr-98
Jul-98
Oct-98
Jan-99
Apr-99
Jul-99
Oct-99
Jan-00
Apr-00
Tot. Depr. Less Dereg. ($M's)
Qwest Test Year
UTI/Staff Test Year
RUCO
Log. (Tot. Depr. Less Dereg. ($M's))

Statement of Position (SOP) 98-1
Accounting for the Costs of Computer Software Developed or Obtained for Internal Use
Calculation of Revenue Requirements over Time if SOP 98-1 Adopted for Intrastate Ratemaking
Based on Methodology Proposed by Staff in Direct Testimony

Ln		$M	1999	2000	2001	2002	2003	2004	2005
0	Total Software Under Construction by Year		420	511	500	500	500	500	500
1	Current Software Into Service (Acct 2001)		420	511	500	500	500	500	500
2	**Intangible Asset (BOP)**		-	420	931	1,431	1,931	2,011	2,000
3	Adds		420	511	500	500	500	500	500
4	Retirements		-	-	-	-	420	511	500
5	Intangible Asset (EOP)		420	931	1,431	1,931	2,011	2,000	2,000
6	Accumulated Amortization (BOP)		-	84	270	556	943	1,009	1,000
7	**Amort of Asset Capitalized Yr**	1	84	84	84	84	84		
8		2		102	102	102	102	102	
9		3			100	100	100	100	100
10		4				100	100	100	100
11		5					100	100	100
12		6						100	100
13		7							100
14	**Lines 14 - 26 are all zeroes**	8							
27	Total Amort for the year (cum Ln 7-26)		84	186	286	386	486	502	500
28	Less Retirements (Ln 4)		-	-	-	-	420	511	500
29	Accumulated Amortization (EOP)		84	270	556	943	1,009	1,000	1,000
30	Deferred Taxes (BOP)		-	135	266	352	397	403	402
31	Adds (40.2% of Ln 3)		169	205	201	201	201	201	201
32	Turnaround (40.2% of Ln 27)		34	75	115	155	195	202	201
33	Deferred Taxes (EOP) (L30+31-32)		135	266	352	397	403	402	402
34	Rate Base (BOP) (Ln2 - Ln6 - Ln30)		-	201	395	523	591	599	598
35	Rate Base (EOP) (Ln5 - Ln29 - Ln33)		201	395	523	591	599	598	598
	Company Level using AZ Tax/Return/Grossup Factors								
36	Authorized NOI Return at 10.86%		22	43	57	64	65	65	65
37	NOI Effect of Income Statement Changes (-(-Ln1+Ln27)*(1-40.2%))		201	194	128	68	8	(1)	-
38	NOI Effect of SOP 98-1 (Ln36 - Ln37)		(179)	(151)	(71)	(4)	57	66	65
39	Revenue Effect (Ln38 * 1.7056 gross-up)		(305)	(258)	(121)	(7)	97	113	111
	Allocation of Revenue Requirement Components to Arizona Level								
40	Arizona Prorate Factor	14.927%							
41	Arizona Intrastate Factor for a/c 6724	79.22%							
42	Authorized NOI Return (Ln36 * Ln40 * Ln41)		3	5	7	8	8	8	8
43	NOI Effects on Income Statement (Ln37 * Ln40 * In41)		24	23	15	8	1	(0)	-
44	NOI Effect of SOP 98-1 (Ln42 - Ln43)		(21)	(18)	(8)	(0)	7	8	8
45	Revenue Effect (Ln44 * 1.7056)		(36)	(31)	(14)	(1)	11	13	13

ASSUMPTIONS:
ANNUAL SHIFT FROM EXPENSE TO CAPITAL BASED ON CURRENT SPENDING / PROJECTIONS
5-YEAR AMORTIZATION PERIOD
ASSUME BEGINNING OF YEAR CAPITALIZATION AND AMORTIZATION
USING ARIZONA PRORATE, SEPARATIONS AND TAX FACTORS

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 APPPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN.	)	DOCKET NO. T-1051B-99-105 AFFIDAVIT OF GEORGE REDDING
STATE OF COLORADO	) :	ss
COUNTY OF DENVER	)	

George Redding, of lawful age being first duly sworn, depose and states:

1. My name is George Redding. I am Director – Regulatory Finance of Qwest Corporation in Denver, Colorado. I have caused to be filed written rebuttal testimony and rebuttal exhibits in support of Qwest in Docket No. T-01051B-99-0105

2. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct to the best of my knowledge and belief.

Further affiant sayeth not.

George Redding

SUBSCRIBED AND SWORN to before me this 17th day of August, 2000.

Notary Public

WILLIAM R. CURTIS NOTARY PUBLIC STATE OF COLORADO

My Commission Expires:

My Commission Expires 10/28/2003

BEFORE THE

ARIZONA CORPORATION COMMISSION

EXHIBIT
Q-31
Admitted

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 OF

KERRY DENNIS WU

ON BEHALF OF

QWEST CORPORATION

AUGUST 21, 2000

REBUTTAL TESTIMONY OF KERRY DENNIS WU
INDEX OF TESTIMONY

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EXECUTIVE OVERVIEW

In Docket No. T-0105B-97-0689, the Commission determined the depreciation rates that would be used in calculating the revenue requirement in this rate proceeding. Decision Nos. 61945 and 62507 are the Commission's orders in that proceeding. Decision No. 62507 directed the Company to file depreciation rates by May 14, 2000 and the order states that it shall become effective immediately.

In their testimony, Messrs. Lee and Dunkel attempt to revisit the Commission's decision in the depreciation docket. Mr. Lee recalculates Qwest's depreciation rates because he believes that the depreciation rates should be effective with the 1/1/97 study date used in the depreciation docket. He erroneously bases his contention on a 1991 FCC order. However, the very order he relies upon provides that "...the states are not bound by effective dates or depreciation rates prescribed by the Commission [the FCC]." In this case, Decision Nos. 61945 and 62507 clearly provide that Qwest's depreciation rates will be used prospectively in Qwest's pending rate application. Mr. Lee's position is really an argument that Qwest should write-off investment equal to three years of depreciation. It is an improper invitation to engage in retroactive rate-making and should be rejected.

In contrast, Mr. Dunkel believes that Qwest's depreciation rates should be recalculated as of December 31, 1999 and that those rates should not be booked until the rates resulting from this rate proceeding become effective.

Assuming for argument's sake that he is correct, the effect would be to increase Qwest's depreciation accrual another $14.5 million above the amount contained in the Company's updated rate filing. Mr. Dunkel also recommends that a credit arrangement be established to encourage retirements of Qwest's plant and equipment. His proposal is at odds with the Commission's expressed intent to encourage investment and should be rejected.

Mr. Brosch recommends removing certain investments from Qwest's rate base because he believes the amounts represent unrecorded retirements. According to ACC Staff Schedule C-22, this would reduce annual depreciation expenses by about $2.9 million. Mr. Brosch bases his proposed adjustment on mistaken assumptions about the plant accounts in question. When those mistaken assumptions are corrected, there is no rational basis for making his proposed adjustment.

IDENTIFICATION OF WITNESS

Q. PLEASE STATE YOUR NAME, OCCUPATION, AND BUSINESS ADDRESS.

A. My name is Kerry Dennis Wu. My title is Director - Capital Recovery for Qwest Corporation (Qwest). My business address is 1600 7th Avenue, Room 3006, Seattle, Washington 98191.

Q. PLEASE GIVE A BRIEF OUTLINE OF YOUR EDUCATIONAL BACKGROUND AND TELEPHONE COMPANY EXPERIENCE.

A. I graduated from Portland State University in 1974, where I earned Bachelor of Science degrees in Business Administration and Science. In 1995, I received a Master of Business Administration from the University of Washington. In addition, I am a Certified Internal Auditor, a Certified Management Accountant and a Certified Public Accountant.

I began working for Pacific Northwest Bell (PNB) in 1974 as an internal auditor specializing in accounting and financial issues. I later managed Corporate Books and was responsible for closing the Company's books and preparation of Securities and Exchange Commission Filings. I subsequently managed Corporate Budget preparation. In the regulatory area, I supported U S WEST's rate of return advocacy by preparing

testimony and related materials. In 1996, I worked for a London-based mobile phone company, where I was responsible for mechanizing annual regulatory filings and developing tariffs. Upon returning to the States, I accepted a position with AirTouch Cellular as a budget analyst. In mid-1998, I was appointed the Director – Capital Recovery at U S WEST. In July, 2000, U S WEST Communications, became Qwest Corporation.

Q. HAVE YOU PREVIOUSLY TESTIFIED IN ARIZONA?

A. Yes. On May 2, 2000, I filed direct testimony in this docket. And, I testified on depreciation matters in the recently concluded Docket No. T-0151B-97-689.

PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. In my testimony, I respond to the arguments made by Department of Defense witness Richard Lee and Staff witnesses William Dunkel and Michael Brosch relating to various depreciation issues.

EXPLANATION OF DEPRECIATION

Q. WHAT IS DEPRECIATION INTENDED TO ACCOMPLISH?

A. Depreciation is the process of determining the future expense associated with capital investment. When a company invests in plant and equipment, it does so because it would like to use that plant and equipment to provide products or services to its customers in a profitable manner. One attribute of the investment as it is used is obsolescence. At some point, the plant and equipment will no longer be capable of generating profits and its economic life will have ended. If the company is to be viable, it must anticipate this obsolescence and invest in new plant and equipment before the old plant and equipment becomes obsolete.

From an investor's point of view, depreciation is about capital recovery. Investors commit funds to the Company with the expectation that capital will be returned as the investment is consumed. Having the appropriate level of depreciation is the mechanism through which proper capital recovery occurs. In telecommunications, this is a particularly critical issue because of the rapid technological and marketplace changes that are sweeping the industry. Full and timely recovery is also in the best interest of Qwest's Arizona customers. Customers ultimately rely on investors to invest funds to provide needed communications infrastructure. If investors are not able to achieve full and timely recovery, they will choose to invest elsewhere or to require higher returns on their invested capital. Neither option is in the best interest of customers or Qwest.

DEPARTMENT OF DEFENSE TESTIMONY

Q. CAN YOU SUMMARIZE MR. LEE'S DEPRECIATION TESTIMONY?

A. Yes. Mr. Lee states that since the Arizona Commission's May 2000 order was based on a study as of 1/1/97, depreciation rates should be effective retroactive to that date. Mr. Lee then recalculated revised depreciation rates based on the assumption that the depreciation rates had been effective beginning 1/1/97.

Q. WHAT'S WRONG WITH MR. LEE'S POSITION?

A. The primary error in Mr. Lee's position is that it is inconsistent with the Commission's depreciation orders. Prior to the Commission's recent decisions, Qwest was required to use the depreciation rates prescribed by the Commission in 1993. Decision No. 62507 prescribed new depreciation rates to be applied going forward and it was not effective until May 4, 2000. Thus, Mr. Lee is proposing a modification to Decision No. 62507 to render it effective retroactively.

Q. MR. LEE RELIES UPON A 1991 FCC MEMORANDUM AND OPINION. IS HIS RELIANCE ON THIS FCC DECISION WELL FOUNDED?

A. No. Mr. Lee has erroneously relied upon FCC Memorandum and Order 91-31. That order states that for interstate purposes, depreciation orders should be effective as of the study date. FCC Memorandum and Order 91-31 was issued in a context in which interstate depreciation decisions were normally decided within the year of the study. In this case, however, the final depreciation order did not occur until nearly three and one half years after the study date. In any event, FCC Memorandum and Order 91-31 leaves it to the states to decide when intrastate depreciation rates will become effective. The Order provides:

> Second, the states are not bound by effective dates or depreciation rates prescribed by the Commission. In Louisiana PSC, the Supreme Court ruled that the Commission could not preempt the states on depreciation for state ratemaking purposes. Thus, while the carriers must use the effective dates prescribed by the Commission for federal accounting purposes, the states may use their own discretion in determining what effective dates should be used for state ratemaking purposes and the dates used for accounting purposes would be accounted for as jurisdictional differences under Part 32.[1]

Q. WHAT IS THE IMPACT OF MR. LEE'S PROPOSAL?

A. If Decision No. 62507 is applied to the years 1997 through 1999, the Company's cost of service for those years will have been increased without any corresponding increase in rates. The effect is a massive write-off of investment and a denial of capital recovery on that investment.

In substance, Mr.Lee has proposed retroactive ratemaking and a writeoff of plant investment that the Commission has not approved. At the hearings in the depreciation docket, DOD and other parties proposed such a writeoff but their proposal was rejected by the Commission.

STAFF TESTIMONY – WILLIAM DUNKEL

Q. CAN YOU SUMMARIZE MR. DUNKEL'S RECOMMENDATIONS?

A. Mr. Dunkel has essentially two recommendations. First, Mr. Dunkel recommends that Qwest's retirements of assets be monitored and that Qwest customers be credited if retirements do not equal the depreciation expense Qwest books each year. Mr. Dunkel apparently believes that ratepayers pay for the retirement of assets. Second, Mr. Dunkel recommends a new calculation of depreciation rates to be applied to Qwest's plant and equipment.

Q. WITH RESPECT TO HIS FIRST POINT, IS MR. DUNKEL CORRECT THAT RATEPAYERS PAY TO HAVE ASSETS RETIRED?

A. Not at all. Ratepayers pay rates for the use of assets that have already placed into service. What they pay must be sufficient to cover a utility's cost of service. Part of that cost of service is the cost a utility incurs as

[1] The Prescription of Revised Percentages of Depreciation pursuant to the Communications Act of 1934, as

1 the economic value of that plant and equipment declines through use and
2 obsolescence. Depreciation is the mechanism by which a utility recovers
3 its investment. If a utility was not afforded a reasonable opportunity to
4 recover its capital investment, it would be unwilling and unable to make
5 investments necessary to provide service.
6 In his testimony, Mr. Dunkel has erroneously equated
7 modernization and retirement. These are really different concepts.
8 Modernization refers to investment in new plant and equipment and new
9 technologies. Retirement is the process by which assets are removed
10 from service. While retirement may occur simultaneously with
11 modernization, it need not. For example, when Qwest invests in a new
12 switch, it may intend that the switch will one day replace another switch
13 that continues to be used. Investment in the new switch may very well
14 precede retirement of the older switch.
15
16 **Q. IS MR. DUNKEL'S RECOMMENDATION THAT THE COMMISSION**
17 **SHOULD MONITOR RETIREMENTS JUSTIFIED?**
18 A. No. In truth, Mr. Dunkel is engaging in a backdoor attempt to revisit
19 issues decided in the recently concluded Depreciation Docket T-01051B-
20 97-0689. To achieve this end, Mr. Dunkel relies upon statements made
21 by Commissioner's Mundel and Irvin at an open meeting in which Qwest's

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amended for Alascom, Inc. , et al., Memorandum and Opinion and Order, FCC 91-31, dated January 31,

depreciation rates were considered. However, his reliance is misplaced because both Commissioners expressed their desire to see Qwest continue to make significant investments in Arizona infrastructure. Commissioner Mundel expressed his concern that "the money actually goes into infrastructure and improving technology." Commissioner Irvin stated that he looked forward to working with his fellow Commissioners to seeing that "updated equipment is put into the ground." (April 25,2000 Open Meeting, Tr., pp.46-47. 52). Neither Commissioner expressed any view about retirements.

Q. IN DOCKET T-01051B-97-0689, WHAT DID THE COMMISSION DECIDE?

A. In Decision No. 62507 Conclusions of Law, the Commission stated, "Advancements in technology, coupled with the desire to create robust competition in Arizona's telecommunications industry, warrants setting U S WEST's depreciation lives within the range of its competitors."

Q. HAS QWEST DEMONSTRATED A COMMITMENT TO INVEST IN ARIZONA?

1991, para. 25.

A. Qwest has an enviable investment track record in Arizona. Shown below is a comparison of the Arizona total depreciation expense and total net investment additions since 1991.

	Gross Adds*	Total Depreciation
1991	$257.6 million	$211.0 million
1992	$247.1	$232.5
1993	$237.7	$243.4
1994	$271.9	$262.0
1995	$312.5	$278.1
1996	$395.5	$295.7
1997	$291.5	$308.5
1998	$294.3	$302.9
1999	$406.0	$307.0

*Includes other debits and credits

As one can see, over the last nine years the Company has invested in Arizona at a rate well in excess of the rate at which it has depreciated its plant and equipment.

Q. WHAT ELSE IS WRONG WITH MR. DUNKEL'S OVER-EMPHASIS ON RETIREMENTS?

A. Mr. Dunkel's focus on retirement does not recognize the phenomena of declining usage and economic value. The American Institute of Certified Public Accountants (AICPA) define depreciation as:

> The cost of a productive facility is one of the costs of the services it renders during its useful economic [emphasis added] life.

> Generally accepted accounting principles require that this cost be spread over the expected useful life of the facility in such a way as to allocate it as equitably as possible to the periods during which services are obtained from the use of the facility. .... It is a process of allocation, not of valuation.
>
> Accounting Research Bulletin 43, Chapter 9, Section C, Paragraph 5.

Declining usage and economic value of plant and equipment suggests that an asset should be fully depreciated prior to its physical retirement.

Q. CAN YOU ILLUSTRATE DECLINING USAGE AND ECONOMIC VALUE?

A. Yes. Let's assume fiber was placed next to a working 100 pair copper cable. As customers are migrated from copper to fiber, there are fewer and fewer working pairs operating over the copper. FCC Part 32 accounting procedures do not allow partial retirements to reflect declining usage and economic value of the copper cable. Only after the last customer is removed from the copper cable that the copper is finally retired. Yet much of the copper became obsolete and had no service value well before the retirement date.

Q. SHOULD MR. DUNKEL'S RECOMMENDATION THAT RETIREMENTS BE TRACKED FOR THE PURPOSE OF ASSESSING RATEPAYER CREDITS BE ADOPTED?

A. No. Mr. Dunkel's recommendation is not sound and fails to recognize the significant investments Qwest has made, and will continue to make in the state of Arizona. In its order approving the recent merger between Qwest's parent corporation and U S WEST, Inc., the Commission imposed a significant investment requirement upon Qwest to ensure that modernization takes place. There is no need for another program to address the adequacy of modernization.

Q. MR. DUNKEL HAS PREPARED A NEW DEPRECIATION RATE CALCULATION. WOULD YOU COMMENT?

A. Yes. Mr. Dunkel recalculated 12/31/99 depreciation rates using 12/31/99 depreciation reserve levels, but he did not consistently use the appropriate 12/31/99 remaining lives. Mr. Dunkel did not composite accounts properly (e.g. buildings), consistently use FCC rounding conventions (e.g. pole lines) or use the proper Analog Switch account remaining life.

Q. IF THE DEPRECIATION RATE FORMULA WAS PROPERLY UPDATED AS OF 12/31/99, WHAT CHANGE IN DEPRECIATION ACCRUALS WOULD RESULT?

A. Updating the remaining life and the depreciation reserve properly increases the test year depreciation accrual by $14.5 million and leads to

an overall increase of $114.2 million as compared to the $99.7 million accrual increase shown in my direct testimony. See Exhibit KDW–1.

Q. MR. DUNKEL CRITICIZED MS. HUGHES REPRODUCTION COST NEW LESS DEPRECIATION (RCNLD) STUDY. WOULD YOU COMMENT?

A. Ms. Hughes completed the study following the same procedures followed in previous rate cases. We are currently examining Mr. Dunkel's suggestions to determine whether they warrant a change in this or future proceedings. We do not believe that they impact revenue requirement in this proceeding, however.

STAFF TESTIMONY – MICHAEL BROSCH

Q. PLEASE SUMMARIZE MR. BROSCH'S TESTIMONY REGARDING DEPRECIATION?

A. 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. According to ACC Staff Schedule C-22, the investment in question is as follows:

General Purpose Computers	$24.1 million
Digital Switching Equipment	0.4 million
Digital Circuit Equipment	0.7 million
Underground Metallic Cable	10.1 million

Buried Metallic Cable	16.8 million
Intra-Building Metallic Cable	3.2 million
Total	$55.3 million

Based on speculation that this investment is longer in service, Mr. Brosch recommends a $2.9 million reduction in depreciation expense related to this investment.

Q. MR. BROSCH RECOMMENDED DISALLOWING 1989 VINTAGE GENERAL PURPOSE COMPUTERS STATING THIS INVESTMENT CONSISTS OF MINI AND MICRO COMPUTERS THAT WERE UNLIKELY TO STILL BE IN SERVICE. WOULD YOU COMMENT?

A. Mr. Brosch's recommendation is based on a misunderstanding of the types of assets that are included in the general purpose computer account. According to FCC Part 32, paragraph 32.2124:

> (a) This account shall include the original cost of computers and peripheral devices which are designed to perform general administrative information activities.
> (b) Administrative information processing includes but is not limited to activities such as the preparation of financial, statistical, or other business analytical reports; preparation of payroll, customer bills, and cash management reports, and other records and reports not specifically designed for testing, diagnosis, maintenance or control of the telecommunications network facilities.

The general computer account consists not only of computers, but also peripheral equipment. Examples of peripherals include power equipment, printers and "dumb" terminals. Thus, one cannot conclude (as Mr. Brosch

apparently has done) that 1989 vintage equipment in this account is out of service simply because 1989 mini and micro computers with a vintage of 1989 or earlier are unlikely to be in service.

Q. WOULD YOU COMMENT ON MR. BROSCH'S DIGITAL SWITCH AND CIRCUIT RECOMMENDATIONS?

A. 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. For example, when analog switch and electro-mechanical investment was retired, a portion of the original investment was reusable with the digital switch replacement. Examples include power equipment and furniture specifically designed for the central office. In the case of digital circuit equipment, items such as cabinets, specific furniture and power equipment would have been transferred from the analog switch account. Again, the original vintage date would have been retained.

A cursory review of the 1955 vintage digital switch investment account indicated that the 1955 vintage equipment simply had the wrong year of placement assigned.

Q. IF THE INVESTMENT VINTAGES WERE RETIRED AS STAFF SUGGESTS, WHAT WOULD HAVE BEEN THE EFFECT ON COMPANY DEPRECIATION RATES?

A. When an asset is retired, the same dollar amount is removed from gross investment and the depreciation reserve. Unless the account is fully depreciated, the resulting depreciation rate will increase.

Q. CAN YOU SHOW AN EXAMPLE THAT DEMONSTRATES THIS?

A. Yes. Let's assume the following:

Gross Investment	$100	
Depreciation Reserve	$ 50	or 50% Reserved
Remaining Life	5 years	

Under the remaining life formula, assuming no future net salvage, the depreciation rate calculation would be

$$\frac{100\% \text{ less } 50\%}{5 \text{ years}} \quad \text{equals} \quad 10\%$$

Let's assume a $10 retirement, the depreciation calculation would be as follows:

Gross Investment	$90	
Depreciation Reserve	$40	or 44.4% Reserved
Remaining Life	5.1 years	

The new depreciation rate calculation would be:

$$\frac{100\% \text{ less } 44.4\%}{5.1 \text{ years}} \quad \text{equals} \quad 10.9\%$$

As demonstrated above, one cannot arbitrarily remove vintage information without considering the effects of what would have happened had its retirement been part of Arizona's recently completed depreciation study.

Q. HAVE YOU DONE THIS CALCULATION FOR ONE OF THE ACCOUNTS IN QUESTION?

A. Yes. I assumed all 1989 and prior of the computer investment in the 1/1/97 depreciation study represented an unrecorded retirement. I then hypothetically "retired" that investment and recalculated the new depreciation rate. Shown below are the original and "revised" depreciation rates for general purpose computers:

	Original Study	"Revised"
Depreciation Reserve	72.4%	59.0%
Remaining Life (Years)	2.4	2.8
Depreciation Rate	9.4%	12.9%

If implemented and incorporated into the study, Mr. Brosch's recommendation would increase the computer depreciation study rate and accrual primarily because the depreciation reserve would decrease from 72.4% to 59.0%.

Q. MR. BROSCH RECOMMENDS REMOVAL OF COPPER INVESTMENT BECAUSE HE BELIEVED METALLIC CABLE WITH A 1925 VINTAGE DATE WAS UNLIKELY TO EXIST. WOULD YOU COMMENT?

A. I take exception to Mr. Brosch's arbitrary treatment. 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. Then, when the capital recovery system receives vintage information from the accounting system, it defaults all 1901 – 1925 vintage years to 1925. Simply having a year placed of 1925 does not mean the plant does not exist or that it was placed 75 years ago. It simply means the asset did not have its actual year of placement identified.

Q. SHOULD THE COMMISSION ACCEPT MR. BROSCH'S PROPOSED $55.3 MILLION RATE BASE ADJUSTMENT AND THE CORRESPONDING REDUCTION IN DEPRECIATION EXPENSE?

A. No. The proposed adjustment is not appropriate and should be rejected.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

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

EXHIBITS OF

KERRY DENNIS WU

ON BEHALF OF

QWEST CORPORATION

AUGUST 21, 2000

Change in Annual Depreciation Accruals Resulting from Changes in Depreciation Rates
Intrastate Factors Applied ($000)

Account Number and Class or Subclass of Plant	Intrastate Investment 12/31/99 A	1/1/97 Study Depreciation Rates B	Rate Amount C = A * B	12/31/99 Study Depreciation Rates D	Rate Amount E = A * D	Change in Depreciation Accrual E - C
2112 MOTOR VEHICLES	47,502	4.9%	2,328	2.7%	1,283	(1,045)
2114 SPEC PURPOSE VEHICLES	18	10.2%	2	13.4%	2	-
2115 GARAGE WORK EQUIP	961	15.6%	150	18.1%	174	24
2116 OTHER WORK EQUIP	15,891	15.9%	2,527	13.8%	2,193	(334)
2121 BUILDINGS	115,383	3.0%	3,461	2.9%	3,346	(115)
2122 FURNITURE	1,208	20.1%	243	21.2%	256	13
2123.1 OFFICE EQUIPMENT	3,883	22.3%	866	19.2%	746	(120)
2123.2 COMPANY COMM EQUIPMENT	1,040	6.1%	63	0.0%	-	(63)
2124 GEN PURPOSE CMPTR	79,409	9.4%	7,464	4.5%	3,573	(3,891)
2211 ANALOG SW EQUIP	110,824	16.2%	17,953	57.0%	63,170	45,217
2212 DIGITAL SW EQUIP	655,053	11.0%	72,056	10.7%	70,091	(1,965)
2220 OPERATOR SYSTEMS	6,498	1.6%	104	7.4%	481	377
2231 RADIO SYSTEMS	23,571	5.8%	1,367	3.3%	778	(589)
2232 CIRCUIT DDS	5,667	5.4%	306	0.0%	-	(306)
2232 CIRCUIT DIGITAL	752,751	9.8%	73,770	8.9%	66,995	(6,775)
2232 CIRCUIT ANALOG	32,631	3.2%	1,044	1.5%	489	(555)
2362 OTHER TERM EQUIP	40,092	7.5%	3,007	7.1%	2,847	(160)
2351 PUB TEL TERM EQUIP	17,969	0.0%	-	3.2%	575	575
2411 POLE LINES	34,403	6.4%	2,202	6.4%	2,202	-
2421 AERIAL CABLE MET	121,417	12.6%	15,299	9.6%	11,656	(3,643)
2421 AERIAL CABLE NON MET	4,563	8.7%	397	9.3%	424	27
2422 UNDGRD CABLE MET	257,054	9.5%	24,420	7.8%	20,050	(4,370)
2422 UNDGRD CABLE NON MET	64,194	10.3%	6,612	11.2%	7,190	578
2423 BURIED CABLE MET	927,241	12.0%	111,269	11.1%	102,924	(8,345)
2423 BURIED CABLE NON MET	12,727	6.4%	815	6.7%	853	38
2424 SUB CABLE MET	2	86.1%	2	192.0%	4	2
2424 SUB CABLE NON MET	-	0.0%	-	0.0%	-	-
2426 INTRA BLDG CABLE MET	30,275	3.5%	1,060	3.2%	969	(91)
2426 INTRA BLDG CABLE NON MET	429	13.1%	56	9.5%	41	(15)
2431 AERIAL WIRE	6,494	20.6%	1,338	17.4%	1,130	(208)
2441 CONDUIT SYSTEMS	225,140	2.2%	4,953	2.3%	5,178	225
Total	3,594,290		355,134		369,620	14,486
Composite Rates			9.9%		10.3%	

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 APPPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN.	)	DOCKET NO. T-1051B-99-105 AFFIDAVIT OF KERRY DENNIS WU
STATE OF WASHINGTON	) :	ss
COUNTY OF KING	)	

Kerry Dennis Wu, of lawful age being first duly sworn, depose and states:

1. My name is Kerry Dennis Wu. I am Director – Capital Recovery of Qwest Corporation in Seattle, Washington. I have caused to be filed written testimony and exhibits in support of Qwest in Docket No. T-01051B-99-0105.

2. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct to the best of my knowledge and belief.

Further affiant sayeth not.

Kerry Dennis Wu

Kerry Dennis Wu

SUBSCRIBED AND SWORN to before me this 17th day of August, 2000.

ANGIE LEIFER
NOTARY PUBLIC
COMMISSION EXPIRES 8-08-02
STATE OF WASHINGTON

Angie Leifer

Notary Public residing at
Seattle, Washington.

My Commission Expires: 8/8/02

BEFORE THE ARIZONA CORPORATION COMMISSION

EXHIBIT
Q-32
Admitted

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 APPPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN.	)	DOCKET NO. T-01051B-99-0105

REJOINDER TESTIMONY OF

PETER C. CUMMINGS

QWEST CORPORATION

SEPTEMBER 19, 2000

REJOINDER TESTIMONY OF PETER C. CUMMINGS
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IDENTIFICATION OF WITNESS

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

A. My name is Peter C. Cummings and my business address is 1600 Bell Plaza, Room 3005, Seattle, Washington 98191. I am employed by Qwest Corporation (Qwest) as Director - Finance and Economic Analysis.

Q. ARE YOU THE SAME PETER C. CUMMINGS THAT FILED DIRECT AND REBUTTAL TESTIMONY IN THIS DOCKET?

A. Yes, I am. My work experience and qualifications are described in my direct testimony.

PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR REJOINDER TESTIMONY?

A. The purpose of my rejoinder testimony is to comment on the surrebuttal testimony filed by Charles W. King on behalf of the United States Department of Defense and Federal Executive Agencies, by Stephen G. Hill on behalf of the Arizona Corporation Commission Staff, by John B. Legler on behalf of the Residential Utility Consumer Office and by Arlene M. Starr on behalf of AT&T

Communications of the Mountain States, Inc. My rejoinder testimony will focus on clarifying limited specific issues related to cost of capital rather than restatement or augmentation of testimony already filed.

COMMENT ON THE TESTIMONY OF CHARLES W. KING

Q. PLEASE COMMENT ON MR. KING'S ASSERTION THAT YOUR GROUP OF COMPARABLE RISK COMPANIES IS NOT RISK COMPARABLE TO U S WEST'S ARIZONA OPERATIONS.

A. In his Exhibit CWK-01, Mr. King graphs Zacks betas from his own source and the DCF required return estimates from my direct and supplemental testimony exhibits. Citing the low correlation between these two data sets, Mr. King concludes that the group of companies is not risk comparable to Qwest's Arizona operations.

Mr. King's Exhibit CWK-01 is an "apples and oranges" comparison and it does not have any linkage to Arizona intrastate operations. He is graphing the required return estimate from application of a DCF model against beta, one of the input values to the capital asset pricing model. The fact that his betas do not track with my DCF model estimates is not surprising. DCF

model results and CAPM model results differ – that's why it's important to use more than one model.

Mr. King's analysis is misplaced and misses two important points. First, the comparable company group in my testimony was selected based on two objective risk measures commensurate with Qwest Corporation (the telephone company); bond rating and cash flow variability. Second, the DCF and CAPM market required return estimates for the comparable companies as a group are in a fairly close range – 13.9% for the DCF and 13.3% for the CAPM. (Cummings Supplemental Direct page 4.)

Q. DOES MR. KING AGREE WITH YOUR REVISION TO THE VERIZON DIVIDEND YIELD SHOWN IN HIS TESTIMONY?

A. Yes. Mr. King agrees that the dividend yield for Verizon should be $1.54 instead of the $0.20 shown on page 18 of his direct testimony. Making that correction changes the DCF return for Verizon from 12.01% to 14.46%.

Q. WHAT IS THE PURPOSE OF MR. KING'S EXHIBIT CWK-02?

A. I found Mr. King's Exhibit CWK-02 to be confusing. It is marked as an exhibit, but reads as question and answer testimony and is dated October 25, 1999. DCF estimates shown in this exhibit are based upon stock prices from

July to October 1999. I am interpreting Exhibit CWK-02 to be part of Mr. King's argument that U S WEST's pending merger with Qwest did not impact capital market data or cost of equity estimates for U S WEST and additionally that Exhibit CWK-02 does not contain data that he is relying upon for his cost of equity capital recommendation to the Commission.

Q. ARE YOUR CONCLUSIONS RELATIVE TO MR. KING'S TESTIMONY THE SAME AS SHOWN IN YOUR REBUTTAL TESTIMONY?

A. Yes. When corrected for the Verizon dividend error, Mr. King's DCF analysis of the three largest telephone companies provides a reasonable estimate of the required equity return for Qwest Corporation – the range of 12.73% to 15.18% with a midpoint of 14.12%.

COMMENT ON THE TESTIMONY OF STEPHEN G. HILL

Q. DO YOU AGREE WITH MR. HILL'S SUMMARY STATEMENT THAT, "MR. HILL DEMONSTRATES THAT HE HAS PROVIDED VERY SPECIFIC EVIDENCE REGARDING THE OPERATIONS OF QWEST'S ARIZONA LOCAL EXCHANGE OPERATIONS WHICH INDICATES THAT THE COMPANY HAS SIMILAR OPERATING RISK TO GAS DISTRIBUTORS.

THESE DATA WERE CONFIRMED INDEPENDENTLY BY OTHER WITNESSES IN THIS PROCEEDING."

A. No. What Mr. Hill has provided in his testimony is an anecdotal comparison of the gas distribution industry and the telephone industry and this comparison appears to end before the Telecommunications Act of 1996. Mr. Hill has not provided any objective measures which demonstrate that the company has similar risk to gas distributors.

I don't understand Mr. Hill's statement that "These data were confirmed independently by other witnesses in this proceeding." Mr. Hill is the only witness making the statement that gas distribution companies have similar risks to Qwest or other telephone operating companies. In fact, Dr. Legler says the exact opposite in his surrebuttal testimony:

> I agree with him [Cummings] the use of other groups of companies, electric companies, 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.
>
> (Legler Surrebuttal, page 2, lines 15-19)

Q. REGARDING YOUR REBUTTAL TESTIMONY, MR. HILL SAYS, "MR. CUMMINGS REBUTTAL IS, IN THE MAIN, EXTREMELY SHORT ON SUBSTANCE. IT FAILS TO ADDRESS OBJECTIVE DIFFERENCES

BETWEEN OUR ANALYTICAL TECHNIQUES THAT MIGHT BE TIED TO UNDERLYING ECONOMIC THEORY AND RELIES, INSTEAD ON DISPARAGING REMARKS ABOUT ME, PERSONALLY." HOW DO YOU RESPOND?

A. My rebuttal testimony is critical of Mr. Hill's methodology; it is not critical of him as a person. My rebuttal testimony focuses on the ways in which Mr. Hill and I differ in our approach to estimating the cost of equity capital. I pointed out that it is to be expected that experts will differ in their use of models and data, and highlighted areas where I believe Mr. Hill's methodology departs significantly from accepted financial theory and practice and significantly affects the cost of equity estimate.

As for "failing to address objective differences between our analytical techniques that might be tied to underlying economic theory," in the 15 pages of testimony devoted to rebuttal of Mr. Hill, I have quoted the investment research firms, Paine Webber and Value Line, the Financial Analysts' Journal, Financial Practice and Education, and the text, Principles of Corporate Finance. Additionally, I provided a 19 page technical Appendix (with exhibits) and referenced 2 data exhibits in addressing Mr. Hill's analytical techniques.

Q. DO YOUR CONCLUSIONS ABOUT MR. HILL'S METHODS AND DATA REMAIN AS STATED IN YOUR REBUTTAL TESTIMONY?

A. Yes.

COMMENT ON THE TESTIMONY OF DR. JOHN. B. LEGLER

Q. DR. LEGLER SAYS "FRANKLY, I DO NOT KNOW WHERE MR. CUMMINGS GOT HIS RISK PREMIUM OF 7.4% AS SHOWN ON PAGE 36, LINE 6 OF HIS REBUTTAL TESTIMONY." CAN YOU EXPLAIN THE 7.4% RISK PREMIUM?

A. Yes. 7.4% is the historical risk premium of total returns for large company stocks over total returns for long term corporate bonds. From the Ibbotson Associates, Stocks, Bonds, Bills, and Inflation 2000 Yearbook cited and shown in my supplemental direct testimony Exhibit PCC-09, stocks had an average annual return of 13.3% over the 74 year period 1926 to 1999 and corporate bonds had an average annual return of 5.9%. The 7.4% average annual return difference is the additional return or risk premium for investors holding stocks instead of corporate bonds. The 7.4% long term historical risk premium is substantially higher than the 2.80% to 3.92% risk premium calculated by Dr. Legler.

Q. ARE YOUR CONCLUSIONS RELATIVE TO DR. LEGLER'S TESTIMONY THE SAME AS SHOWN IN YOUR REBUTTAL TESTIMONY?

A. Yes.

COMMENT ON THE TESTIMONY OF ARLENE M. STARR

Q. MS. STARR SAYS THAT QWEST IS USING AN OVERSTATED COST OF MONEY IN ITS ACCESS COST STUDIES BECAUSE THAT COST OF MONEY IS GREATER THAN THE 10.86% OVERALL RETURN RECOMMENDED IN YOUR TESTIMONY. CAN YOU EXPLAIN THE DIFFERENCE BETWEEN THE OVERALL RETURN RECOMMENDATION AND THE COST OF MONEY FOR ACCESS COST STUDIES?

A. Yes. The cost of money for access cost studies is not "overstated" – it is legitimately greater than the overall return because the firm's weighted average cost of capital is greater than the Commission allowed cost of capital. The cost of money for cost studies is an application of the firm's **weighted average cost of capital** or alternatively called the firm's **marginal or incremental cost of capital**. In their well known finance text, Professors Brealey and Myers explain the weighted average cost of capital. Their formula says that the weighted average cost of capital is equal to proportion

of debt times the after tax borrowing rate plus the proportion of equity times the expected rate of return on the firm's stock:

> We refer to the *weighted-average cost of capital.* Sometimes we call it the *textbook formula*, since many other textbooks have put heavy emphasis on it. The formula is
>
> $$r^* = r_D (1 - T_c) \frac{D}{V} + r_E \frac{E}{V}$$
>
> where:
>
> r^* = the adjusted cost of capital [weighted average cost of capital]
>
> r_D = the firm's current borrowing rate
>
> T_c = the marginal *corporate* income tax rate
>
> r_E = the expected rate of return on the firm's stock (which depends on the firm's business risk and its debt ratio)
>
> D,E = the market values of currently outstanding debt and equity
>
> V = D + E
>
> (Richard A. Brealey and Stewart C. Myers, Principles of Corporate Finance, (4th Ed; New York: McGraw-Hill, Inc.; 1991), p. 465.)

There are several key features of this textbook formula for the weighted average cost of capital which I want to highlight. The formula uses the firm's **current** borrowing rate, the **expected** rate of return on the firm's stock, and the **market** values of currently outstanding debt and equity. Along with the marginal tax rate, these features define the company's marginal cost of capital. The weighted average (or marginal cost of capital) is a weighted

average of the opportunity costs of the company's financing sources. This weighted average cost of capital is the proper input for TSLRIC or TELRIC forward looking cost models.

The forward looking weighted average cost of capital is markedly different from my recommendation of 10.86% for a Commission authorized return, even though the terms of "debt", "equity", "cost of capital" and "capital structure" are common to both. Using an authorized return in place of the weighted average cost of capital in cost studies destroys the economic rationale underlying the cost studies.

The Commission authorized return uses the company's **embedded** cost of debt; that is, the historical cost of debt from the company's books. The weighted average cost of capital calls for the company's **current** or **incremental** cost of new debt.

The Commission authorized return uses the company's regulatory **book value** capital structure. The weighted average cost of capital calls for the **market values** of debt and equity. The Commission authorized return and the weighted average cost of capital have only one parameter in common -- the **expected** rate of return on the company's stock or equity capital.

Q. DOES THE FINANCIAL LITERATURE RECOGNIZE THE DISTINCTION BETWEEN THE WEIGHTED AVERAGE COST OF CAPITAL AND A COMMISSION ALLOWED COST OF CAPITAL?

A. Yes. In a chapter devoted to cost of capital for regulated companies, Professor Erhardt contrasts the weighted average cost of capital and the allowable cost of capital, first describing the role of cost of capital in the regulatory process of setting customer rates:

> In a typical rate case hearing, a necessary step is the establishment of a rate base. This rate base is usually the sum of the book values of debt and equity. The next step is to estimate the components of the allowable cost of capital. The cost of debt is the weighted average of the coupon rates on all of the company's existing debt. This historical pre-tax cost of debt is frequently called the "embedded cost of debt." The Commission also establishes an allowable cost of equity.
>
> > *The allowable weighted average cost of capital equals the percent book equity of total book value capital times the allowable cost of equity plus the percent book debt of total book value capital times the historical cost of debt.*
>
> The Commission multiplies the allowable cost of capital by the rate base to determine the allowable revenues. The Commission adds tax expenses, estimated production costs, and other expenses to these revenues. The resulting figure is analogous to the net sales of a manufacturer. The commission divides this figure by the forecasted demanded quantity and the result is allowable price.
>
> This might be an appropriate process for regulators, because the objective of the regulatory commission is to determine the

> allowable price. Yet this allowable cost of capital is different from the weighted average cost of capital.

Erhardt then goes on to discuss the differences between the weighted average cost of capital and the allowable cost of capital:

> Chapter 2 defines the weighted average cost of capital as:
>
> > *The Weighted Average Cost of Capital equals the percent equity market value of total market value times the cost of equity plus the percent debt market value of total market value times the current rate at which you could issue debt.*
>
> One obvious difference is the use of book weights for the allowable cost of capital and market weights for the weighted average cost of capital. ...
>
> A second difference between the allowable cost of capital and the weighted average cost of capital is the interest rate. The interest rate for the allowable cost of capital is the embedded historical rate, not the current rate.
>
> (Michael C. Erhardt, The Search For Value: Measuring the Company's Cost of Capital, Boston, MA: Harvard Business School Press, 1994, pp. 166-167)

Q. WHAT IS YOUR CONCLUSION ABOUT THE COST OF CAPITAL FOR THE RATE CASE AND FOR ACCESS COST STUDIES?

A. The Commission allowed cost of capital is appropriate for historical cost rate base regulation, and the weighted average cost of capital is appropriate for economic analysis and forward looking cost studies.

Q. DOES THIS CONCLUDE YOUR REJOINDER TESTIMONY?

A. Yes, it does.

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 APPPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN.	)	DOCKET NO. T-1051B-99-105

STATE OF WASHINGTON)
: ss AFFIDAVIT OF PETER C. CUMMINGS
COUNTY OF KING)

Peter C. Cummings, of lawful age being first duly sworn, depose and states:

1. My name is Peter C. Cummings. I am Director – Finance & Economic Analysis of Qwest Corporation in Seattle, Washington. I have caused to be filed written testimony and exhibits in support of U S WEST Communications, Inc. (Now Qwest Corporation) in Docket No. T-01051B-99-105.

2. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct to the best of my knowledge and belief.

Peter C. Cummings

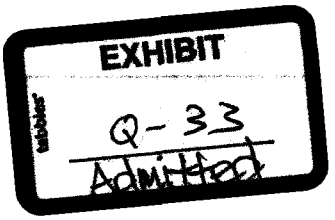
SUBSCRIBED AND SWORN to before me this 12th day of September, 2000.

Elizabeth M Weber
Notary Public residing at
Seattle, Washington.

My Commission Expires: 09/15/02

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	)	DOCKET NO. T-01051B-99-0105

REJOINDER TESTIMONY OF

PHILIP E. GRATE

QWEST CORPORATION

SEPTEMBER 19, 2000

REJOINDER TESTIMONY OF PHILIP E. GRATE

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INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Philip E. Grate. My business address is 1600 Bell Plaza, Room 3008, Seattle, Washington 98024.

Q. ARE YOU THE SAME PHILIP E. GRATE WHO FILED REBUTTAL TESTIMONY IN THIS CASE?

A. Yes.

Q. U S WEST HAS UNDERGONE A NAME CHANGE. HOW WILL YOU REFER TO THE FORMER U S WEST IN YOUR REJOINDER TESTIMONY?

A. The regulated telecommunications subsidiary of Qwest Communications International, Inc. (formerly U S WEST, Inc.) is now Qwest Corporation. Qwest Corporation is the new name of the former U S WEST Communication, Inc. In my testimony I will refer to the former U S WEST Communications, Inc. as "Qwest" or the "Company."

Q. WHAT IS THE PURPOSE OF YOUR REJOINDER TESTIMONY?

A. The purpose of my rejoinder testimony is to respond to the surrebuttal testimonies of Steven C. Carver on behalf of Staff and Hugh Larkin, Jr. on behalf of RUCO concerning incentive compensation and pension asset in revenue requirement.

INCENTIVE COMPENSATION

Rejoinder To RUCO's Surrebuttal

Q. RUCO SUGGESTS THAT 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. [LARKIN, P. 3, L. 11] MR. LARKIN ALSO ASSERTS, "THE COMPANY'S APPROACH WOULD ESSENTIALLY DISCONTINUE ANY SORT OF PRUDENCE REVIEWS OR ANALYSIS OF SPECIFIC COST ITEMS." [LARKIN, P. 3, L. 29] ARE THESE FAIR CHARACTERIZATIONS OF YOUR REBUTTAL TESTIMONY?

A. No. As I stated in my rebuttal testimony, prudence and reasonableness are the standards against which these costs should be reviewed.

> To the extent costs are necessary and prudently incurred in the conduct of the utility's business and reasonable in amount, they should not be disallowed. [Grate rebuttal testimony, page 5]

Although he mentions prudence [Larkin surrebuttal, p. 3, l. 20, p. 5, l. 10] and market power [Larkin surrebuttal, p. 4, l. 6], Mr. Larkin has made no attempt to show that Qwest's incentive compensation plans are in any way imprudent, unreasonable, or an abuse of market power. To make such a showing, Mr. Larkin would have to demonstrate that companies that lack market power do not use such plans, that companies that lack

1 market power do not use performance criteria like those in Qwest's plans
2 and that the amount Qwest pays its employees is more than the amount
3 companies that lack market power pay their employees. Mr. Larkin has
4 not made such a demonstration.

5

6 The review and analysis that Mr. Larkin offers to support his
7 recommended 50% disallowance of Qwest's ABP and STIP is limited to
8 broad observations that "these plans result in benefits to both ratepayers
9 and shareholders" [Larkin direct, p. 18, l. 18, p. 19, l. 5] and "[s]ome of the
10 specific goals appear to be in direct conflict with ratepayer interests."
11 [Larkin, p. 19, l. 6]. Mr. Larkin could have recommended specific
12 disallowances of costs he believes are incurred in direct conflict with
13 ratepayer interests. Instead, he suggests 50% without offering anything to
14 show why 50% is not an arbitrary number. Mr. Larkin's testimony does
15 not evidence any effort to perform a detailed review or rigorous analysis.

16

17 It is very easy for just about anyone to find something to criticize in a
18 compensation plan. But such criticisms should not be used as the basis
19 for a disallowance of costs unless those costs are clearly unnecessary,
20 imprudent or unreasonable in amount. This is particularly true when—as
21 is the case in this proceeding—no party disputes that the costs were
22 actually incurred.

23

Q. RUCO ARGUES THAT INCENTIVE COMPENSATION SHOULD BE DISALLOWED BECAUSE IT IS SUBJECT TO MANAGEMENT DISCRETION AND SHAREHOLDERS STAND TO BENEFIT FROM IT. [LARKIN SURREBUTTAL, PP. 7-8] IS THE FACT THAT SHAREHOLDERS BENEFIT LEGITIMATE GROUNDS FOR A DISALLOWANCE OF A COST?

A. No. This argument is incorrect for many reasons. First, management has discretion over every aspect of the operation of the Company, not just incentive compensation. Except in the case of cooperatives, ratepayers have no expectation of being involved in the management of utilities. The argument that a cost should be disallowed because it is subject to management discretion proves too much and could be improperly used to justify disallowance of any expense no matter how reasonable and prudent.

Second, under cost of service regulation, ratepayers and shareholders both benefit from the same financial performance. My rebuttal testimony illustrates how this mechanism works. Mr. Larkin suggests my illustration is overly simplistic, is not specific to U S West's/Qwest's experience and should be given no weight. [Larkin, p. 6, l. 19] My illustration is simple so that the concepts it is explaining can be readily understood. It is non-specific because it illustrates a ratemaking mechanism, not a specific fact pattern. While Mr. Larkin would like the Commission to ignore the illustration, he does not dispute that 1) cost of service ratemaking provides a mechanism that allows ratepayers to benefit from improved financial

performance and 2) the ratemaking mechanism the illustration describes applies to Qwest in Arizona.

Finally, the fact that shareholders benefit from incentive compensation is not grounds for its disallowance. The ACC should not disallow a cost designed to provide financial benefits to shareholders merely because ratepayers will receive those same benefits (through reduced revenue requirement) only after shareholders have received them. Such a disallowance would financially penalize shareholders for employing a management strategy that increases the likelihood ratepayers will get a financial benefit. Furthermore, to disallow such costs is to give ratepayers a free ride. Ratepayers would get the benefit of a utility whose revenue requirement and rates are more likely to decline. But ratepayers will not have to pay the full cost of employee compensation that motivates employees to achieve results that reduce revenue requirement and lower rates.

Rejoinder to Staff's Surrebuttal

Q. IN SURREBUTTAL, STAFF ARGUES:

"THE INCENTIVE COMPENSATION PLAN COSTS THAT THE STAFF HAS RECOMMENDED BE DISALLOWED ARE PRIMARILY DRIVEN BY CORPORATE-WIDE FINANCIAL RESULTS OR SURVEYS OF CUSTOMER PERCEPTIONS OF THE COMPANY. IN GENERAL TERMS, THESE CORPORATE-WIDE GOALS AND OBJECTIVES DO

NOT ADDRESS OR DEFINE SPECIFIC SERVICE QUALITY MEASURES OR PERFORMANCE EXPECTATIONS THAT ARE UNIQUE TO THE SPECIFIC WORK ACTIVITY OF THE INDIVIDUAL COMPANY EMPLOYEE OR COMMON GROUPS OF EMPLOYEES, WHICH WOULD MOST DIRECTLY MOTIVATE EMPLOYEE WORK." [CARVER, P. 37, LINES 1-6]

DOES THE USE OF CORPORATE WIDE GOALS INSTEAD OF SPECIFIC WORK ACTIVITY GOALS OF THE INDIVIDUAL EMPLOYEE JUSTIFY DISALLOWANCE OF INCENTIVE COMPENSATION?

A. No. The use of company-wide goals instead of employee or group specific goals in no way justifies a disallowance. Mr. Carver offers no ratemaking principles in support of his position that incentive compensation should be disallowed unless it is tailored to individual employees or common groups of employees. Instead, he merely implies that, because they do not exclusively use specific service quality measures or performance expectations that are unique to the specific work activity of the individual Company employee or common groups of employees, Qwest's plans are so defective that their costs should be disallowed.

Based on his experience, Mr. Carver may sincerely believe that goals tailored to individuals and work groups goals are better motivators. However he has never been employed by a large corporation, managed a large corporation or managed a large group of people. Mr. Carver has not

shown that incentive compensation plans in general, or Qwest's plans in particular, are ineffective at motivating employees or that such plans are imprudent or unreasonable. Nor has he shown why his preference for goals tailored to individuals and work groups justifies a disallowance.

The Commission should not disallow a cost because the Company's professional managers have adopted a management technique different from that which the Commission's Staff's prefers.

Q. IN SURREBUTTAL, STAFF ARGUES:

"THE COMPANY HAS NOT DEMONSTRATED THE DEGREE TO WHICH THE CORPORATE-WIDE GOALS AND OBJECTIVES HAVE MOTIVATED THE BROAD BASE OF EMPLOYEES TO PERFORM AT LEVELS UNLIKELY TO BE ATTAINED IN THE ABSENCE OF SUCH PLANS OR THAT THE PLANS HAVE RESULTED IN ACHIEVEMENTS BENEFITING ARIZONA RATEPAYERS THAT COULD NOT HAVE BEEN ATTAINED WITHOUT SUCH PLANS."

SHOULD QWEST'S INCENTIVE COMPENSATION PLANS BE DISALLOWED UNLESS THE COMPANY DEMONSTRATES HOW THE PLANS HAVE MOTIVATED EMPLOYEES TO ATTAIN ACHIEVEMENTS BENEFITING ARIZONA RATEPAYERS THAT COULD NOT HAVE BEEN ATTAINED WITHOUT SUCH PLANS?

A. No. A common theme runs through Mr. Carver's incentive compensation and pension asset testimony. That common theme is Mr. Carver's

argument that expenses should be disallowed from results of operations and assets should be disallowed from ratebase unless the Company can prove something that is not provable.

Mr. Carver argues that Pension Asset must be removed from ratebase unless the Company can prove that ratepayers have recovered all pension credits the Company has recorded. He also argues that any reconciliation of pension expenses and credits must go back many decades to the beginning of the Company's pension plan (this requirement assures that records necessary to conduct the reconciliation are unavailable). By Mr. Carver's own admission, this is a standard that the Company can not meet.

Now in surrebuttal testimony Mr. Carver introduces a new requirement that he argues the Company must satisfy if its incentive compensation expenses are to be allowed. In proposing to assign his new standard-of-proof, he argues incentive compensation costs should be disallowed unless the Company identifies and quantifies the degree to which incentive compensation has caused improvements in financial and service quality performance, "that could not have been attained without such plans." Meeting this standard would be an impressive accomplishment indeed.

Obviously, it is impossible to know what would have been achieved had Qwest had no incentive compensation plans because there is only one Company and one set of outcomes to measure. The outcomes that would have been achieved with different plans or no plans are purely a matter of speculation.

Q. MR. CARVER CLAIMS TO HAVE BEEN "RATHER SURPRISED THAT THE COMPANY WAS UNABLE TO PROVIDE ANY DATA TO DEMONSTRATE...TANGIBLE BENEFITS." [CARVER, P. 37, L. 26] WHAT IS YOUR RESPONSE?

A. In 1999 any particular firm either had an incentive compensation plan or it did not. Expecting Qwest to measure and compare the benefits achieved through its plans with the benefits that would have been achieved with no plans is like expecting a person to identify and quantify how their lifetime income would have been different had they chosen a different career. The best anyone can do is speculate. What we do know with certainty is that incentive compensation costs were incurred as part of a total compensation package offered to management and employees for the work they perform in providing telecommunications services to Arizona ratepayers.

Q. MR. CARVER ARGUES THAT QWEST'S INCENTIVE COMPENSATION EXPENSES SHOULD BE DISALLOWED IN PART BECAUSE THEY RELY ON SURVEYS INSTEAD OF "TRADITIONAL" MEASURES OF

SERVICE QUALITY. [CARVER SURREBUTTAL, P. 40, LINE 16 THROUGH P. 41, LINE 22] IS THIS A REASONABLE BASIS FOR A DISALLOWANCE?

A. No. While Mr. Carver professes to make no "judgement" about the CVA, he does make a judgement because he recommends disallowance based on Qwest's use of the CVA. Based on his belief that CVA surveys are inferior to more "traditional" and direct measures of service quality, he opines that the costs of incentive compensation for the CVA should be disallowed. Here again he asks the Commission to disallow a cost because the Company's professional managers have not adopted the management technique that he prefers. Unless Staff can show that the CVA is unreasonable or imprudent, the costs incurred for it should not be disallowed.

Q. DOES THE CVA'S RELIANCE ON SURVEYS MAKE IT UNREASONABLE OR IMPRUDENT?

A. No. All measures of service quality have their shortcomings. It is easy to find something to criticize in any service quality measure.

The use of customer surveys to ascertain customer satisfaction is widespread and commonplace in the United States. No one can reasonably argue that use of customer surveys to measure service quality for purposes of incentive compensation is unreasonable or imprudent. Mr. Carver's preference for "traditional" measures of service quality and

his criticisms of the CVA do not justify disallowing incentive compensation costs.

Q. MR. CARVER STATES IN SURREBUTTAL:

TO THE EXTENT THAT ARIZONA CUSTOMERS ARE BEING ASKED TO PAY FOR THE COST OF IMPROVING SERVICE QUALITY, BOTH THE COSTS SOUGHT FOR RECOVERY AND THE IMPROVEMENT IN QUALITY SHOULD BE BASED ON ARIZONA OPERATIONS—NOT COSTS OR IMPROVEMENTS IN OTHER STATE JURISDICTIONS MUCH LESS COMPANY WIDE PERCEPTIONS THAT MAY NOT DIRECTLY TRANSLATE INTO THE PROVISION OF HIGHER QUALITY ARIZONA SERVICE. [CARVER, P. 42, L. 16]

WHAT IS YOUR RESPONSE?

A. Mr. Carver is suggesting incentive plans should be disallowed unless the Company can show how Arizona ratepayers benefited from the costs incurred in Arizona for the plans because "the corporate-wide benefits alleged to result from these plans...are not necessarily realized or realizable in Arizona—because Arizona does not necessarily mirror the Company's consolidated operations." [Carver surrebuttal, p. 44, l. 20] He concludes that "[b]ecause of the structure of the incentive plans and the cost allocation process employed, employee payouts and the apportionment of costs to Arizona are not based on the financial or service achievements attained in Arizona." [Carver, p. 45, l.11]

1 This argument is another variation on Mr. Carver's impossible-to satisfy
2 standard-of-proof strategy. In this case, he is asserting that unless there
3 is a direct and demonstrable link between the incentive compensation
4 costs incurred in Arizona and the benefits derived from them in Arizona,
5 those costs should be disallowed. It is undeniable that the benefits of
6 incentive compensation are not necessarily realized among the 14 states
7 in direct proportion to the costs each of those states incur for incentive
8 compensation. But this does not mean that the incentive compensation
9 costs incurred in Arizona provide no benefit to Arizona or that the costs
10 are unreasonable or imprudent.

11

12 The employees whose compensation costs are charged to the Arizona
13 jurisdiction were subject to these plans. While these employees
14 performed work in or on behalf of (and, therefore, charged to) Arizona
15 they were under the influence of the incentives in the plans.
16 Consequently, the work performed in or on behalf of Arizona was
17 influenced by the incentives and the influence of the plans is imbedded in
18 the costs charged to Arizona and the results of the work done in or for
19 Arizona.

20

21 Even if the benefits of incentive compensation could be specifically
22 identified and quantified (which they can't), it still would not be reasonable
23 to expect the Company to demonstrate that all the incentive compensation
24 costs incurred or charged to Arizona yielded benefits that stayed in
25 Arizona. Similarly, some of the benefits realized in Arizona may be linked

to incentive compensation costs borne by other jurisdictions. Further, even if there were 14 separate state incentive compensation plans there would be no assurance that the cost/benefit ratio of each state would be the same.

Ratepayers pay for service, not for specific elements of a utility's costs; were it otherwise, rates would be adjusted annually to provide full recovery of costs actually incurred. Rates in Arizona are not set by reference to any formula that makes adjustments for differently levels of service quality. Instead, Qwest's service quality levels in Arizona are subject to rules that provide for financial rewards and penalties. So it is a mischaracterization to claim that "Arizona customers are being asked to pay for the cost of improving service quality."

Under the cost-of-service method of ratemaking now employed in Arizona, rates should be designed to provide a reasonable opportunity for a utility to recover the reasonable and prudent costs of providing service. If the incentives in Qwest's plans do not make Qwest's employee compensation unreasonable or imprudent, such costs should not be disallowed. A corporation that operates in multiple states can hardly be said to act imprudently on unreasonably because it does not measure state specific performance, particularly where state specific service quality performance is not an element in the computation of rates and service quality levels are a result of many variables.

Q. IN SURREBUTTAL MR. CARVER ALLEGES:

...EMPLOYEES PARTICIPATING IN THE COMPANY'S 1999 STIP AND ABP COULD STILL ACHIEVE A NEAR-TARGET TOTAL BONUS FROM EXCEPTIONAL FINANCIAL PERFORMANCE EVEN IF NO BONUS IS ACHIEVED FOR SERVICE QUALITY. [CARVER, P. 43, L. 10]

WHAT IS YOUR RESPONSE?

A. The targets in the plans are just that, targets. They are not maximums and they do not define the limit of employees' desire to earn compensation. The fact that near-target payouts could be made does not diminish the fact that employees would be leaving incentive compensation dollars "on the table" if they do not get a payout for service quality. So any implication Mr. Carver might try to make 1) that employees would view payouts for exceptional financial performance as full compensation for missing service quality objectives or 2) that the structure of the plan negates the motivational effect of service quality incentives, is false.

Mr. Carver's suggestion that all of the costs of the STIP and ABP should be disallowed because, <u>under exceptional circumstances</u>, employees <u>could</u> receive a <u>near-target</u> payout is yet another one of his criticisms. In direct testimony, Mr. Carver suggests the STIP and APB should be disallowed because they "focus heavily on increasing financial targets and enhancing corporate profitability." [Carver, p. 45, l. 11] His criticism here—based on exceptional circumstances—is a variation on that

complaint. It does not demonstrate the plans are unreasonable or imprudent and does not justify a disallowance.

Q. IN SURREBUTTAL MR. CARVER ALLEGES:

ARIZONA EMPLOYEES COULD PERCEIVE DIMINISHED INCENTIVES BECAUSE THE STATE'S RESULTS ARE CO-MINGELD WITH AND DILUTED BY THOSE OF THE OTHER 13-STATE OPERATIONS, EITHER POSITIVELY OR NEGATIVELY. [CARVER, P. 45, L. 4]

WHAT IS YOUR RESPONSE?

A. Mr. Carver argues that Arizona employees' incentives could be diminished because the level of performance in Arizona is diluted by the other 13 states. [Carver, p. 45, l. 1] Following his line of reasoning to its logical conclusion, all employees experience diminished incentives because their performance is diluted by all other employees' performance. Here again Mr. Carver would justify a disallowance based on a philosophical difference. Incentive compensation can be individualized at the risk of promoting selfishness and parochialism or it can be based on broad outcomes at the risk of diminishing individual incentives. Mr. Carver's preference for individual instead of corporate or large group incentives does not make them unreasonable or imprudent and a disallowance based on his preference would be an unreasonable financial penalty.

Q. DO YOU HAVE ANY REJOINDER TO MR. CARVER'S SURREBUTTAL CONCERNING THE IT CAREER STRUCTURE BONUS PLAN?

A. No. Mr. Carver offers no surrebuttal to my rebuttal testimony on this plan.

Reasonableness and Prudence

Q. SHOULD THERE BE DIFFERENT STANDARDS OF REASONABLENESS AND PRUDENCE FOR JUDGING THE COSTS OF REGULATED UTILITIES AND THE COSTS OF NON-REGULATED BUSINESSES?

A. No. In Mr. Larkin's words, "one of the purposes of regulation...is to ensure that the captive ratepayers are not being harmed through the market power of the utilities." [Larkin, p. 4, l. 4] It follows that the standard of reasonableness for reviewing a utility cost should be whether prudently and competently operated companies without market power would incur that same cost and in the same amount. If so, the cost is reasonable. Staff's and RUCO's testimonies completely fail to show that Qwest's incentive compensation plans do not satisfy that reasonableness test.

Neither Staff nor RUCO articulate a standard of review for incentive compensation costs in their direct testimony. Instead, they criticize various features of the plans because they are not structured the way Staff and RUCO would prefer them to be structured. It is easy to criticize the structure of any particular incentive compensation plan because there are so many other ways plans can be structured. It is much harder to manage, motivate and compensate a very large and diverse workforce of a multi-state company. It is inappropriate to financially penalize a utility

for incentive compensation plans that are reasonable, prudent, and designed to provide benefit to ratepayers because the plans are not structured the way consumer advocates or regulatory staff would prefer that they be structured.

No witness alleges that Qwest pays its employees too much. Consequently, whether the Commission should financial penalize shareholders—as Mr. Larkin and Mr. Carver recommend—should be determined by deciding this question: would ratepayers be better served if the amount management employees received in 1999 for incentive compensation was paid as base salary instead?

If the Commission determines that paying incentive compensation instead of base salary was imprudent and, therefore, harmed ratepayers, then a disallowance of the portion that was imprudent would be appropriate. To the extent, however, paying incentive compensation left ratepayers no worse off than if the amount paid had been base salary, no disallowance can be justified, regardless of Staff's and RUCO's criticisms of Qwest's plans.

Q. ARE QWEST'S APB, STIP, AND ITCSBP REASONABLE AND PRUDENT FROM A MANAGEMENT COMPENSATION STANDPOINT?

A. Like Mr. Carver and Mr. Larkin, my credentials do not qualify me as an expert on the effectiveness or reasonableness of incentive compensation

1 plans from the perspective of the management compensation discipline.
2 Accordingly, I have asked Qwest's Director of Management
3 Compensation, Mr. Jeffrey Haynes, to provide his expert opinion
4 regarding the effectiveness, reasonableness and prudence of Qwest's
5 1999 APB, STIP and ITCSBP. Attachment PG-1 is Mr. Haynes sworn
6 affidavit that the performance criteria of Qwest's 1999 APB, STIP and
7 ITCSBP were reasonable and prudent from a management compensation
8 standpoint and that the total compensation Qwest paid its managers was
9 reasonable in amount based on a comparison with other firms.
10
11 **PENSION ASSET**

12 ***Rejoinder To RUCO's Surrebuttal***

13 **Q. ARE YOU RESPONDING TO SURREBUTTAL FROM RUCO?**

14 A. No. RUCO did not file any surrebuttal testimony on Pension Asset.

15

16 ***Rejoinder To Staff's Surrebuttal***

17 **Q. MR. CARVER SUGGESTS THAT YOU CRITICIZE HIS OPINION ONLY**
18 **BECAUSE IT DIFFERS FROM YOUR OWN. [CARVER, P 51, LINES. 9--**
19 **11. IS THIS TRUE?**

20 A. No. I drew attention to the fact that Mr. Carver relies only on his opinion
21 because that opinion:

22 1. is unsupported by sound ratemaking principles;

2. supports a test for disallowance that violates the rule against retroactive ratemaking;

3. supports a standard-of-proof that even Mr. Carver acknowledges cannot be satisfied;

4. applies to the one major balance created by accruals that happens to reduce ratebase (Pension Asset); and

5. does not apply to the two major balances created by accruals that do not happen to reduce ratebase (accumulated depreciation and accumulated deferred taxes).

Q. MR. CARVER SUGGESTS THE STANDARD-OF-PROOF ON PENSION ASSET SHOULD BE DIFFERENT THAN THE STANDARD-OF-PROOF THAT APPLIES TO ACCUMULATED DEPRECIATION AND ACCUMULATED DEFERRED TAXES BECAUSE "PENSION ACCOUNTING CHANGED DRAMATICALLY WITH THE ADOPTION OF SFAS 87." [CARVER SURREBUTTAL P. 52, L. 3—13] DO YOU AGREE WITH HIS REASONING?

A. No. Mr. Carver relies on a distinction that makes no difference. No ratemaking principle suggests that one element of the balance sheet should be subject to a different standard-of-proof than all the other elements of the balance sheet. The change in accounting brought about by SFAS 87 does not justify imposing on Pension Asset a standard-of-proof that violates the rule against retroactive ratemaking.

Nor does the fact that the Pension Asset was created by a "dramatic" or "radical" accounting change suggest that it should be treated differently. Pension Asset is not the only ratebase balance created by a significant change. A similarly significant change in federal income tax law gave rise to the recording of accumulated deferred taxes that can and do vary from year to year.

Section 441 of the Tax Reform Act of 1969 enacted rules requiring the "normalization method of accounting" as a condition to the use of accelerated methods of depreciation for purposes of computing income taxes applicable to regulated utility plant placed in service after January 1, 1970. Only after the rules requiring the normalization method of accounting went into effect did Mountain Bell (Qwest's predecessor in the 1970's) and all the other Bell Operating Companies begin to compute income taxes using the accelerated methods of depreciation that have created the accumulated deferred tax balances on the Company's books today. The fact that the Pension Asset was created by a "dramatic" or "radical" change hardly makes it unique.

Q. IF ACCUMULATED DEFERRED TAXES WERE EXCLUDED FROM RATEBASE FOR FAILING THE SAME TEST MR. CARVER WOULD APPLY TO PENSION ASSET, HOW MUCH WOULD THE TEST YEAR'S RATEBASE BE INCREASED?

A. If Qwest's 1999 test year Arizona ratebase excluded accumulated deferred taxes, the ratebase would increase over $300 million, an amount far greater than the amount ratebase would decrease if Pension Asset were excluded.

Q. IN SURREBUTTAL, MR. CARVER CLAIMS THAT IF PENSION ASSET IS TO BE INCLUDED IN RATEBASE, "REGULATORS MUST BE ASSURED THAT RATEPAYERS HAVE FULLY ENJOYED REDUCED RATES OR SOMEHOW BEEN PROVIDED THE BENEFIT OF THE NEGATIVE COSTS RESULTING FROM THE ADOPTION OF FAS87." [CARVER SURREBUTTAL, P. 53, L. 14] DO ALL REGULATORS REQUIRE SUCH ASSURANCE?

A. No. I am aware of several jurisdictions in which regulators have included pension asset in ratebase without imposing the standard-of-proof that Mr. Carver argues is required. Such jurisdictions include, for example, the federal jurisdiction, Colorado, Iowa, Minnesota, Oregon and Washington.

The FCC's rules specifically provide for inclusion of Pension Asset in ratebase. In Docket 86-497, the FCC examined its rules to prescribe components of rate base and net income of dominant carriers such as the Company. In an Order adopted December 17, 1987, in Docket 86-497, the FCC ruled, at paragraph 43 regarding items to be included in rate base,

> We will allow deferred charges related to...pension fund payments in excess of expenses recognized for regulatory purposes.

Hence, for ratemaking purposes, the FCC determined to include the pension asset in rate base in 1987.

Q. DOES THE PUBLIC UTILITY COMMISSION OF COLORADO REQUIRE THE STANDARD-OF-PROOF MR. CARVER SUGGESTS REGULATORS MUST IMPOSE?

A. No. Pages 28 through 30 of USWC witness G. Y. Fleming's direct testimony in Colorado Docket No. 90S-544T, explains that his filing follows the FCC's approach regarding the pension asset. Mr. Fleming's testimony quoted footnote 35 in the FCC's Report and Order in Docket No. 86-497 adopted December 17, 1989. That footnote states:

> In the Pension and Debt Proceeding (note 31 supra), we concluded that it would be appropriate to include in the rate base pension fund payments in excess of recognized expenses. We also concluded that in the converse situation, the excess should be deducted from the rate base, to the extent recognized expenses exceed pension fund payments. (emphasis added)

In rate case Docket No. 90S-544T, USWC included a pension asset as part of its Cash Working Capital (CWC) requirement in the amount of $13.6 million. Following negotiations and a stipulation in the case, this asset was removed from the CWC calculation and included as a rate base item.

Q. DOES THE IOWA UTILITIES BOARD REQUIRE THE STANDARD-OF-PROOF MR. CARVER SUGGESTS REGULATORS MUST IMPOSE?

A. No. The IUB did not initially accept adoption of SFAS 87 so the pension credit was not initially recognized in Iowa cost of service. In 1994, in Docket No. RPU-93-9 (TF-94-343) the IUB changed its position and ordered amortization of the pension credit into cost of service over seven years. In regards to the pension asset, Page 6 of the Commission's order states:

> The rate base will not be adjusted. It is based on a 13-month average, and the record contains no persuasive evidence that an adjustment is necessary. As the FAS 87 negative pension expense is amortized, future 13-month average rate bases will reflect the change. (emphasis added)

Q. DOES THE MINNESOTA DEPARTMENT OF PUBLIC SERVICE REQUIRE THE STANDARD-OF-PROOF MR. CARVER SUGGESTS REGULATORS MUST IMPOSE?

A. No. On pages 6 and 7 of the comments concerning USWC's incentive regulation plan, dated May 17, 1996, filed in Minnesota Docket No. P421/EM-89-860, the Minnesota DPS explained :

> The pension asset has been included in every filing since the first one in 1990, and its basis comes from the settlement in Docket No.P421/C-86-354, where negative rather than positive pension expense was first recognized. The Incentive Plan calls for the inclusion of a cash working capital requirement, and the pension asset component of the cash working capital requirement reflects the accumulation of negative pension expenses as a result of an over-funded pension trust. No cash flows back to USWC for the negative expense credit because the Company is not reimbursed by the trustee for temporary excesses in the pension fund. Consequently, this deferred asset is included in the cash working capital requirement representing an accumulated cash drain as a result of the negative pension expense credited to USWC's operations. If and when it is determined that additional funds are needed in the pension trust, a positive expense will be recognized, and a corresponding reduction will be made in the deferred asset balance. Until future pension expense fully reduce this deferred

asset, it is included in the cash working capital requirement of USWC's rate base so that a return can be earned on this balance of negative expenses that have not been compensated by cash flows from the pension fund. (emphasis added)

Q. DOES THE PUBLIC UTILITY COMMISSION OR OREGON REQUIRE THE STANDARD-OF-PROOF MR. CARVER SUGGESTS REGULATORS MUST IMPOSE?

A. No. In Docket UT 125, the pension asset was initially a contested issue. However, after discussions between the Company and Public Utility Commission of Oregon Staff, the issue was settled. The following appears on page 29 of Oregon Staff Exhibit 87 which is witness Lambeth's Supplemental Testimony on Support of the Second Stipulation in Docket UT 125.

Q. DO STAFF AND USWC AGREE ON THIS ADJUSTMENT, SHOWN IN EXHIBIT REVISED STAFF/3, LAMBETH/17, COLUMN 35?

A. Yes. This issue is completely settled. Exhibit Staff/88, paragraph 5, shows that staff and USWC agree to (1) leave the negative expense in operating expenses, (2) leave accumulated deferred taxes in the rate base, and (3) add the pension asset to the rate base.

Q. WHAT IS THE BASIS OF THE STIPULATION?

A. I added the pension asset to the rate base because it is fair to the company and to its customers.

Q. DOES THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION REQUIRE THE STANDARD-OF-PROOF MR. CARVER SUGGESTS REGULATORS MUST IMPOSE?

A. No. In Docket No. UT-950200, the Washington Utilities and Transportation Commission's Order, dated April 11, 1996, addresses the pension asset on pages 66 and 67. In conclusion, it provides:

> The Company proposes to include the pension asset as a discrete item in rate base. Ms. Wright discusses the pension asset adjustment, PFA-3. which increases rate base by $69.9 million.
>
> * * *
>
> The commission accepts the Company position on this adjustment. All of the return earned in the fund is used to reduce the need for further investment by the company, and thus it works to reduce the pension expense. That was the company's position in docket No. UT-930307. The Company's proposal appears to be consistent with the prior order. The order in that docket states that the commission does not question the prudence of the asset, and that the reason for rejection at that time was merely that it should be examined in conjunction with a total working capital analysis such as the one presented in this proceeding.

Q. IN QWEST'S LAST RATE CASE DID THE ACC CONCLUDE THAT PENSION ASSET SHOULD BE EXCLUDED FROM RATEBASE AS A MATTER OF PRINCIPLE?

A. No. The ACC's order dated January 3, 1995, in Docket No. E-1051-93-183, UT-950200, addresses the pension asset issue on pages 3 through 5. In pertinent part, the order states:

> We concur with the Company that the overfunded pension assets which were contributed by shareholders should be included in rate base. It would be unfair to permit ratepayers to benefit by reduced expenses resulting from capital invested by Company shareholders.

Q. THEN WHY DID THE ACC EXCLUDE PENSION ASSET FROM RATEBASE IN QWEST'S LAST RATE CASE?

A. In Qwest's last rate case Mr. Carver proposed the same standard-of-proof for Pension Asset that he is proposing in this case. In the prior case, the ACC concluded:

> Although the Company has presented evidence in an effort to demonstrate that since 1986 the shareholders have provided the monies which resulted in the current overfunded pension asset, Staff's analysis has raised significant questions as to the accuracy of the Company's claim. Even if we were convinced of the accuracy of the Company's number for the 1976-1993 period, we would still not be able to conclude that shareholders have advanced the excess pension amounts. Accordingly, we must deny the Company's request to include the net amount overfunding of $36,213,000 in rate base.

I did not attempt to satisfy Mr. Carver's proposed standard-of-proof because it is not supported by sound ratemaking principles, violates the rule against retroactive ratemaking, is proposed for no other element of ratebase and is, by Mr. Carver's own admission, impossible to satisfy. For these reasons, I respectfully request the ACC to reconsider the evidentiary test and standard-of-proof upon which it relied to disallow Qwest's Pension Asset in Qwest's last rate case.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

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	)	DOCKET NO. T-01051B-99-0105

EXHIBITS OF

PHILIP E. GRATE

QWEST CORPORATION

SEPTEMBER 19, 2000

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 APPPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN.	)	DOCKET NO. T-1051B-99-105
STATE OF COLORADO	)	AFFIDAVIT OF JEFFREY A. HAYNES
COUNTY OF Denver	)	ss

Jeffrey A. Haynes, of lawful age being first duly sworn, depose and states:

1. My name is Jeffrey Haynes. I have been awarded a Bachelors of Arts Degree majoring in Psychology from the University of Colorado and a Masters of Business Administration with an emphasis in Human Resource Management from Colorado State University. I have been occupied as a human resources consultant for eight years and have been employed by U S WEST / Qwest for the last three years. I am currently Director of Management Compensation for Qwest. In this capacity I am responsible for providing expertise and consultation on the development and administration of management salary and incentive programs, ensuring competitive and equitable plans.

The opinions expressed herein are based upon my training, experience as a human resources consultant and upon benchmarking surveys in which U S WEST/Qwest participate annually to ascertain what levels and types of compensation are necessary to attract and retain the managerial talent necessary to operate successfully in our industry.

In my opinion, U S WEST/Qwest's use of the Annual Bonus Plan, Short Term Incentive Compensation Plan and IT-Career Structure Bonus Plan in 1999 was prudent and reasonable. Viewed from the perspective of the management compensation discipline, these plans should properly be characterized as "competitive." By "competitive" I mean that they were designed to attract, retain and motivate management employees with the skill sets and personal productivity necessary to successfully operate U S WEST/Qwest's business without paying them excessively.

I believe the design of the plans is both prudent and reasonable. First, the plans are designed to reflect and reward employees for the success of the firm as a whole and to balance the need to meet short term financial goals with the need to maintain appropriate levels of customer service and satisfaction. Second, the plans are designed to recognize and reward individual performance in accordance with the company's philosophy of paying more for higher levels of employee performance.

In my opinion, U S WEST/Qwest's use of benchmarking ensures that the firm's compensation plan, including incentive compensation, is competitive with other firm's plans in the labor market. Making the payouts under the plans dependent on business performance helps assure a reasonable and prudent payout level. Conditioning the level of payout to individual employees upon on individual's performance levels helps assure adherence to the company's pay-for-performance philosophy.

2. I hereby swear and affirm that the foregoing statements are true and correct to the best of my knowledge and belief.

Further affiant sayeth not.

Jeffrey A. Haynes

SUBSCRIBED AND SWORN to before me this 6th day of September, 2000.

Jennifer M Young
Notary Public residing at
Denver, Colorado.

My Commission Expires: My Commission Expires May 23, 2004

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 APPPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN.	)	DOCKET NO. T-1051B-99-105 AFFIDAVIT OF PHILIP E. GRATE
STATE OF WASHINGTON	) :	ss
COUNTY OF KING	)	

Philip E. Grate, of lawful age being first duly sworn, depose and states:

1. My name is Philip E. Grate. I am State Finance Director of Qwest Corporation in Seattle, Washington. I have caused to be filed written testimony and exhibits in support of USWC in Docket No. T-01051B-99-0105

2. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct to the best of my knowledge and belief.

Further affiant sayeth not.

Philip E. Grate

Philip E. Grate

SUBSCRIBED AND SWORN to before me this 18th day of September, 2000.

Elizabeth M Webb

Notary Public residing at
Seattle, Washington.

My Commission Expires: 09/15/02

BEFORE THE

ARIZONA CORPORATION COMMISSION

EXHIBIT
Q-34
Admitted

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	)	DOCKET NO. T-01051B-99-0105

REJOINDER TESTIMONY OF

NANCY HELLER-HUGHES

QWEST CORPORATION

SEPTEMBER 19, 2000

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NANCY HELLER HUGHES

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SUMMARY OF TESTIMONY

1. The Reproduction Cost New Less Depreciation (RCNLD) study filed by Qwest Corporation (Qwest) in this proceeding in Supplemental Exhibit NHH-1 was developed using the same methodology used in previous RCNLD studies which has been accepted with approval by the Arizona Corporation Commission.
2. The methodology used by Qwest to estimate the RCNLD value and the methodology proposed by Mr. Dunkel are both acceptable methodologies to use in calculating the RCNLD value of Qwest's Arizona plant in service.
3. Based on Mr. Dunkel's proposed methodology, with the corrections described in Ms. Hughes testimony, the total estimated RCNLD value of Qwest's Arizona plant in service as of December 31, 1999 is equal to $2,723,688,605.

IDENTIFICATION OF WITNESS

Q. PLEASE STATE YOUR NAME, OCCUPATION, AND BUSINESS ADDRESS.

A. My name is Nancy Heller Hughes. I am a Senior Director in the Seattle office of R. W. Beck, Inc. My business address is 1001 Fourth Avenue, Suite 2500, Seattle, Washington 98154-1004.

Q. ARE YOU THE SAME NANCY HELLER HUGHES THAT FILED DIRECT AND SUPPLEMENTAL TESTIMONY IN THIS PROCEEDING?

A. Yes, I am. I have filed direct and supplemental testimony on behalf of U S WEST Communications, Inc. (now Qwest Corporation) in this proceeding.

PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR REJOINDER TESTIMONY?

A. The purpose of my rejoinder testimony is to comment on the direct testimony of William Dunkel filed on behalf of Staff regarding the Reproduction Cost New Less Depreciation (RCNLD) value of Qwest's plant in service in Arizona as of December 31, 1999.

RCNLD STUDY

Q. DID YOU PREPARE THE RCNLD STUDIES PREVIOUSLY FILED BY QWEST IN THIS CASE?

A. Yes. The RCNLD studies were prepared under my direction.

Q. WHAT COMMENTS DOES MR. DUNKEL HAVE REGARDING THE RCNLD STUDY AS OF DECEMBER 31, 1999 THAT WAS FILED WITH YOUR SUPPLEMENTAL TESTIMONY?

A. Mr. Dunkel proposes three revisions to the RCNLD study:

1. One-half year should be added to the age of all plant vintages to reflect use of the mid-year convention, i.e., plant added during the year is assumed to be added at the mid-year.
2. The remaining life years should be calculated using the equal life group (ELG) procedure, not the vintage group (VG) procedure which was used in the RCNLD study.
3. The unit summation procedure should be used to calculate the "percent condition", not the average life procedure which was used in the RCNLD study.

Q. REGARDING THE FIRST REVISION, DO YOU AGREE THAT THE AGE OF ALL THE PLANT VINTAGES SHOULD BE INCREASED BY ONE-HALF YEAR?

A. Yes. In updating the RCNLD study to reflect the test year ended December 31, 1999 (Supplemental Exhibit NHH-1) from the earlier RCNLD study filed in this case which reflected a June 30, 1998 test year, I neglected to reflect the mid-year convention. Under the mid-year convention, plant installed during the year is assumed to be installed at July 1. For example, plant installed during 1999 is assumed to have an average age of 0.5 year as of December 31, 1999. The effect of making this change to my RCNLD study (Supplemental Exhibit NHH-1) is to decrease the RCNLD value as of December 31, 1999 from $3,558,480,937 to $3,462,036,296. (Please note that this value is a correction to the value indicated in Qwest's response to Staff data request WDA 34-023.) This represents less than a 3 percent decrease in the RCNLD value from the figure filed in my Supplemental Testimony.

Q. PLEASE COMMENT ON MR. DUNKEL'S OTHER PROPOSED CHANGES TO THE RCNLD STUDY.

A. Mr. Dunkel is proposing changes to the methodology that has been used and approved by the Arizona Corporation Commission in rate cases since the early 1970's. The RCNLD study filed by Qwest in this case was performed in accordance with the methodology that has been accepted by the Commission. The changes that Mr. Dunkel proposes reflect the use of equal life group depreciation methods rather than corrections to so-called "errors" in my RCNLD study.

1 **Q. WHAT METHOD OF DEPRECIATION IS REFLECTED IN QWEST'S RCNLD**
2 **STUDY?**
3 A. The RCNLD study filed by Qwest reflects the use of the vintage group (VG)
4 depreciation methods.
5
6 **Q. IS USE OF THE EQUAL LIFE GROUP PROCEDURE IN THE RCNLD STUDY**
7 **APPROPRIATE?**
8 A. Yes. Since the Commission confirmed the use of ELG depreciation earlier this
9 year in Docket No. T-01051B-97-0689, it may be appropriate to reflect the use of
10 ELG depreciation methods in calculating the RCNLD value in this or future rate
11 cases.
12
13 **Q. HAVE YOU RECALCULATED THE RCNLD VALUE USING THE**
14 **METHODOLOGY PROPOSED BY MR. DUNKEL?**
15 A. Yes, I have. The detailed calculations are provided in Exhibit NHH-1 to my
16 rejoinder testimony.
17
18 **Q. DO YOU AGREE WITH THE RESULTS OF MR. DUNKEL'S ANALYSIS?**
19 A. No, I do not. Mr. Dunkel made an error in the life expectancies he used in his
20 analysis.
21
22 **Q. WHAT LIFE EXPECTANCIES DID YOU USE IN YOUR ANALYSIS IN EXHIBIT**
23 **NHH-1 TO YOUR REJOINDER TESTIMONY?**

A. I used the remaining life years shown in the generation arrangement tables prepared by Qwest for each plant account which reflect the survivor curves and average service lives approved by the Commission this year in Decision No. 62507. A copy of the generation arrangement table for Account 2232 – Circuit Digital was provided on pages 3 and 4 of Schedule WDA-11 of Mr. Dunkel's direct testimony. As shown on the table, the years 1983 through 1999 are noted with an asterisk indicating vintage years that are depreciated using ELG depreciation. The years 1982 and earlier are depreciated using VG depreciation. This is consistent with the Commission's Procedural Order dated January 7, 2000 in Docket No. T-01051B-97-0689 which states that Qwest's depreciation rates shall be calculated using the ELG approach following Federal Communications Commission (FCC) rules and guidelines. The FCC approved the use of ELG depreciation for new plant additions beginning in 1981 over a three-year phase-in period.

Q. WHAT ERROR DID MR. DUNKEL MAKE IN THE LIFE EXPECTANICES?

A. Mr. Dunkel incorrectly used the ELG remaining life years as the life expectancies for <u>all</u> vintage years. This is demonstrated on Schedule WDA-13 of Mr. Dunkel's direct testimony. This schedule shows Mr. Dunkel's calculation of the RCNLD value for Account 2232 – Circuit Digital. The life expectancies are shown in column G of the schedule. As shown, the life expectancies Mr. Dunkel used in Schedule WDA-13 for the years <u>1983 through 1999</u> match the remaining life years shown in the generation arrangement table for this account (see Schedule WDA-11, page 3, column E). However, the life expectancies shown in Schedule

WDA-13 for the years 1982 and prior do not match the remaining life years shown in the generation arrangement table. The remaining life years shown in the generation arrangement table for the years 1982 and prior are based on the VG depreciation method. Mr. Dunkel incorrectly used the ELG remaining life years for all the vintage years when he should have applied the ELG remaining life years only to the years 1983 through 1999. The life expectancies for the years 1982 and period should be equal to the VG remaining life years.

Q. WHAT IS THE EFFECT OF MR. DUNKEL'S ERROR IN THE LIFE EXPECTANICES?

A. The effect of incorrectly using the ELG remaining life years (instead of using the VG remaining life years) for the earlier vintages understates the life expectancy, understates the condition percent and understates the RCNLD value.

Q. PLEASE COMMENT ABOUT THE METHOD MR. DUNKEL USED TO CALCULATE THE "PERCENT CONDITION" IN SCHEDULE WDA-13?

A. The method Mr. Dunkel used to calculate the "percent condition" is based on the unit summation procedure and is consistent with the use of ELG depreciation methods. The method I used to calculate the condition percent in the RCNLD study is based on the average life procedure.

Q. EARLIER YOU STATED THAT YOU HAVE RECALCULATED THE RCNLD VALUE USING THE METHODOLOGY PROPOSED BY MR. DUNKEL. WHAT ARE THE RESULTS OF YOUR ANALYSIS?

A. Using the methodology proposed by Mr. Dunkel, including the correction to the life expectancies described above, the total estimated RCN and RCNLD values of the Arizona plant in service of Qwest as of December 31, 1999 are equal to:

Reproduction Cost New	$6,361,585,948
Reproduction Cost New Less Depreciation	$2,723,688,605
Condition Percent.....	43%

Detailed work papers showing the calculation of the RCNLD value based on Mr. Dunkel's proposed methodology are provided in Exhibit NHH-1 to this testimony

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

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	)	DOCKET NO. T-01051B-99-0105

EXHIBITS OF

NANCY HELLER-HUGHES

QWEST CORPORATION

SEPTEMBER 19, 2000

Table 1

Based on Staff Witness Dunkel Methodology

US WEST COMMUNICATIONS, INC.

REPRODUCTION COST NEW LESS DEPRECIATION
TELEPHONE PLANT IN SERVICE

As of December 31, 1999

	Original Cost	Reproduction Cost New	Depreciation	Reproduction Cost New Less Depreciation
Vintage Plant (1)	$4,890,129,675	$6,257,477,341	$3,604,587,672	$2,652,889,669
Land	10,221,552	10,221,552	0	10,221,552
Artwork	207,237	207,237	0	207,237
Embedded Plant (2)				
COE Accounts	0	0	0	0
Other Plant Accounts	22,074,120	16,276,086	8,464,245	7,811,841
Subtotal Embedded Plant	22,074,120	16,276,086	8,464,245	7,811,841
Unregulated and Other Plant (3)	77,403,732	77,403,732	24,845,426	52,558,306
Total Arizona Plant	$5,000,036,315	$6,361,585,948	$3,637,897,343	$2,723,688,605

(1) See Table 2
(2) See Table 3
(3) See Table 4

Table 2

Based on Staff Witness Dunkel Methodology

US WEST COMMUNICATIONS, INC.

REPRODUCTION COST NEW LESS DEPRECIATION
VINTAGE PLANT

As of December 31, 1999

Account	Description	Original Cost 12/31/99	Telephone Plant Translator	Reproduction Cost New	Condition Percent	Reproduction Cost New Less Depreciation
2112	Motor Vehicles	$67,008,716	1.079	$72,326,913	38.2%	$27,624,257
2114	Special Purpose Vehicles	25,794	1.219	31,447	44.7%	14,058
2115	Garage Work Equip	1,356,323	1.239	1,680,681	53.3%	895,506
2116	Other Work Equip	22,416,411	1.168	26,177,888	45.0%	11,773,969
2121	Buildings	162,763,559	2.059	335,131,472	54.0%	181,105,878
2122	Furniture	1,703,616	1.122	1,910,709	57.3%	1,094,857
2123	Company Comm Equip	6,944,455	0.957	6,646,073	29.1%	1,933,570
2124	Gen Purpose Computer	112,016,697	0.469	52,564,359	45.7%	24,036,462
2211	Analog SW Equip	138,599,056	1.206	167,207,907	68.1%	113,797,777
2212	Digital SW Equip	819,225,291	0.987	808,935,651	53.2%	430,587,166
2220	Operator Systems	7,080,061	1.021	7,228,640	46.9%	3,387,738
2231	Radio Systems	35,323,150	1.016	35,891,456	34.3%	12,317,495
2232	Circuit Equip	1,185,447,017	0.993	1,177,608,648	51.2%	602,541,859
2362	Other Term Equip	48,461,067	1.061	51,412,073	56.3%	28,923,865
2411	Pole Lines	46,616,809	4.341	202,360,271	44.5%	89,984,269
2421	Aerial Cable	170,704,495	1.723	294,160,265	24.1%	70,909,699
2422	Underground Cable	435,295,207	1.218	530,303,739	26.0%	137,653,136
2423	Buried Cable	1,273,669,392	1.352	1,722,089,520	33.4%	574,602,845
2424	Sub Cable	2,572	1.256	3,232	2.6%	85
2426	Intra Bldg Cable	41,603,544	1.825	75,914,620	24.6%	18,681,703
2431	Aerial Wire	8,798,956	1.346	11,843,641	40.0%	4,735,781
2441	Conduit Systems	305,067,487	2.216	676,048,139	46.8%	316,287,695
	Total Vintage Plant	$4,890,129,675		$6,257,477,341		$2,652,889,669

Table 3

Based on Staff Witness Dunkel Methodology

US WEST COMMUNICATIONS, INC.

REPRODUCTION COST NEW LESS DEPRECIATION
EMBEDDED PLANT

As of December 31, 1999

Account	Sub Code	Description	Original Cost 12/31/99	Telephone Plant Translator	Reproduction Cost New	Condition Percent	Reproduction Cost New Less Depreciation
2115	1264c	Garage Work Equipment	37,512	1.257	47,151	100.00%	47,151
2116	1564c	Other Work Equipment	4,740,516	1.205	5,712,893	86.42%	4,937,094
2122	2161c	Furniture	467,604	1.210	565,895	70.89%	401,167
2123.1	2261c	Office Equipment	675,540	1.021	689,435	46.38%	319,753
2123.2	124c, 114c	Comp Comm Equip	9,419,400	0.723	6,806,585	22.25%	1,514,488
2124	1361c	General Purpose Computers	6,733,548	0.364	2,454,127	24.13%	592,188
		Total Embedded Plant	$22,074,120	0.737	$16,276,086	48.00%	$7,811,841

Table 4

Based on Staff Witness Dunkel Methodology

US WEST COMMUNICATIONS, INC.

REPRODUCTION COST NEW LESS DEPRECIATION
NONREGULATED AND OTHER ACCOUNTS

As of December 31, 1999

Account	Sub Codes	Description	Original Cost 12/31/99	Telephone Plant Translator	Reproduction Cost New	Condition Percent	Reproduction Cost New Less Depreciation
2112	9464c	Motor Vehicles	$1,547,495	1.000	$1,547,495	79.02%	$1,222,885
2124	6361c	General Purpose Computers	6,821	1.000	6,821	90.75%	6,190
2212	5377c, 6377c, 9007c, 9277c, 9577c	Digital Electronic Switching	19,764,232	1.000	19,764,232	51.97%	10,270,807
2231	367c	Radio Systems	216,210	1.000	216,210	83.33%	180,175
2232	6257c, 9057c	Circuit Equipment	12,391,098	1.000	12,391,098	86.05%	10,662,581
2311	6048c, 9128c	Station Apparatus	25,501,769	1.000	25,501,769	89.96%	22,942,052
2351	9188c, 9288c, 9488c, 9688c, 9788c, 9988c	Public Tel. Term. Equip.	17,969,238	1.000	17,969,238	40.44%	7,266,747
2422	685c	Underground Cable	3,752	1.000	3,752	100.00%	3,752
2423	645c, 6845c	Buried Cable	3,117	1.000	3,117	100.00%	3,117
		Total Nonregulated Plant	$77,403,732		$77,403,732	67.90%	$52,558,306

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Motor Vehicles
Plant Sub-Account:	Passenger Cars
Index Number:	2112
Field Code:	MVA
Survivor Curve:	L3
Average Service Life:	8.6

Year of Placing	Original Cost as of 12/31/99	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/99	Life Expectancy When New	Life Expectancy 12/31/99	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1984	34,255	92.0	1.268	43,449	15.50	8.60	1.03	6.23%	2,707
1985	9,585	94.0	1.241	11,894	14.50	8.60	1.22	7.76%	923
1986	72,649	96.5	1.210	87,879	13.50	8.60	1.43	9.58%	8,419
1987	243,615	98.8	1.182	287,862	12.50	8.60	1.64	11.60%	33,392
1988	689,909	100.0	1.167	805,124	11.50	8.60	1.85	13.86%	111,590
1989	682,880	102.7	1.136	775,661	10.50	8.60	2.04	16.27%	126,200
1990	334,394	104.5	1.117	373,400	9.50	8.60	2.18	18.66%	69,676
1991	229,918	108.0	1.081	248,537	8.50	8.60	2.28	21.15%	52,566
1992	17,077	110.4	1.057	18,046	7.50	8.60	2.40	24.24%	4,374
1993	0	113.2	1.031	0	6.50	8.60	0.00	0.00%	0
1994	0	116.2	1.004	0	5.50	8.60	0.00	0.00%	0
1995	0	117.6	0.992	0	4.50	8.60	0.00	0.00%	0
1996	0	118.6	0.984	0	3.50	8.60	0.00	0.00%	0
1997	0	117.3	0.995	0	2.50	8.60	0.00	0.00%	0
1998	0	116.2	1.004	0	1.50	8.60	0.00	0.00%	0
1999	0	116.7	1.000	0	0.50	8.60	0.00	0.00%	0
	2,314,282		1.146	2,651,851				15.46%	409,847

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Motor Vehicles
Plant Sub-Account:	Light Trucks
Index Number:	2112
Field Code:	MVB
Survivor Curve:	L3
Average Service Life:	8.6

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1980	10,441	73.4	1.590	16,600	19.50	8.60	0.50	2.50%	415
1981	0	83.6	1.396	0	18.50	8.60	0.00	0.00%	0
1982	20,244	88.4	1.320	26,725	17.50	8.60	0.70	3.85%	1,029
1983	148,606	90.4	1.291	191,840	16.50	8.60	0.85	4.90%	9,400
1984	1,787,285	92.0	1.268	2,267,132	15.50	8.60	1.03	6.23%	141,242
1985	49,118	94.0	1.241	60,979	14.50	8.60	1.22	7.76%	4,732
1986	97,499	96.5	1.209	117,908	13.50	8.60	1.43	9.58%	11,296
1987	649,079	98.8	1.181	766,675	12.50	8.60	1.64	11.60%	88,934
1988	4,122,139	100.0	1.167	4,810,536	11.50	8.60	1.85	13.86%	666,740
1989	6,012,363	102.7	1.136	6,831,965	10.50	8.60	2.04	16.27%	1,111,561
1990	4,585,754	104.5	1.117	5,121,124	9.50	8.60	2.18	18.66%	955,602
1991	5,781,578	108.0	1.081	6,247,316	8.50	8.60	2.28	21.15%	1,321,307
1992	4,383,380	110.4	1.057	4,633,519	7.50	8.60	2.40	24.24%	1,123,165
1993	4,462,088	113.2	1.031	4,600,050	6.50	8.60	2.62	28.73%	1,321,594
1994	2,281,980	116.2	1.004	2,291,799	5.50	8.60	3.03	35.52%	814,047
1995	281,045	117.6	0.992	278,894	4.50	8.60	3.63	44.65%	124,526
1996	5,438,004	118.6	0.984	5,350,886	3.50	8.60	4.38	55.58%	2,974,022
1997	3,289,100	117.3	0.995	3,272,276	2.50	8.60	5.20	67.53%	2,209,768
1998	4,283,235	116.2	1.004	4,301,665	1.50	8.60	6.10	80.26%	3,452,517
1999	10,820,302	116.7	1.000	10,820,302	0.50	8.60	7.08	93.40%	10,106,162
	58,503,240		1.060	62,008,193				42.64%	26,438,060

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Motor Vehicles
Plant Sub-Account:	Heavy Trucks
Index Number:	2112
Field Code:	MVC
Survivor Curve:	L3
Average Service Life:	8.6

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1980	167,307	73.4	1.590	266,004	19.50	8.60	0.50	2.50%	6,650
1981	768,571	83.6	1.396	1,072,874	18.50	8.60	0.57	2.99%	32,079
1982	710,235	88.4	1.320	937,607	17.50	8.60	0.70	3.85%	36,098
1983	1,275,965	90.4	1.291	1,647,180	16.50	8.60	0.85	4.90%	80,712
1984	1,054,158	92.0	1.268	1,337,177	15.50	8.60	1.03	6.23%	83,306
1985	211,991	94.0	1.241	263,185	14.50	8.60	1.22	7.76%	20,423
1986	0	96.5	1.209	0	13.50	8.60	0.00	0.00%	0
1987	125,275	98.8	1.181	147,972	12.50	8.60	1.64	11.60%	17,165
1988	115,878	100.0	1.167	135,230	11.50	8.60	1.85	13.86%	18,743
1989	39,621	102.7	1.136	45,022	10.50	8.60	2.04	16.27%	7,325
1990	350,956	104.5	1.117	391,929	9.50	8.60	2.18	18.66%	73,134
1991	157,139	108.0	1.081	169,797	8.50	8.60	2.28	21.15%	35,912
1992	186,537	110.4	1.057	197,182	7.50	8.60	2.40	24.24%	47,797
1993	894,132	113.2	1.031	921,777	6.50	8.60	2.62	28.73%	264,827
1994	118,627	116.2	1.004	119,137	5.50	8.60	3.03	35.52%	42,318
1995	5,702	117.6	0.992	5,658	4.50	8.60	3.63	44.65%	2,526
1996	0	118.6	0.984	0	3.50	8.60	0.00	0.00%	0
1997	0	117.3	0.995	0	2.50	8.60	0.00	0.00%	0
1998	9,100	116.2	1.004	9,139	1.50	8.60	6.10	80.26%	7,335
1999	0	116.7	1.000	0	0.50	8.60	0.00	0.00%	0
	6,191,194		1.238	7,666,870				10.13%	776,349

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Special Purpose Vehicles
Plant Sub-Account:	Special Purpose Vehicles
Index Number:	2114
Field Code:	SPZ
Survivor Curve:	S6
Average Service Life:	16.1

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1975	8	48.2	2.863	23	24.50	16.10	0.50	2.00%	0
1976	14	51.7	2.669	37	23.50	16.10	0.50	2.08%	1
1977	55	55.6	2.482	137	22.50	16.10	0.50	2.17%	3
1978	193	60.5	2.281	440	21.50	16.10	0.50	2.27%	10
1979	258	66.5	2.075	535	20.50	16.10	0.50	2.38%	13
1980	330	75.2	1.835	606	19.50	16.10	0.54	2.69%	16
1981	642	83.4	1.655	1,062	18.50	16.10	0.60	3.14%	33
1982	609	89.4	1.544	940	17.50	16.10	0.71	3.90%	37
1983	1,062	91.5	1.508	1,602	16.50	16.10	0.91	5.23%	84
1984	1,191	92.8	1.487	1,771	15.50	16.10	1.26	7.52%	133
1985	697	94.6	1.459	1,017	14.50	16.10	1.84	11.26%	114
1986	361	95.4	1.447	522	13.50	16.10	2.65	16.41%	86
1987	297	97.4	1.417	421	12.50	16.10	3.61	22.41%	94
1988	830	100.0	1.380	1,145	11.50	16.10	4.60	28.57%	327
1989	1,704	105.7	1.306	2,225	10.50	16.10	5.60	34.78%	774
1990	61	112.1	1.231	75	9.50	16.10	6.60	40.99%	31
1991	512	118.0	1.169	599	8.50	16.10	7.60	47.20%	283
1992	162	122.4	1.127	183	7.50	16.10	8.60	53.42%	98
1993	0	124.7	1.107	0	6.50	16.10	0.00	0.00%	0
1994	16,808	128.1	1.077	18,107	5.50	16.10	10.60	65.84%	11,922
1995	0	132.0	1.045	0	4.50	16.10	0.00	0.00%	0
1996	0	135.1	1.021	0	3.50	16.10	0.00	0.00%	0
1997	0	136.5	1.011	0	2.50	16.10	0.00	0.00%	0
1998	0	138.1	0.999	0	1.50	16.10	0.00	0.00%	0
1999	0	138.0	1.000	0	0.50	16.10	0.00	0.00%	0
	25,794		1.219	31,447				44.71%	14,058

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Garage Work Equipment
Plant Sub-Account:	Garage Work Equipment
Index Number:	2115
Field Code:	GWZ
Survivor Curve:	L0
Average Service Life:	13.7

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1975	213	48.2	2.863	610	24.50	13.70	5.20	17.51%	107
1976	455	51.7	2.669	1,215	23.50	13.70	5.41	18.71%	227
1977	1,991	55.6	2.482	4,942	22.50	13.70	5.63	20.01%	989
1978	8,274	60.5	2.281	18,873	21.50	13.70	5.85	21.39%	4,037
1979	12,554	66.5	2.075	26,052	20.50	13.70	6.08	22.87%	5,958
1980	17,913	75.2	1.835	32,872	19.50	13.70	6.32	24.48%	8,047
1981	38,218	83.4	1.655	63,238	18.50	13.70	6.57	26.21%	16,575
1982	39,105	89.4	1.544	60,363	17.50	13.70	6.82	28.04%	16,926
1983	72,807	91.5	1.508	109,807	16.50	13.70	7.09	30.06%	33,008
1984	86,174	92.8	1.487	128,147	15.50	13.70	7.36	32.20%	41,263
1985	52,754	94.6	1.459	76,956	14.50	13.70	7.64	34.51%	26,558
1986	28,365	95.4	1.447	41,031	13.50	13.70	7.94	37.03%	15,194
1987	24,091	97.4	1.417	34,133	12.50	13.70	8.24	39.73%	13,561
1988	69,246	100.0	1.380	95,559	11.50	13.70	8.55	42.64%	40,747
1989	145,582	105.7	1.306	190,069	10.50	13.70	8.88	45.82%	87,090
1990	5,278	112.1	1.231	6,497	9.50	13.70	9.22	49.25%	3,200
1991	45,296	118.0	1.169	52,973	8.50	13.70	9.57	52.96%	28,055
1992	11,612	122.4	1.127	13,092	7.50	13.70	9.93	56.97%	7,458
1993	46,705	124.7	1.107	51,686	6.50	13.70	10.31	61.33%	31,699
1994	166,895	128.1	1.077	179,793	5.50	13.70	10.70	66.05%	118,753
1995	127,154	132.0	1.045	132,934	4.50	13.70	11.12	71.19%	94,636
1996	127,561	135.1	1.021	130,299	3.50	13.70	11.58	76.79%	100,057
1997	134,101	136.5	1.011	135,575	2.50	13.70	12.08	82.85%	112,324
1998	21,800	138.1	0.999	21,784	1.50	13.70	12.64	89.39%	19,473
1999	72,179	138.0	1.000	72,179	0.50	13.70	13.30	96.38%	69,566
	1,356,323		1.239	1,680,681				53.28%	895,506

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Other Work Equipment
Plant Sub-Account:	Other Work Equipment
Index Number:	2116
Field Code:	OWZ
Survivor Curve:	L4
Average Service Life:	11.5

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1963	10	23.1	5.662	57	36.50	11.50	0.50	1.35%	1
1964	52	23.7	5.519	287	35.50	11.50	0.50	1.39%	4
1965	155	24.3	5.383	834	34.50	11.50	0.50	1.43%	12
1966	245	25.1	5.211	1,277	33.50	11.50	0.50	1.47%	19
1967	1,060	26.0	5.031	5,333	32.50	11.50	0.50	1.52%	81
1968	1,160	27.5	4.756	5,517	31.50	11.50	0.50	1.56%	86
1969	4,262	28.7	4.557	19,424	30.50	11.50	0.50	1.61%	313
1970	11,085	30.0	4.360	48,331	29.50	11.50	0.50	1.67%	807
1971	7,388	31.6	4.139	30,581	28.50	11.50	0.50	1.72%	526
1972	13,753	32.7	4.000	55,012	27.50	11.50	0.50	1.79%	985
1973	14,919	34.0	3.847	57,394	26.50	11.50	0.50	1.85%	1,062
1974	25,885	39.6	3.303	85,499	25.50	11.50	0.50	1.92%	1,642
1975	18,224	48.2	2.714	49,454	24.50	11.50	0.50	2.00%	989
1976	18,069	51.7	2.530	45,714	23.50	11.50	0.50	2.08%	951
1977	37,807	55.6	2.353	88,942	22.50	11.50	0.62	2.68%	2,384
1978	94,521	60.5	2.162	204,353	21.50	11.50	0.69	3.11%	6,355
1979	96,869	66.5	1.967	190,533	20.50	11.50	0.78	3.67%	6,993
1980	115,658	75.2	1.739	201,171	19.50	11.50	0.90	4.41%	8,872
1981	220,977	83.4	1.568	346,568	18.50	11.50	1.04	5.32%	18,437
1982	231,732	89.4	1.463	339,044	17.50	11.50	1.20	6.42%	21,767
1983	460,273	91.5	1.430	657,964	16.50	11.50	1.38	7.72%	50,795
1984	597,312	92.8	1.409	841,901	15.50	11.50	1.57	9.20%	77,455
1985	402,706	94.6	1.383	556,807	14.50	11.50	1.79	10.99%	61,193
1986	236,602	95.4	1.371	324,398	13.50	11.50	1.99	12.85%	41,685
1987	684,041	97.4	1.343	918,609	12.50	11.50	2.16	14.73%	135,311
1988	1,350,624	100.0	1.308	1,766,616	11.50	11.50	2.29	16.61%	293,435
1989	1,218,993	104.8	1.248	1,521,415	10.50	11.50	2.52	19.35%	294,394
1990	863,283	108.8	1.202	1,037,844	9.50	11.50	2.93	23.57%	244,620
1991	1,324,054	112.0	1.168	1,546,306	8.50	11.50	3.56	29.52%	456,470
1992	3,017,109	115.1	1.136	3,428,652	7.50	11.50	4.32	36.55%	1,253,172
1993	1,107,763	118.1	1.108	1,226,887	6.50	11.50	5.15	44.21%	542,407
1994	1,617,552	119.6	1.094	1,769,028	5.50	11.50	6.05	52.38%	926,617
1995	553,437	122.3	1.070	591,902	4.50	11.50	7.01	60.90%	360,468
1996	1,707,641	125.0	1.046	1,786,876	3.50	11.50	8.00	69.57%	1,243,129
1997	2,273,826	127.2	1.028	2,338,180	2.50	11.50	9.00	78.26%	1,829,859
1998	235,521	129.8	1.008	237,335	1.50	11.50	10.00	86.96%	206,387
1999	3,851,843	130.8	1.000	3,851,843	0.50	11.50	11.00	95.65%	3,684,288
	22,416,411		1.168	26,177,888				44.98%	11,773,969

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account: Buildings
Plant Sub-Account: Large Buildings
Index Number: 2121
Field Code: BUA
Survivor Curve: R1
Average Service Life: 43

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1925	25,540	11.9	10.880	277,865	74.50	43.00	3.85	4.91%	13,643
1926	0	11.9	10.880	0	73.50	43.00	0.00	0.00%	0
1927	0	11.9	10.880	0	72.50	43.00	0.00	0.00%	0
1928	49,465	11.9	10.880	538,160	71.50	43.00	4.74	6.22%	33,474
1929	0	11.9	10.880	0	70.50	43.00	0.00	0.00%	0
1930	9,600	11.9	10.880	104,444	69.50	43.00	5.36	7.16%	7,478
1931	0	11.9	10.880	0	68.50	43.00	0.00	0.00%	0
1932	1,084	11.9	10.880	11,793	67.50	43.00	6.00	8.16%	962
1933	0	11.9	10.880	0	66.50	43.00	0.00	0.00%	0
1934	0	11.9	10.880	0	65.50	43.00	0.00	0.00%	0
1935	0	11.9	10.880	0	64.50	43.00	0.00	0.00%	0
1936	0	11.9	10.880	0	63.50	43.00	0.00	0.00%	0
1937	0	11.9	10.880	0	62.50	43.00	0.00	0.00%	0
1938	4,200	11.9	10.880	45,694	61.50	43.00	8.05	11.57%	5,287
1939	0	11.9	10.880	0	60.50	43.00	0.00	0.00%	0
1940	0	11.9	10.880	0	59.50	43.00	0.00	0.00%	0
1941	0	11.9	10.880	0	58.50	43.00	0.00	0.00%	0
1942	739	11.9	10.880	8,040	57.50	43.00	9.53	14.22%	1,143
1943	3,148	11.9	10.880	34,249	56.50	43.00	9.91	14.92%	5,110
1944	0	11.9	10.880	0	55.50	43.00	0.00	0.00%	0
1945	0	11.9	10.880	0	54.50	43.00	0.00	0.00%	0
1946	0	11.9	10.880	0	53.50	43.00	0.00	0.00%	0
1947	92,249	13.6	9.578	883,540	52.50	43.00	11.52	17.99%	158,949
1948	286,594	14.8	8.755	2,509,041	51.50	43.00	11.94	18.82%	472,201
1949	564,972	15.4	8.457	4,778,171	50.50	43.00	12.37	19.68%	940,344
1950	58,142	15.5	8.363	486,223	49.50	43.00	12.80	20.55%	99,919
1951	170,514	16.5	7.892	1,345,620	48.50	43.00	13.24	21.44%	288,501
1952	266,690	17.1	7.597	2,026,121	47.50	43.00	13.69	22.37%	453,243
1953	293,536	17.6	7.397	2,171,198	46.50	43.00	14.14	23.32%	506,323
1954	173,825	18.0	7.206	1,252,658	45.50	43.00	14.60	24.29%	304,271
1955	382,229	18.6	7.004	2,677,036	44.50	43.00	15.07	25.30%	677,290
1956	455,020	19.7	6.611	3,008,233	43.50	43.00	15.55	26.33%	792,068
1957	1,015,867	20.2	6.440	6,542,417	42.50	43.00	16.04	27.40%	1,792,622
1958	427,224	20.7	6.278	2,682,057	41.50	43.00	16.53	28.49%	764,118
1959	698,206	21.1	6.174	4,310,797	40.50	43.00	17.03	29.60%	1,275,996
1960	1,799,852	21.2	6.123	11,021,389	39.50	43.00	17.54	30.75%	3,389,077
1961	1,680,305	21.3	6.107	10,261,307	38.50	43.00	18.06	31.93%	3,276,435
1962	241,540	21.5	6.041	1,459,136	37.50	43.00	18.59	33.14%	483,558
1963	739,092	22.0	5.898	4,359,087	36.50	43.00	19.12	34.38%	1,498,654
1964	913,445	22.7	5.732	5,235,839	35.50	43.00	19.66	35.64%	1,866,053
1965	172,505	23.4	5.561	959,350	34.50	43.00	20.22	36.95%	354,480
1966	267,795	24.3	5.349	1,432,416	33.50	43.00	20.77	38.27%	548,185

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Buildings
Plant Sub-Account:	Large Buildings
Index Number:	2121
Field Code:	BUA
Survivor Curve:	R1
Average Service Life:	43

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1967	409,895	25.5	5.105	2,092,612	32.50	43.00	21.34	39.64%	829,511
1968	764,279	26.8	4.851	3,707,580	31.50	43.00	21.91	41.02%	1,520,849
1969	772,512	28.5	4.555	3,519,012	30.50	43.00	22.50	42.45%	1,493,821
1970	1,827,916	31.1	4.181	7,643,144	29.50	43.00	23.09	43.91%	3,356,105
1971	2,850,678	33.8	3.844	10,958,730	28.50	43.00	23.69	45.39%	4,974,168
1972	4,400,876	36.7	3.541	15,581,743	27.50	43.00	24.29	46.90%	7,307,837
1973	5,358,582	39.4	3.296	17,661,256	26.50	43.00	24.90	48.44%	8,555,112
1974	1,432,712	45.1	2.881	4,127,242	25.50	43.00	25.52	50.02%	2,064,446
1975	1,731,721	50.9	2.553	4,420,425	24.50	43.00	26.15	51.63%	2,282,265
1976	265,869	54.2	2.397	637,289	23.50	43.00	26.78	53.26%	339,420
1977	1,601,227	58.0	2.241	3,588,670	22.50	43.00	27.42	54.93%	1,971,256
1978	1,175,586	62.8	2.071	2,435,049	21.50	43.00	28.07	56.63%	1,378,968
1979	2,877,870	67.7	1.919	5,522,159	20.50	43.00	28.72	58.35%	3,222,180
1980	2,053,406	74.3	1.750	3,592,579	19.50	43.00	29.37	60.10%	2,159,140
1981	3,955,108	81.3	1.600	6,327,044	18.50	43.00	30.03	61.88%	3,915,175
1982	5,472,397	87.3	1.489	8,149,326	17.50	43.00	30.70	63.69%	5,190,306
1983	1,685,106	90.1	1.443	2,431,848	16.50	43.00	24.91	60.15%	1,462,756
1984	3,590,741	91.2	1.426	5,119,319	15.50	43.00	25.24	61.95%	3,171,418
1985	11,751,297	92.6	1.405	16,506,079	14.50	43.00	25.56	63.80%	10,530,878
1986	4,559,977	96.1	1.353	6,171,389	13.50	43.00	25.86	65.70%	4,054,603
1987	2,691,571	97.4	1.335	3,592,822	12.50	43.00	26.13	67.64%	2,430,185
1988	6,165,657	100.0	1.300	8,015,354	11.50	43.00	26.38	69.64%	5,581,893
1989	5,181,373	100.5	1.294	6,704,673	10.50	43.00	26.59	71.69%	4,806,580
1990	4,108,193	102.9	1.263	5,190,125	9.50	43.00	26.75	73.79%	3,829,793
1991	3,782,035	105.6	1.231	4,654,748	8.50	43.00	26.88	75.98%	3,536,678
1992	5,221,571	108.9	1.194	6,233,280	7.50	43.00	26.95	78.23%	4,876,295
1993	1,967,751	116.8	1.113	2,190,134	6.50	43.00	26.94	80.56%	1,764,372
1994	2,288,433	117.8	1.104	2,525,435	5.50	43.00	26.85	83.00%	2,096,111
1995	6,093,261	123.2	1.055	6,429,577	4.50	43.00	26.63	85.54%	5,499,860
1996	4,272,639	127.0	1.024	4,373,567	3.50	43.00	26.24	88.23%	3,858,799
1997	2,809,931	127.7	1.018	2,860,541	2.50	43.00	25.57	91.09%	2,605,666
1998	1,610,162	128.4	1.012	1,630,226	1.50	43.00	24.41	94.21%	1,535,836
1999	4,667,411	130.0	1.000	4,667,411	0.50	43.00	21.95	97.77%	4,563,328
	120,191,121		2.161	259,682,271				52.67%	136,774,998

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Buildings
Plant Sub-Account:	Other Buildings
Index Number:	2121
Field Code:	BUB
Survivor Curve:	R1
Average Service Life:	43

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1926	2,619	11.9	10.880	28,494	73.50	43.00	4.14	5.33%	1,519
1927	6,423	11.9	10.880	69,880	72.50	43.00	4.44	5.77%	4,032
1928	2,702	11.9	10.880	29,397	71.50	43.00	4.74	6.22%	1,828
1929	2,496	11.9	10.880	27,156	70.50	43.00	5.05	6.68%	1,814
1930	0	11.9	10.880	0	69.50	43.00	0.00	0.00%	0
1931	0	11.9	10.880	0	68.50	43.00	0.00	0.00%	0
1932	0	11.9	10.880	0	67.50	43.00	0.00	0.00%	0
1933	0	11.9	10.880	0	66.50	43.00	0.00	0.00%	0
1934	0	11.9	10.880	0	65.50	43.00	0.00	0.00%	0
1935	0	11.9	10.880	0	64.50	43.00	0.00	0.00%	0
1936	5,691	11.9	10.880	61,916	63.50	43.00	7.34	10.36%	6,414
1937	0	11.9	10.880	0	62.50	43.00	0.00	0.00%	0
1938	2,791	11.9	10.880	30,365	61.50	43.00	8.05	11.57%	3,513
1939	0	11.9	10.880	0	60.50	43.00	0.00	0.00%	0
1940	1,077	11.9	10.880	11,717	59.50	43.00	8.77	12.85%	1,506
1941	0	11.9	10.880	0	58.50	43.00	0.00	0.00%	0
1942	4,668	11.9	10.880	50,786	57.50	43.00	9.53	14.22%	7,222
1943	0	11.9	10.880	0	56.50	43.00	0.00	0.00%	0
1944	7,532	11.9	10.880	81,945	55.50	43.00	10.30	15.65%	12,824
1945	0	11.9	10.880	0	54.50	43.00	0.00	0.00%	0
1946	3,399	11.9	10.880	36,980	53.50	43.00	11.11	17.20%	6,361
1947	0	13.6	9.578	0	52.50	43.00	0.00	0.00%	0
1948	0	14.8	8.755	0	51.50	43.00	0.00	0.00%	0
1949	55,377	15.4	8.457	468,343	50.50	43.00	12.37	19.68%	92,170
1950	16,323	15.5	8.363	136,504	49.50	43.00	12.80	20.55%	28,052
1951	3,975	16.5	7.892	31,369	48.50	43.00	13.24	21.44%	6,725
1952	7,508	17.1	7.597	57,040	47.50	43.00	13.69	22.37%	12,760
1953	6,133	17.6	7.397	45,364	46.50	43.00	14.14	23.32%	10,579
1954	80,437	18.0	7.206	579,664	45.50	43.00	14.60	24.29%	140,800
1955	95,499	18.6	7.004	668,851	44.50	43.00	15.07	25.30%	169,219
1956	55,188	19.7	6.611	364,859	43.50	43.00	15.55	26.33%	96,067
1957	107,435	20.2	6.440	691,906	42.50	43.00	16.04	27.40%	189,582
1958	132,113	20.7	6.278	829,388	41.50	43.00	16.53	28.49%	236,293
1959	32,239	21.1	6.174	199,047	40.50	43.00	17.03	29.60%	58,918
1960	362,119	21.2	6.123	2,217,435	39.50	43.00	17.54	30.75%	681,861
1961	428,964	21.3	6.107	2,619,602	38.50	43.00	18.06	31.93%	836,439
1962	191,787	21.5	6.041	1,158,580	37.50	43.00	18.59	33.14%	383,953
1963	152,363	22.0	5.898	898,621	36.50	43.00	19.12	34.38%	308,946
1964	88,272	22.7	5.732	505,972	35.50	43.00	19.66	35.64%	180,329
1965	62,843	23.4	5.561	349,488	34.50	43.00	20.22	36.95%	129,136
1966	81,735	24.3	5.349	437,194	33.50	43.00	20.77	38.27%	167,314
1967	58,179	25.5	5.105	297,018	32.50	43.00	21.34	39.64%	117,738

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Buildings
Plant Sub-Account:	Other Buildings
Index Number:	2121
Field Code:	BUB
Survivor Curve:	R1
Average Service Life:	43

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1968	146,007	26.8	4.851	708,292	31.50	43.00	21.91	41.02%	290,541
1969	178,069	28.5	4.555	811,155	30.50	43.00	22.50	42.45%	344,335
1970	370,876	31.1	4.181	1,550,760	29.50	43.00	23.09	43.91%	680,939
1971	338,118	33.8	3.844	1,299,811	28.50	43.00	23.69	45.39%	589,984
1972	565,710	36.7	3.541	2,002,953	27.50	43.00	24.29	46.90%	939,385
1973	871,098	39.4	3.296	2,871,037	26.50	43.00	24.90	48.44%	1,390,730
1974	624,065	45.1	2.881	1,797,756	25.50	43.00	25.52	50.02%	899,238
1975	1,167,463	50.9	2.553	2,980,089	24.50	43.00	26.15	51.63%	1,538,620
1976	335,886	54.2	2.397	805,121	23.50	43.00	26.78	53.26%	428,807
1977	336,288	58.0	2.241	753,689	22.50	43.00	27.42	54.93%	414,001
1978	554,991	62.8	2.071	1,149,580	21.50	43.00	28.07	56.63%	651,007
1979	771,625	67.7	1.919	1,480,622	20.50	43.00	28.72	58.35%	863,943
1980	372,571	74.3	1.750	651,839	19.50	43.00	29.37	60.10%	391,755
1981	927,481	81.3	1.600	1,483,705	18.50	43.00	30.03	61.88%	918,117
1982	1,141,924	87.3	1.489	1,700,518	17.50	43.00	30.70	63.69%	1,083,060
1983	2,013,400	90.1	1.443	2,905,623	16.50	43.00	24.91	60.15%	1,747,732
1984	868,827	91.2	1.426	1,238,686	15.50	43.00	25.24	61.95%	767,366
1985	3,875,584	92.6	1.405	5,443,714	14.50	43.00	25.56	63.80%	3,473,089
1986	3,637,460	96.1	1.353	4,922,872	13.50	43.00	25.86	65.70%	3,234,327
1987	3,510,579	97.4	1.335	4,686,069	12.50	43.00	26.13	67.64%	3,169,657
1988	3,967,836	100.0	1.300	5,158,187	11.50	43.00	26.38	69.64%	3,592,161
1989	2,972,140	100.5	1.294	3,845,935	10.50	43.00	26.59	71.69%	2,757,151
1990	2,302,354	102.9	1.263	2,908,701	9.50	43.00	26.75	73.79%	2,146,331
1991	935,053	105.6	1.231	1,150,819	8.50	43.00	26.88	75.98%	874,392
1992	839,463	108.9	1.194	1,002,114	7.50	43.00	26.95	78.23%	783,954
1993	975,577	116.8	1.113	1,085,831	6.50	43.00	26.94	80.56%	874,745
1994	831,037	117.8	1.104	917,104	5.50	43.00	26.85	83.00%	761,196
1995	329,873	123.2	1.055	348,080	4.50	43.00	26.63	85.54%	297,748
1996	215,986	127.0	1.024	221,088	3.50	43.00	26.24	88.23%	195,066
1997	728,357	127.7	1.018	741,475	2.50	43.00	25.57	91.09%	675,410
1998	2,587,453	128.4	1.012	2,619,695	1.50	43.00	24.41	94.21%	2,468,015
1999	1,221,400	130.0	1.000	1,221,400	0.50	43.00	21.95	97.77%	1,194,163
	42,572,438		1.772	75,449,200				58.76%	44,330,881

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Furniture
Plant Sub-Account:	Furniture
Index Number:	2122
Field Code:	FEZ
Survivor Curve:	O4
Average Service Life:	9.5

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent*	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1971	802	34.5	3.635	2,915	28.50	9.50	6.44	18.43%	537
1972	1,947	35.1	3.573	6,956	27.50	9.50	6.91	20.08%	1,397
1973	0	37.8	3.317	0	26.50	9.50	0.00	0.00%	0
1974	8,900	44.5	2.818	25,080	25.50	9.50	7.84	23.52%	5,899
1975	4,531	48.7	2.575	11,667	24.50	9.50	8.30	25.30%	2,952
1976	945	50.6	2.478	2,342	23.50	9.50	8.74	27.11%	635
1977	7,070	54.3	2.309	16,327	22.50	9.50	9.18	28.98%	4,732
1978	3,490	58.8	2.133	7,443	21.50	9.50	9.61	30.89%	2,299
1979	450	64.7	1.938	872	20.50	9.50	10.02	32.83%	286
1980	7,881	68.9	1.820	14,344	19.50	9.50	10.42	34.83%	4,996
1981	24,923	75.2	1.668	41,560	18.50	9.50	10.80	36.86%	15,319
1982	22,817	80.4	1.560	35,588	17.50	9.50	11.16	38.94%	13,858
1983	15,580	83.7	1.498	23,342	16.50	9.50	9.54	36.64%	8,553
1984	20,115	86.8	1.445	29,060	15.50	9.50	9.63	38.32%	11,136
1985	26,114	90.1	1.392	36,345	14.50	9.50	9.66	39.98%	14,531
1986	15,207	92.9	1.350	20,527	13.50	9.50	9.63	41.63%	8,545
1987	4,607	95.5	1.313	6,049	12.50	9.50	9.54	43.28%	2,618
1988	20,160	100.0	1.254	25,281	11.50	9.50	9.36	44.87%	11,343
1989	299,670	103.9	1.207	361,681	10.50	9.50	9.10	46.43%	167,928
1990	0	107.4	1.168	0	9.50	9.50	0.00	0.00%	0
1991	0	109.7	1.143	0	8.50	9.50	0.00	0.00%	0
1992	81,008	111.2	1.128	91,353	7.50	9.50	7.75	50.82%	46,425
1993	8,526	113.1	1.109	9,453	6.50	9.50	7.12	52.28%	4,942
1994	31,279	116.5	1.076	33,669	5.50	9.50	6.44	53.94%	18,161
1995	9,792	119.3	1.051	10,293	4.50	9.50	5.73	56.01%	5,765
1996	285,895	122.1	1.027	293,622	3.50	9.50	5.03	58.97%	173,149
1997	72,399	124.2	1.010	73,099	2.50	9.50	4.38	63.66%	46,535
1998	729,508	125.0	1.003	731,842	1.50	9.50	3.74	71.37%	522,316
1999	0	125.4	1.000	0	0.50	9.50	0.00	0.00%	0
	1,703,616		1.122	1,910,709				57.30%	1,094,857

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Office Equipment
Plant Sub-Account:	Office Equipment
Index Number:	2123.1
Field Code:	OEZ
Survivor Curve:	L0.5
Average Service Life:	7

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1974	4,794	93.5	1.119	5,363	25.50	7.00	0.50	1.92%	103
1975	0	93.9	1.114	0	24.50	7.00	0.00	0.00%	0
1976	1,667	94.4	1.108	1,847	23.50	7.00	0.92	3.77%	70
1977	4,349	94.8	1.103	4,799	22.50	7.00	1.05	4.46%	214
1978	1,675	95.3	1.098	1,838	21.50	7.00	1.20	5.29%	97
1979	3,990	95.8	1.092	4,357	20.50	7.00	1.32	6.05%	264
1980	10,963	96.2	1.087	11,920	19.50	7.00	1.44	6.88%	820
1981	17,262	96.7	1.082	18,672	18.50	7.00	1.54	7.68%	1,434
1982	21,352	97.2	1.076	22,978	17.50	7.00	1.64	8.57%	1,969
1983	0	97.6	1.072	0	16.50	7.00	0.00	0.00%	0
1984	188,754	98.1	1.066	201,261	15.50	7.00	1.74	10.09%	20,307
1985	3,678	98.6	1.061	3,902	14.50	7.00	1.85	11.31%	441
1986	78,773	99.0	1.057	83,229	13.50	7.00	1.98	12.79%	10,645
1987	73,456	99.5	1.051	77,221	12.50	7.00	2.12	14.50%	11,197
1988	168,236	100.0	1.046	175,975	11.50	7.00	2.27	16.49%	29,018
1989	1,668,506	102.3	1.022	1,706,019	10.50	7.00	2.43	18.79%	320,561
1990	1,322,201	102.3	1.022	1,351,928	9.50	7.00	2.60	21.49%	290,529
1991	114,269	102.6	1.019	116,496	8.50	7.00	2.77	24.58%	28,635
1992	227,485	103.7	1.009	229,459	7.50	7.00	2.94	28.16%	64,616
1993	22,445	103.7	1.009	22,640	6.50	7.00	3.11	32.36%	7,326
1994	58,226	104.0	1.006	58,562	5.50	7.00	3.28	37.36%	21,879
1995	655,465	104.2	1.004	657,981	4.50	7.00	3.44	43.32%	285,037
1996	100,004	104.7	0.999	99,908	3.50	7.00	3.57	50.50%	50,454
1997	457,409	105.0	0.996	455,666	2.50	7.00	3.71	59.74%	272,215
1998	14,226	105.0	0.996	14,172	1.50	7.00	3.87	72.07%	10,214
1999	258,340	104.6	1.000	258,340	0.50	7.00	3.95	88.76%	229,303
	5,477,525		1.020	5,584,533				29.68%	1,657,348

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Company Communications Equipment
Plant Sub-Account:	Stand Alone
Index Number:	2123.2
Field Code:	OECA
Survivor Curve:	L0.5
Average Service Life:	8.3

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1988	3,210	100.0	0.664	2,131	11.50	8.30	3.48	23.23%	495
1989	4,092	111.0	0.598	2,448	10.50	8.30	3.73	26.21%	642
1990	3,272	114.5	0.580	1,897	9.50	8.30	3.99	29.58%	561
1991	2,033	114.8	0.578	1,176	8.50	8.30	4.28	33.49%	394
1992	2,801	100.7	0.659	1,847	7.50	8.30	4.58	37.91%	700
1993	25,923	96.7	0.687	17,800	6.50	8.30	4.91	43.03%	7,659
1994	12,454	83.0	0.800	9,963	5.50	8.30	5.26	48.88%	4,870
1995	2,637	80.0	0.830	2,189	4.50	8.30	5.63	55.58%	1,216
1996	3,003	69.1	0.961	2,886	3.50	8.30	6.05	63.35%	1,828
1997	0	68.1	0.975	0	2.50	8.30	0.00	0.00%	0
1998	0	66.8	0.994	0	1.50	8.30	0.00	0.00%	0
1999	5,151	66.4	1.000	5,151	0.50	8.30	7.88	94.03%	4,843
	64,576		0.735	47,488				48.87%	23,209

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Company Communication Equipment
Plant Sub-Account:	PBX & Key Intrasystems
Index Number:	2123.2
Field Code:	OECB
Survivor Curve:	L0.5
Average Service Life:	8.3

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1978	38,639	74.7	0.889	34,346	21.50	8.30	1.85	7.92%	2,720
1979	873	78.3	0.848	740	20.50	8.30	1.96	8.73%	65
1980	1,724	81.1	0.819	1,412	19.50	8.30	2.07	9.60%	136
1981	3,260	88.4	0.751	2,449	18.50	8.30	2.19	10.58%	259
1982	21,419	98.0	0.678	14,512	17.50	8.30	2.33	11.75%	1,705
1983	157,399	102.7	0.647	101,765	16.50	8.30	2.48	13.07%	13,301
1984	33,322	94.4	0.703	23,438	15.50	8.30	2.65	14.60%	3,422
1985	28,603	85.3	0.778	22,265	14.50	8.30	2.83	16.33%	3,636
1986	567,820	86.8	0.765	434,369	13.50	8.30	3.03	18.33%	79,620
1987	3	86.7	0.766	2	12.50	8.30	3.25	20.63%	0
1988	72,682	100.0	0.664	48,261	11.50	8.30	3.48	23.23%	11,211
1989	55,921	111.0	0.598	33,452	10.50	8.30	3.73	26.21%	8,768
1990	51,101	114.5	0.580	29,634	9.50	8.30	3.99	29.58%	8,766
1991	23,524	114.8	0.578	13,606	8.50	8.30	4.28	33.49%	4,557
1992	134,813	100.7	0.659	88,894	7.50	8.30	4.58	37.91%	33,700
1993	69,199	96.7	0.687	47,516	6.50	8.30	4.91	43.03%	20,446
1994	118,364	83.0	0.800	94,691	5.50	8.30	5.26	48.88%	46,285
1995	581	80.0	0.830	482	4.50	8.30	5.63	55.58%	268
1996	22,790	69.1	0.961	21,900	3.50	8.30	6.05	63.35%	13,873
1997	0	68.1	0.975	0	2.50	8.30	0.00	0.00%	0
1998	191	66.8	0.994	190	1.50	8.30	7.16	82.68%	157
1999	126	66.4	1.000	126	0.50	8.30	7.88	94.03%	118
	1,402,354		0.723	1,014,051				24.95%	253,012

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	General Purpose Computer
Plant Sub-Account:	General Purpose Computer
Index Number:	2124
Field Code:	GCZ
Survivor Curve:	O1
Average Service Life:	5

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1976	2,230	90.3	0.239	533	23.50	5.00	0.50	2.08%	11
1977	0	86.1	0.251	0	22.50	5.00	0.00	0.00%	0
1978	0	78.4	0.276	0	21.50	5.00	0.00	0.00%	0
1979	0	74.9	0.288	0	20.50	5.00	0.00	0.00%	0
1980	0	75.1	0.288	0	19.50	5.00	0.00	0.00%	0
1981	64,507	82.3	0.262	16,930	18.50	5.00	0.50	2.63%	445
1982	18,625	92.9	0.233	4,330	17.50	5.00	0.50	2.78%	120
1983	866,462	103.8	0.208	180,304	16.50	5.00	0.50	2.94%	5,301
1984	288,877	108.6	0.199	57,456	15.50	5.00	0.50	3.13%	1,798
1985	165,757	103.0	0.210	34,761	14.50	5.00	0.50	3.33%	1,158
1986	1,439,726	101.1	0.214	307,597	13.50	5.00	0.50	3.57%	10,981
1987	900,033	98.9	0.218	196,569	12.50	5.00	0.50	3.85%	7,568
1988	554,276	100.0	0.216	119,724	11.50	5.00	0.50	4.17%	4,992
1989	24,060,104	99.9	0.216	5,202,185	10.50	5.00	0.50	4.55%	236,699
1990	2,433,138	95.8	0.225	548,599	9.50	5.00	0.50	5.00%	27,430
1991	1,310,940	79.4	0.272	356,629	8.50	5.00	0.81	8.70%	31,027
1992	6,399,262	66.6	0.324	2,075,436	7.50	5.00	1.24	14.19%	294,504
1993	11,436,799	58.4	0.370	4,230,049	6.50	5.00	1.66	20.34%	860,392
1994	16,901,961	53.7	0.402	6,798,554	5.50	5.00	2.05	27.15%	1,845,807
1995	10,617,387	48.1	0.449	4,767,891	4.50	5.00	2.41	34.88%	1,663,040
1996	8,087,743	40.4	0.535	4,324,140	3.50	5.00	2.72	43.73%	1,890,946
1997	6,575,394	32.6	0.663	4,356,703	2.50	5.00	2.94	54.04%	2,354,362
1998	8,167,572	24.3	0.889	7,260,064	1.50	5.00	3.02	66.81%	4,850,449
1999	11,725,904	21.6	1.000	11,725,904	0.50	5.00	2.80	84.85%	9,949,430
	112,016,697		0.469	52,564,359				45.73%	24,036,462

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Analog Switching Equipment
Plant Sub-Account:	Analog Switching Equipment
Index Number:	2211
Field Code:	AEZ
Survivor Curve:	C2
Average Service Life:	33.34

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1955	30,903	60.6	2.053	63,438	44.50	33.34	11.09	19.95%	12,656
1956	0	62.1	2.003	0	43.50	33.34	0.00	0.00%	0
1957	0	65.0	1.914	0	42.50	33.34	0.00	0.00%	0
1958	0	66.4	1.873	0	41.50	33.34	0.00	0.00%	0
1959	2,486	65.6	1.896	4,714	40.50	33.34	13.09	24.43%	1,152
1960	0	64.8	1.920	0	39.50	33.34	0.00	0.00%	0
1961	0	64.1	1.941	0	38.50	33.34	0.00	0.00%	0
1962	4,830	63.7	1.953	9,433	37.50	33.34	14.59	28.01%	2,642
1963	0	64.6	1.926	0	36.50	33.34	0.00	0.00%	0
1964	362	65.1	1.911	692	35.50	33.34	15.59	30.51%	211
1965	668	64.3	1.935	1,292	34.50	33.34	16.09	31.80%	411
1966	415	65.0	1.914	794	33.50	33.34	16.59	33.12%	263
1967	0	67.4	1.846	0	32.50	33.34	0.00	0.00%	0
1968	616	70.9	1.755	1,081	31.50	33.34	17.59	35.83%	387
1969	1,350	74.0	1.681	2,269	30.50	33.34	18.09	37.23%	845
1970	181	76.3	1.630	295	29.50	33.34	18.59	38.66%	114
1971	947,818	79.3	1.569	1,486,867	28.50	33.34	19.09	40.11%	596,382
1972	1,720,491	81.2	1.532	2,635,826	27.50	33.34	19.59	41.60%	1,096,504
1973	2,943,958	81.1	1.534	4,515,763	26.50	33.34	20.09	43.12%	1,947,197
1974	121,219	85.1	1.462	177,199	25.50	33.34	20.59	44.67%	79,155
1975	1,926,418	91.4	1.361	2,621,952	24.50	33.34	21.08	46.25%	1,212,653
1976	177,638	94.7	1.314	233,349	23.50	33.34	21.58	47.87%	111,704
1977	104,583	92.4	1.346	140,802	22.50	33.34	22.08	49.53%	69,739
1978	610,818	87.4	1.423	869,402	21.50	33.34	22.58	51.23%	445,395
1979	1,871,890	86.2	1.443	2,701,428	20.50	33.34	23.08	52.96%	1,430,676
1980	6,316,234	87.8	1.417	8,949,197	19.50	33.34	23.58	54.74%	4,898,791
1981	5,899,834	95.4	1.304	7,693,285	18.50	33.34	24.08	56.55%	4,350,552
1982	22,593,223	106.9	1.164	26,291,833	17.50	33.34	24.58	58.41%	15,357,060
1983	7,686,580	118.3	1.052	8,082,929	16.50	33.34	25.08	60.32%	4,875,623
1984	11,215,307	129.8	0.958	10,748,723	15.50	33.34	25.58	62.27%	6,693,230
1985	4,553,326	118.1	1.053	4,796,221	14.50	33.34	26.08	64.27%	3,082,532
1986	7,140,581	109.6	1.135	8,104,820	13.50	33.34	26.58	66.32%	5,375,117
1987	4,948,775	105.9	1.175	5,813,292	12.50	33.34	27.08	68.42%	3,977,454
1988	6,805,031	100.0	1.244	8,465,459	11.50	33.34	27.58	70.57%	5,974,074
1989	6,300,094	98.9	1.258	7,924,486	10.50	33.34	28.08	72.78%	5,767,441
1990	3,712,433	95.4	1.304	4,840,950	9.50	33.34	28.58	75.05%	3,633,133
1991	8,151,767	92.3	1.348	10,986,780	8.50	33.34	29.08	77.38%	8,501,571
1992	4,777,889	92.0	1.352	6,460,537	7.50	33.34	29.58	79.77%	5,153,570
1993	5,406,583	96.0	1.296	7,006,030	6.50	33.34	30.08	82.23%	5,761,059
1994	3,699,142	93.5	1.330	4,921,639	5.50	33.34	30.58	84.76%	4,171,581
1995	3,106,302	102.7	1.211	3,762,648	4.50	33.34	31.08	87.35%	3,286,673
1996	4,273,004	105.3	1.181	5,048,069	3.50	33.34	31.58	90.02%	4,544,272

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Analog Switching Equipment
Plant Sub-Account:	Analog Switching Equipment
Index Number:	2211
Field Code:	AEZ
Survivor Curve:	C2
Average Service Life:	33.34

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1997	1,803,897	109.6	1.135	2,047,489	2.50	33.34	32.08	92.77%	1,899,455
1998	5,596,508	123.2	1.010	5,651,019	1.50	33.34	32.58	95.60%	5,402,375
1999	4,145,902	124.4	1.000	4,145,902	0.50	33.34	33.08	98.51%	4,084,128
	138,599,056		1.206	167,207,907				68.06%	113,797,777

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account: Digital Switching Equipment
Plant Sub-Account: Digital Switching Equipment
Index Number: 2212
Field Code: DEZ
Survivor Curve: O1
Average Service Life: 10

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1950	31,531	44.6	1.982	62,496	49.50	10.00	0.50	1.00%	625
1951	0	46.3	1.909	0	48.50	10.00	0.00	0.00%	0
1952	0	42.4	2.085	0	47.50	10.00	0.00	0.00%	0
1953	0	38.9	2.272	0	46.50	10.00	0.00	0.00%	0
1954	0	39.3	2.249	0	45.50	10.00	0.00	0.00%	0
1955	397,001	39.2	2.255	895,278	44.50	10.00	0.50	1.11%	9,938
1956	0	39.8	2.221	0	43.50	10.00	0.00	0.00%	0
1957	48,452	41.4	2.135	103,458	42.50	10.00	0.50	1.16%	1,200
1958	13,628	42.3	2.090	28,480	41.50	10.00	0.50	1.19%	339
1959	43,254	41.5	2.130	92,136	40.50	10.00	0.50	1.22%	1,124
1960	95,256	40.6	2.177	207,405	39.50	10.00	0.50	1.25%	2,593
1961	88,176	40.4	2.188	192,940	38.50	10.00	0.50	1.28%	2,470
1962	10,034	39.6	2.232	22,399	37.50	10.00	0.50	1.32%	296
1963	169	39.8	2.221	375	36.50	10.00	0.50	1.35%	5
1964	31,855	39.8	2.221	70,753	35.50	10.00	0.50	1.39%	983
1965	14,060	38.7	2.284	32,116	34.50	10.00	0.50	1.43%	459
1966	437,109	38.3	2.308	1,008,889	33.50	10.00	0.50	1.47%	14,831
1967	2,594	39.0	2.267	5,880	32.50	10.00	0.50	1.52%	89
1968	37,432	40.4	2.188	81,906	31.50	10.00	0.50	1.56%	1,278
1969	18,745	41.5	2.130	39,929	30.50	10.00	0.50	1.61%	643
1970	107,024	42.6	2.075	222,087	29.50	10.00	0.50	1.67%	3,709
1971	607,296	44.4	1.991	1,209,121	28.50	10.00	0.50	1.72%	20,797
1972	575,108	45.6	1.939	1,114,902	27.50	10.00	0.50	1.79%	19,957
1973	632,352	47.7	1.853	1,171,906	26.50	10.00	0.50	1.85%	21,680
1974	808,944	53.0	1.668	1,349,258	25.50	10.00	0.50	1.92%	25,906
1975	305,680	57.5	1.537	469,950	24.50	10.00	0.50	2.00%	9,399
1976	80,138	59.8	1.478	118,465	23.50	10.00	0.50	2.08%	2,464
1977	2,197,539	61.1	1.447	3,179,418	22.50	10.00	0.50	2.17%	68,993
1978	2,387,941	61.3	1.442	3,443,621	21.50	10.00	0.50	2.27%	78,170
1979	3,625,923	62.8	1.408	5,104,006	20.50	10.00	0.50	2.38%	121,475
1980	2,582,348	64.2	1.377	3,555,756	19.50	10.00	0.50	2.50%	88,894
1981	4,529,625	69.9	1.265	5,728,453	18.50	10.00	0.83	4.29%	245,751
1982	11,071,404	75.4	1.172	12,980,267	17.50	10.00	1.30	6.91%	896,936
1983	2,571,938	83.4	1.060	2,726,131	16.50	10.00	1.73	9.49%	258,710
1984	6,337,953	87.6	1.009	6,395,834	15.50	10.00	2.18	12.33%	788,606
1985	10,120,427	97.0	0.911	9,223,152	14.50	10.00	2.62	15.30%	1,411,142
1986	26,189,840	101.8	0.868	22,742,454	13.50	10.00	3.06	18.48%	4,202,806
1987	33,437,261	100.2	0.882	29,499,540	12.50	10.00	3.47	21.73%	6,410,250
1988	40,036,816	100.0	0.884	35,392,545	11.50	10.00	3.87	25.18%	8,911,843
1989	38,953,470	99.1	0.892	34,744,380	10.50	10.00	4.26	28.86%	10,027,228
1990	30,469,702	98.2	0.900	27,428,043	9.50	10.00	4.62	32.72%	8,974,456
1991	32,038,707	99.6	0.888	28,445,956	8.50	10.00	4.95	36.80%	10,468,112

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Digital Switching Equipment
Plant Sub-Account:	Digital Switching Equipment
Index Number:	2212
Field Code:	DEZ
Survivor Curve:	O1
Average Service Life:	10

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1992	47,446,729	94.7	0.933	44,282,866	7.50	10.00	5.26	41.22%	18,253,397
1993	47,220,109	91.2	0.969	45,769,412	6.50	10.00	5.52	45.92%	21,017,314
1994	59,784,926	88.8	0.996	59,517,153	5.50	10.00	5.75	51.11%	30,419,217
1995	92,935,566	86.2	1.026	95,336,156	4.50	10.00	5.91	56.77%	54,122,335
1996	65,965,159	86.9	1.017	67,103,798	3.50	10.00	5.99	63.12%	42,355,917
1997	55,987,858	84.5	1.046	58,571,913	2.50	10.00	5.94	70.38%	41,222,912
1998	92,932,319	88.1	1.003	93,248,774	1.50	10.00	5.69	79.14%	73,797,080
1999	106,015,893	88.4	1.000	106,015,893	0.50	10.00	4.96	90.84%	96,304,837
	819,225,291		0.987	808,935,651				53.23%	430,587,166

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Operator Systems
Plant Sub-Account:	Operator Systems
Index Number:	2220
Field Code:	OSZ
Survivor Curve:	S2
Average Service Life:	10.7

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1979	27,900	71.3	1.496	41,752	20.50	10.70	0.50	2.38%	994
1980	0	73.0	1.462	0	19.50	10.70	0.00	0.00%	0
1981	2,005	79.2	1.347	2,701	18.50	10.70	0.67	3.50%	95
1982	80,948	87.3	1.222	98,936	17.50	10.70	0.84	4.58%	4,531
1983	6,290	96.5	1.106	6,955	16.50	10.70	1.01	5.77%	401
1984	2,826	103.3	1.033	2,919	15.50	10.70	1.22	7.30%	213
1985	0	105.6	1.010	0	14.50	10.70	0.00	0.00%	0
1986	554	104.7	1.019	565	13.50	10.70	1.68	11.07%	62
1987	5,844	102.2	1.044	6,101	12.50	10.70	1.95	13.49%	823
1988	0	100.0	1.067	0	11.50	10.70	0.00	0.00%	0
1989	0	101.3	1.053	0	10.50	10.70	0.00	0.00%	0
1990	1,570,820	104.4	1.022	1,605,426	9.50	10.70	2.89	23.33%	374,546
1991	2,517,049	104.2	1.024	2,577,439	8.50	10.70	3.28	27.84%	717,559
1992	177,904	104.0	1.026	182,523	7.50	10.70	3.72	33.16%	60,525
1993	460,114	102.9	1.037	477,106	6.50	10.70	4.21	39.31%	187,550
1994	8,699	106.7	1.000	8,699	5.50	10.70	4.78	46.50%	4,045
1995	0	105.1	1.015	0	4.50	10.70	0.00	0.00%	0
1996	182,772	107.5	0.993	181,412	3.50	10.70	6.17	63.81%	115,759
1997	35,281	107.4	0.993	35,051	2.50	10.70	7.01	73.71%	25,836
1998	0	107.0	0.997	0	1.50	10.70	0.00	0.00%	0
1999	2,001,055	106.7	1.000	2,001,055	0.50	10.70	8.91	94.69%	1,894,799
	7,080,061		1.021	7,228,640				46.87%	3,387,738

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account: Radio Systems
Plant Sub-Account: Radio Systems
Index Number: 2231
Field Code: RDZ
Survivor Curve: S1.5
Average Service Life: 15.1

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1960	6,677	33.2	2.877	19,206	39.50	15.10	0.50	1.25%	240
1961	6,716	32.9	2.903	19,495	38.50	15.10	0.50	1.28%	250
1962	4,353	32.7	2.920	12,713	37.50	15.10	0.50	1.32%	168
1963	2,877	33.1	2.885	8,301	36.50	15.10	0.50	1.35%	112
1964	16,819	33.1	2.885	48,526	35.50	15.10	0.50	1.39%	675
1965	1,818	32.2	2.966	5,392	34.50	15.10	0.50	1.43%	77
1966	6,235	31.8	3.003	18,725	33.50	15.10	0.50	1.47%	275
1967	7,289	33.5	2.851	20,779	32.50	15.10	0.50	1.52%	316
1968	45,268	35.8	2.668	120,757	31.50	15.10	0.50	1.56%	1,884
1969	7,337	36.7	2.602	19,092	30.50	15.10	0.50	1.61%	307
1970	50,837	37.5	2.547	129,465	29.50	15.10	0.50	1.67%	2,162
1971	169,794	39.0	2.449	415,778	28.50	15.10	0.59	2.03%	8,440
1972	247,659	40.3	2.370	586,884	27.50	15.10	0.79	2.79%	16,374
1973	330,274	42.5	2.247	742,145	26.50	15.10	1.02	3.71%	27,534
1974	77,131	46.9	2.036	157,058	25.50	15.10	1.26	4.71%	7,397
1975	91,617	51.1	1.869	171,222	24.50	15.10	1.51	5.81%	9,948
1976	232,464	54.1	1.765	410,357	23.50	15.10	1.76	6.97%	28,602
1977	295,324	58.4	1.635	482,936	22.50	15.10	2.01	8.20%	39,601
1978	304,728	63.4	1.506	459,015	21.50	15.10	2.28	9.59%	44,019
1979	227,207	69.2	1.380	313,559	20.50	15.10	2.55	11.06%	34,680
1980	182,674	73.5	1.299	237,352	19.50	15.10	2.84	12.71%	30,167
1981	178,361	81.0	1.179	210,290	18.50	15.10	3.15	14.55%	30,597
1982	163,485	86.1	1.109	181,334	17.50	15.10	3.48	16.59%	30,083
1983	1,359,496	90.1	1.060	1,440,975	16.50	15.10	3.48	17.42%	251,018
1984	659,442	97.7	0.977	644,593	15.50	15.10	3.78	19.61%	126,405
1985	5,371,671	99.3	0.962	5,166,109	14.50	15.10	4.10	22.04%	1,138,610
1986	762,163	98.8	0.967	736,706	13.50	15.10	4.44	24.75%	182,335
1987	4,401,567	97.3	0.982	4,320,140	12.50	15.10	4.80	27.75%	1,198,839
1988	4,623,326	100.0	0.955	4,415,276	11.50	15.10	5.19	31.10%	1,373,151
1989	3,358,029	101.4	0.942	3,162,641	10.50	15.10	5.60	34.78%	1,099,966
1990	2,421,797	103.6	0.922	2,232,448	9.50	15.10	6.05	38.91%	868,646
1991	857,900	106.1	0.900	772,191	8.50	15.10	6.53	43.45%	335,517
1992	1,714,157	105.6	0.904	1,550,208	7.50	15.10	7.04	48.42%	750,611
1993	1,310,723	107.5	0.888	1,164,410	6.50	15.10	7.60	53.90%	627,617
1994	2,846,386	106.4	0.898	2,554,792	5.50	15.10	8.21	59.88%	1,529,809
1995	142,245	101.2	0.944	134,233	4.50	15.10	8.86	66.32%	89,023
1996	729,679	100.2	0.953	695,453	3.50	15.10	9.57	73.22%	509,210
1997	297,847	94.7	1.008	300,363	2.50	15.10	10.33	80.51%	241,822
1998	727,226	95.4	1.001	727,988	1.50	15.10	11.15	88.14%	641,649
1999	1,082,552	95.5	1.000	1,082,552	0.50	15.10	12.04	96.01%	1,039,358
	35,323,150		1.016	35,891,456				34.32%	12,317,495

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Circuit DDS
Plant Sub-Account:	Circuit DDS
Index Number:	2232
Field Code:	CRDA
Survivor Curve:	L1
Average Service Life:	8.1

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1976	13,302	59.8	1.452	19,308	23.50	8.10	0.59	2.45%	473
1977	66	61.1	1.421	94	22.50	8.10	0.72	3.10%	3
1978	4,321	61.3	1.416	6,118	21.50	8.10	0.85	3.80%	233
1979	31,919	62.8	1.382	44,117	20.50	8.10	1.00	4.65%	2,051
1980	4,896	64.2	1.352	6,620	19.50	8.10	1.16	5.61%	371
1981	10,435	69.9	1.242	12,958	18.50	8.10	1.34	6.75%	875
1982	138,493	75.4	1.151	159,432	17.50	8.10	1.52	7.99%	12,739
1983	173,111	83.4	1.041	180,168	16.50	8.10	1.62	8.94%	16,107
1984	121,222	87.6	0.991	120,115	15.50	8.10	1.80	10.40%	12,492
1985	341,551	97.0	0.895	305,635	14.50	8.10	1.98	12.01%	36,707
1986	100,982	101.8	0.853	86,103	13.50	8.10	2.16	13.79%	11,874
1987	260,934	100.2	0.866	226,039	12.50	8.10	2.35	15.82%	35,759
1988	430,092	100.0	0.868	373,320	11.50	8.10	2.54	18.09%	67,534
1989	291,734	98.8	0.879	256,301	10.50	8.10	2.74	20.69%	53,029
1990	282,109	99.0	0.877	247,344	9.50	8.10	2.93	23.57%	58,299
1991	309,050	100.3	0.865	267,453	8.50	8.10	3.13	26.91%	71,972
1992	670,464	92.2	0.941	631,196	7.50	8.10	3.33	30.75%	194,093
1993	731,765	90.6	0.958	701,073	6.50	8.10	3.52	35.13%	246,287
1994	896,309	89.4	0.971	870,242	5.50	8.10	3.70	40.22%	350,011
1995	1,008,687	86.9	0.999	1,007,526	4.50	8.10	3.87	46.24%	465,880
1996	837,484	87.2	0.995	833,642	3.50	8.10	4.05	53.64%	447,166
1997	734,459	87.1	0.997	731,929	2.50	8.10	4.30	63.24%	462,872
1998	731,215	86.8	1.000	731,215	1.50	8.10	4.64	75.57%	552,579
1999	368,025	86.8	1.000	368,025	0.50	8.10	5.03	90.96%	334,756
	8,492,625		0.964	8,185,973				41.95%	3,434,160

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Circuit Digital
Plant Sub-Account:	Circuit Digital
Index Number:	2232
Field Code:	CRD
Survivor Curve:	O2
Average Service Life:	10

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1950	151,692	44.6	1.982	300,663	49.50	10.00	0.50	1.00%	3,007
1951	0	46.3	1.909	0	48.50	10.00	0.00	0.00%	0
1952	3,609	42.4	2.085	7,524	47.50	10.00	0.50	1.04%	78
1953	0	38.9	2.272	0	46.50	10.00	0.00	0.00%	0
1954	749	39.3	2.249	1,685	45.50	10.00	0.50	1.09%	18
1955	737,034	39.2	2.255	1,662,087	44.50	10.00	0.50	1.11%	18,449
1956	394	39.8	2.221	875	43.50	10.00	0.50	1.14%	10
1957	1,641	41.4	2.135	3,504	42.50	10.00	0.50	1.16%	41
1958	544	42.3	2.090	1,137	41.50	10.00	0.50	1.19%	14
1959	666	41.5	2.130	1,419	40.50	10.00	0.50	1.22%	17
1960	1,262	40.6	2.177	2,748	39.50	10.00	0.50	1.25%	34
1961	22,563	40.4	2.188	49,371	38.50	10.00	0.50	1.28%	632
1962	1,336	39.6	2.232	2,982	37.50	10.00	0.50	1.32%	39
1963	6,884	39.8	2.221	15,290	36.50	10.00	0.50	1.35%	206
1964	43,099	39.8	2.221	95,727	35.50	10.00	0.50	1.39%	1,331
1965	20,933	38.7	2.284	47,816	34.50	10.00	0.50	1.43%	684
1966	59,510	38.3	2.308	137,355	33.50	10.00	0.50	1.47%	2,019
1967	77,917	39.0	2.267	176,612	32.50	10.00	0.50	1.52%	2,685
1968	9,779	40.4	2.188	21,398	31.50	10.00	0.50	1.56%	334
1969	327,820	41.5	2.130	698,296	30.50	10.00	0.50	1.61%	11,243
1970	208,647	42.6	2.075	432,967	29.50	10.00	0.83	2.74%	11,863
1971	466,490	44.4	1.991	928,777	28.50	10.00	1.28	4.30%	39,937
1972	495,276	45.6	1.939	960,140	27.50	10.00	1.75	5.98%	57,416
1973	951,699	47.7	1.853	1,763,736	26.50	10.00	2.21	7.70%	135,808
1974	1,196,551	53.0	1.668	1,995,757	25.50	10.00	2.66	9.45%	188,599
1975	834,144	57.5	1.537	1,282,406	24.50	10.00	3.10	11.23%	144,014
1976	1,085,942	59.8	1.478	1,605,306	23.50	10.00	3.53	13.06%	209,653
1977	712,952	61.1	1.447	1,031,505	22.50	10.00	3.93	14.87%	153,385
1978	1,038,904	61.3	1.442	1,498,191	21.50	10.00	4.31	16.70%	250,198
1979	2,002,245	62.8	1.408	2,818,447	20.50	10.00	4.65	18.49%	521,131
1980	3,727,123	64.2	1.377	5,132,051	19.50	10.00	4.96	20.28%	1,040,780
1981	6,515,999	69.9	1.265	8,240,548	18.50	10.00	5.23	22.04%	1,816,217
1982	12,388,237	75.4	1.172	14,524,140	17.50	10.00	5.46	23.78%	3,453,840
1983	21,143,649	83.4	1.060	22,411,254	16.50	10.00	4.90	22.90%	5,132,177
1984	29,096,112	87.6	1.009	29,361,830	15.50	10.00	4.92	24.09%	7,073,265
1985	49,313,875	97.0	0.911	44,941,717	14.50	10.00	4.90	25.26%	11,352,278
1986	51,645,717	101.8	0.868	44,847,558	13.50	10.00	4.86	26.47%	11,871,149
1987	41,471,890	100.2	0.882	36,587,975	12.50	10.00	4.84	27.91%	10,211,704
1988	46,458,503	100.0	0.884	41,069,317	11.50	10.00	4.84	29.62%	12,164,732
1989	41,665,493	99.1	0.892	37,163,358	10.50	10.00	4.89	31.77%	11,806,799
1990	53,834,118	98.2	0.900	48,460,089	9.50	10.00	4.98	34.39%	16,665,425
1991	54,557,795	99.6	0.888	48,439,803	8.50	10.00	5.10	37.50%	18,164,926

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Circuit Digital
Plant Sub-Account:	Circuit Digital
Index Number:	2232
Field Code:	CRD
Survivor Curve:	O2
Average Service Life:	10

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1992	51,192,730	94.7	0.933	47,779,075	7.50	10.00	5.24	41.13%	19,651,533
1993	44,952,094	91.2	0.969	43,571,075	6.50	10.00	5.38	45.29%	19,733,340
1994	62,727,461	88.8	0.996	62,446,508	5.50	10.00	5.51	50.05%	31,254,477
1995	80,249,683	86.2	1.026	82,322,587	4.50	10.00	5.60	55.45%	45,647,875
1996	121,882,842	86.9	1.017	123,986,689	3.50	10.00	5.63	61.66%	76,450,192
1997	81,098,786	84.5	1.046	84,841,807	2.50	10.00	5.56	68.98%	58,523,878
1998	123,445,446	88.1	1.003	123,865,805	1.50	10.00	5.30	77.94%	96,541,008
1999	140,227,026	88.4	1.000	140,227,026	0.50	10.00	4.59	90.18%	126,456,732
	1,128,054,861		0.982	1,107,763,931				52.97%	586,765,172

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Circuit Analog
Plant Sub-Account:	Circuit Analog
Index Number:	2232
Field Code:	CRA
Survivor Curve:	L0
Average Service Life:	8

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1949	4,816	43.4	2.544	12,251	50.50	8.00	0.50	0.98%	120
1950	11,710	44.6	2.475	28,986	49.50	8.00	0.50	1.00%	290
1951	1,971	46.3	2.384	4,700	48.50	8.00	0.50	1.02%	48
1952	733	42.4	2.604	1,909	47.50	8.00	0.50	1.04%	20
1953	0	38.9	2.838	0	46.50	8.00	0.00	0.00%	0
1954	3,664	39.3	2.809	10,293	45.50	8.00	0.50	1.09%	112
1955	6,288	39.2	2.816	17,709	44.50	8.00	0.50	1.11%	197
1956	3,278	39.8	2.774	9,093	43.50	8.00	0.50	1.14%	104
1957	5,185	41.4	2.667	13,827	42.50	8.00	0.50	1.16%	160
1958	40,733	42.3	2.610	106,310	41.50	8.00	0.50	1.19%	1,265
1959	5,702	41.5	2.660	15,169	40.50	8.00	0.50	1.22%	185
1960	13,834	40.6	2.719	37,618	39.50	8.00	0.50	1.25%	470
1961	2,543	40.4	2.733	6,949	38.50	8.00	0.50	1.28%	89
1962	9,529	39.6	2.788	26,566	37.50	8.00	0.50	1.32%	351
1963	427,078	39.8	2.774	1,184,659	36.50	8.00	0.50	1.35%	15,993
1964	13,767	39.8	2.774	38,188	35.50	8.00	0.50	1.39%	531
1965	21,102	38.7	2.853	60,198	34.50	8.00	0.50	1.43%	861
1966	30,480	38.3	2.883	87,859	33.50	8.00	0.50	1.47%	1,292
1967	28,567	39.0	2.831	80,867	32.50	8.00	0.50	1.52%	1,229
1968	31,008	40.4	2.733	84,735	31.50	8.00	0.50	1.56%	1,322
1969	76,673	41.5	2.660	203,969	30.50	8.00	0.50	1.61%	3,284
1970	155,074	42.6	2.592	401,882	29.50	8.00	0.50	1.67%	6,711
1971	400,906	44.4	2.486	996,847	28.50	8.00	0.85	2.90%	28,909
1972	188,980	45.6	2.421	457,531	27.50	8.00	0.98	3.44%	15,739
1973	276,994	47.7	2.314	641,093	26.50	8.00	1.11	4.02%	25,772
1974	229,966	53.0	2.083	479,024	25.50	8.00	1.23	4.60%	22,035
1975	356,528	57.5	1.920	684,534	24.50	8.00	1.37	5.30%	36,280
1976	244,738	59.8	1.846	451,824	23.50	8.00	1.50	6.00%	27,109
1977	353,477	61.1	1.807	638,688	22.50	8.00	1.64	6.79%	43,367
1978	517,503	61.3	1.801	932,012	21.50	8.00	1.79	7.69%	71,672
1979	1,159,491	62.8	1.758	2,038,341	20.50	8.00	1.94	8.65%	176,316
1980	1,266,952	64.2	1.720	2,178,684	19.50	8.00	2.10	9.72%	211,768
1981	1,829,590	69.9	1.579	2,889,653	18.50	8.00	2.26	10.89%	314,683
1982	3,164,892	75.4	1.464	4,634,006	17.50	8.00	2.44	12.24%	567,202
1983	3,590,547	83.4	1.324	4,752,954	16.50	8.00	2.40	12.70%	603,625
1984	3,381,676	87.6	1.260	4,261,838	15.50	8.00	2.55	14.13%	602,198
1985	4,126,296	97.0	1.138	4,696,320	14.50	8.00	2.70	15.70%	737,322
1986	4,453,965	101.8	1.084	4,830,233	13.50	8.00	2.86	17.48%	844,325
1987	4,547,991	100.2	1.102	5,010,960	12.50	8.00	3.02	19.46%	975,133
1988	3,346,578	100.0	1.104	3,694,622	11.50	8.00	3.18	21.66%	800,255
1989	3,188,852	103.7	1.065	3,394,882	10.50	8.00	3.35	24.19%	821,222
1990	1,651,687	103.3	1.069	1,765,211	9.50	8.00	3.51	26.98%	476,254

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Circuit Analog
Plant Sub-Account:	Circuit Analog
Index Number:	2232
Field Code:	CRA
Survivor Curve:	L0
Average Service Life:	8

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1991	1,247,794	106.5	1.037	1,293,488	8.50	8.00	3.68	30.21%	390,763
1992	2,015,225	108.2	1.020	2,056,200	7.50	8.00	3.83	33.80%	694,996
1993	1,338,798	109.7	1.006	1,347,341	6.50	8.00	3.99	38.04%	512,528
1994	794,135	111.8	0.987	784,191	5.50	8.00	4.13	42.89%	336,339
1995	810,638	111.8	0.987	800,487	4.50	8.00	4.24	48.51%	388,316
1996	698,426	111.6	0.989	690,916	3.50	8.00	4.32	55.24%	381,662
1997	507,149	111.9	0.987	500,351	2.50	8.00	4.35	63.50%	317,723
1998	1,236,809	109.8	1.005	1,243,568	1.50	8.00	4.31	74.18%	922,478
1999	1,079,213	110.4	1.000	1,079,213	0.50	8.00	4.10	89.13%	961,903
	48,899,531		1.261	61,658,744				20.02%	12,342,528

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Other Term Equipment
Plant Sub-Account:	Other Term Equipment
Index Number:	2362
Field Code:	OTO
Survivor Curve:	O3
Average Service Life:	6.8

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1955	75,102	33.2	3.274	245,891	44.50	6.80	0.50	1.11%	2,729
1956	7,168	33.9	3.206	22,984	43.50	6.80	0.50	1.14%	262
1957	0	34.8	3.124	0	42.50	6.80	0.00	0.00%	0
1958	0	35.6	3.053	0	41.50	6.80	0.00	0.00%	0
1959	0	36.0	3.019	0	40.50	6.80	0.00	0.00%	0
1960	0	35.8	3.036	0	39.50	6.80	0.00	0.00%	0
1961	55,484	35.9	3.028	167,998	38.50	6.80	0.50	1.28%	2,150
1962	4,553	36.0	3.019	13,748	37.50	6.80	0.50	1.32%	181
1963	19,311	36.3	2.994	57,827	36.50	6.80	0.50	1.35%	781
1964	5,753	37.4	2.906	16,721	35.50	6.80	0.50	1.39%	232
1965	10,401	37.8	2.876	29,910	34.50	6.80	0.50	1.43%	428
1966	139,738	38.7	2.809	392,494	33.50	6.80	0.50	1.47%	5,770
1967	15,280	40.0	2.718	41,523	32.50	6.80	0.50	1.52%	631
1968	30,133	41.6	2.613	78,737	31.50	6.80	0.50	1.56%	1,228
1969	14,444	44.5	2.443	35,282	30.50	6.80	0.50	1.61%	568
1970	54,634	46.4	2.343	127,990	29.50	6.80	0.50	1.67%	2,137
1971	125,671	49.2	2.209	277,651	28.50	6.80	0.50	1.72%	4,776
1972	12,292	52.4	2.074	25,499	27.50	6.80	0.50	1.79%	456
1973	63,021	53.8	2.020	127,331	26.50	6.80	0.50	1.85%	2,356
1974	93,982	57.6	1.887	177,358	25.50	6.80	0.60	2.30%	4,079
1975	84,953	63.2	1.720	146,114	24.50	6.80	1.07	4.18%	6,108
1976	155,084	67.6	1.608	249,373	23.50	6.80	1.55	6.19%	15,436
1977	166,804	71.4	1.522	253,944	22.50	6.80	2.02	8.24%	20,925
1978	269,061	74.1	1.467	394,695	21.50	6.80	2.49	10.38%	40,969
1979	287,844	77.7	1.399	402,685	20.50	6.80	2.95	12.58%	50,658
1980	231,224	83.2	1.306	302,092	19.50	6.80	3.40	14.85%	44,861
1981	143,278	89.8	1.210	173,433	18.50	6.80	3.83	17.15%	29,744
1982	123,260	97.7	1.113	137,138	17.50	6.80	4.25	19.54%	26,797
1983	304,472	99.7	1.090	331,957	16.50	6.80	4.65	21.99%	72,997
1984	275,403	96.5	1.126	310,221	15.50	6.80	5.03	24.50%	76,004
1985	16,026	91.9	1.183	18,956	14.50	6.80	5.38	27.06%	5,129
1986	3,683,331	95.5	1.138	4,192,441	13.50	6.80	5.70	29.69%	1,244,736
1987	2,174,799	96.6	1.125	2,447,212	12.50	6.80	5.98	32.36%	791,918
1988	1,382,671	100.0	1.087	1,502,963	11.50	6.80	6.23	35.14%	528,141
1989	960,522	98.7	1.101	1,057,839	10.50	6.80	6.43	37.98%	401,767
1990	1,408,555	99.0	1.098	1,546,565	9.50	6.80	6.58	40.92%	632,854
1991	1,361,110	99.8	1.089	1,482,492	8.50	6.80	6.68	44.01%	652,445
1992	1,636,571	102.4	1.062	1,737,258	7.50	6.80	6.73	47.29%	821,550
1993	2,579,268	106.7	1.019	2,627,614	6.50	6.80	6.73	50.87%	1,336,667
1994	3,433,359	110.3	0.985	3,383,555	5.50	6.80	6.69	54.88%	1,856,895
1995	4,905,879	111.0	0.979	4,804,226	4.50	6.80	6.63	59.57%	2,861,877
1996	5,230,536	110.4	0.985	5,149,993	3.50	6.80	6.58	65.28%	3,361,916

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Other Term Equipment
Plant Sub-Account:	Other Term Equipment
Index Number:	2362
Field Code:	OTO
Survivor Curve:	O3
Average Service Life:	6.8

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1997	5,395,928	109.3	0.995	5,366,307	2.50	6.80	6.57	72.44%	3,887,353
1998	5,386,025	108.1	1.006	5,415,920	1.50	6.80	6.61	81.50%	4,413,975
1999	6,138,137	108.7	1.000	6,138,137	0.50	6.80	6.73	93.08%	5,713,378
	48,461,067		1.061	51,412,073				56.26%	28,923,865

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Pole Lines
Plant Sub-Account:	Pole Lines
Index Number:	2411
Field Code:	PLZA
Survivor Curve:	O1
Average Service Life:	46.4

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1925	64,891	12.1	13.802	895,603	74.50	46.40	9.16	10.95%	98,069
1926	28,839	12.1	13.802	398,026	73.50	46.40	9.66	11.62%	46,251
1927	72,160	12.1	13.802	995,927	72.50	46.40	10.16	12.29%	122,399
1928	55,479	12.1	13.802	765,702	71.50	46.40	10.65	12.96%	99,235
1929	84,819	12.1	13.802	1,170,642	70.50	46.40	11.15	13.66%	159,910
1930	92,458	12.1	13.802	1,276,073	69.50	46.40	11.65	14.36%	183,244
1931	20,894	12.1	13.802	288,372	68.50	46.40	12.15	15.07%	43,458
1932	26,477	12.1	13.802	365,426	67.50	46.40	12.65	15.78%	57,664
1933	27,175	12.1	13.802	375,060	66.50	46.40	13.15	16.51%	61,922
1934	21,849	12.1	13.802	301,552	65.50	46.40	13.65	17.25%	52,018
1935	57,910	12.1	13.802	799,254	64.50	46.40	14.15	17.99%	143,786
1936	42,578	12.1	13.802	587,647	63.50	46.40	14.65	18.75%	110,184
1937	63,972	12.1	13.802	882,919	62.50	46.40	15.15	19.51%	172,258
1938	43,267	12.1	13.802	597,156	61.50	46.40	15.65	20.29%	121,163
1939	50,425	12.1	13.802	695,948	60.50	46.40	16.15	21.07%	146,636
1940	126,592	12.1	13.802	1,747,179	59.50	46.40	16.65	21.86%	381,933
1941	137,285	12.1	13.802	1,894,760	58.50	46.40	17.15	22.67%	429,542
1942	80,067	12.1	13.802	1,105,057	57.50	46.40	17.65	23.49%	259,578
1943	41,120	12.1	13.802	567,524	56.50	46.40	18.15	24.31%	137,965
1944	52,554	12.1	13.802	725,332	55.50	46.40	18.65	25.15%	182,421
1945	136,072	12.1	13.802	1,878,019	54.50	46.40	19.15	26.00%	488,285
1946	179,258	12.1	13.802	2,474,057	53.50	46.40	19.65	26.86%	664,532
1947	234,395	14.3	11.678	2,737,340	52.50	46.40	20.15	27.74%	759,338
1948	242,125	14.7	11.361	2,750,672	51.50	46.40	20.65	28.62%	787,242
1949	253,642	14.5	11.517	2,921,256	50.50	46.40	21.15	29.52%	862,355
1950	346,045	14.7	11.361	3,931,260	49.50	46.40	21.65	30.43%	1,196,282
1951	380,035	15.7	10.637	4,042,411	48.50	46.40	22.15	31.35%	1,267,296
1952	442,253	16.6	10.060	4,449,172	47.50	46.40	22.65	32.29%	1,436,638
1953	583,746	17.2	9.709	5,667,766	46.50	46.40	23.15	33.24%	1,883,966
1954	835,921	17.0	9.824	8,211,695	45.50	46.40	23.65	34.20%	2,808,400
1955	673,735	16.8	9.940	6,697,247	44.50	46.40	24.15	35.18%	2,356,091
1956	721,790	17.9	9.330	6,734,018	43.50	46.40	24.65	36.17%	2,435,694
1957	944,636	19.1	8.743	8,259,383	42.50	46.40	25.15	37.18%	3,070,839
1958	1,223,987	19.3	8.653	10,590,976	41.50	46.40	25.65	38.20%	4,045,753
1959	1,655,248	19.8	8.434	13,960,930	40.50	46.40	26.15	39.23%	5,476,873
1960	1,574,146	20.2	8.267	13,013,979	39.50	46.40	26.65	40.29%	5,243,332
1961	883,961	20.3	8.227	7,271,994	38.50	46.40	27.15	41.36%	3,007,697
1962	652,870	20.4	8.186	5,344,573	37.50	46.40	27.65	42.44%	2,268,237
1963	776,309	20.8	8.029	6,232,866	36.50	46.40	28.15	43.54%	2,713,790
1964	661,435	21.5	7.767	5,137,658	35.50	46.40	28.65	44.66%	2,294,478
1965	531,007	22.2	7.523	3,994,512	34.50	46.40	29.15	45.80%	1,829,487
1966	350,965	23.4	7.137	2,504,750	33.50	46.40	29.65	46.95%	1,175,980

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Pole Lines
Plant Sub-Account:	Pole Lines
Index Number:	2411
Field Code:	PLZA
Survivor Curve:	O1
Average Service Life:	46.4

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1967	251,215	24.6	6.789	1,705,403	32.50	46.40	30.15	48.12%	820,640
1968	312,055	25.9	6.448	2,012,092	31.50	46.40	30.65	49.32%	992,364
1969	343,521	27.4	6.095	2,093,723	30.50	46.40	31.15	50.53%	1,057,958
1970	356,318	29.4	5.680	2,023,983	29.50	46.40	31.65	51.76%	1,047,614
1971	273,963	32.9	5.076	1,390,633	28.50	46.40	32.15	53.01%	737,174
1972	222,085	34.9	4.785	1,062,699	27.50	46.40	32.65	54.28%	576,833
1973	387,735	37.9	4.406	1,708,489	26.50	46.40	33.15	55.57%	949,408
1974	280,517	48.9	3.415	958,003	25.50	46.40	33.65	56.89%	545,008
1975	175,148	52.4	3.187	558,201	24.50	46.40	34.15	58.23%	325,040
1976	1,252,040	55.7	2.998	3,753,872	23.50	46.40	34.65	59.59%	2,236,932
1977	337,702	59.2	2.821	952,639	22.50	46.40	35.15	60.97%	580,824
1978	373,626	62.7	2.663	995,144	21.50	46.40	35.65	62.38%	620,771
1979	189,895	69.8	2.393	454,333	20.50	46.40	36.15	63.81%	289,910
1980	200,326	78.3	2.133	427,260	19.50	46.40	36.65	65.27%	278,872
1981	226,019	85.6	1.951	440,948	18.50	46.40	37.15	66.76%	294,377
1982	1,060,268	91.3	1.829	1,939,373	17.50	46.40	27.64	61.23%	1,187,478
1983	1,152,088	95.3	1.752	2,018,874	16.50	46.40	27.68	62.65%	1,264,825
1984	892,370	100.0	1.670	1,490,258	15.50	46.40	27.70	64.12%	955,553
1985	1,197,865	99.7	1.675	2,006,454	14.50	46.40	27.69	65.63%	1,316,836
1986	1,614,928	99.8	1.673	2,702,334	13.50	46.40	27.64	67.19%	1,815,699
1987	973,767	98.4	1.697	1,652,633	12.50	46.40	27.56	68.80%	1,137,012
1988	1,308,264	100.0	1.670	2,184,801	11.50	46.40	27.44	70.47%	1,539,629
1989	2,351,991	103.5	1.614	3,795,000	10.50	46.40	27.28	72.21%	2,740,369
1990	1,696,634	110.5	1.511	2,564,144	9.50	46.40	27.06	74.02%	1,897,979
1991	1,649,511	116.3	1.436	2,368,601	8.50	46.40	26.77	75.90%	1,797,768
1992	1,387,089	121.7	1.372	1,903,401	7.50	46.40	26.42	77.89%	1,482,559
1993	1,725,717	128.5	1.300	2,242,761	6.50	46.40	25.97	79.98%	1,793,760
1994	1,824,713	139.2	1.200	2,189,131	5.50	46.40	25.41	82.21%	1,799,685
1995	1,459,452	146.0	1.144	1,669,373	4.50	46.40	24.70	84.59%	1,412,123
1996	747,156	151.2	1.104	825,232	3.50	46.40	23.77	87.17%	719,355
1997	1,851,677	158.8	1.052	1,947,293	2.50	46.40	22.53	90.01%	1,752,758
1998	1,522,899	165.4	1.010	1,537,631	1.50	46.40	20.73	93.25%	1,433,841
1999	1,543,863	167.0	1.000	1,543,863	0.50	46.40	17.57	97.23%	1,501,098
	46,616,809		4.341	202,360,271				44.47%	89,984,269

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Aerial Cable Metal
Plant Sub-Account:	Aerial Cable Metal
Index Number:	2421
Field Code:	ACM
Survivor Curve:	R1
Average Service Life:	12

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1926	5,596	20.6	6.345	35,505	73.50	12.00	0.50	0.68%	241
1927	5,767	20.6	6.345	36,590	72.50	12.00	0.50	0.68%	249
1928	10,188	20.6	6.345	64,639	71.50	12.00	0.50	0.69%	446
1929	14,345	20.6	6.345	91,014	70.50	12.00	0.50	0.70%	637
1930	2,582	20.6	6.345	16,382	69.50	12.00	0.50	0.71%	116
1931	1,707	20.6	6.345	10,830	68.50	12.00	0.50	0.72%	78
1932	1,180	20.6	6.345	7,487	67.50	12.00	0.50	0.74%	55
1933	1,575	20.6	6.345	9,993	66.50	12.00	0.50	0.75%	75
1934	2,069	20.6	6.345	13,127	65.50	12.00	0.50	0.76%	100
1935	5,522	20.6	6.345	35,035	64.50	12.00	0.50	0.77%	270
1936	4,983	20.6	6.345	31,615	63.50	12.00	0.50	0.78%	247
1937	2,605	20.6	6.345	16,528	62.50	12.00	0.50	0.79%	131
1938	3,470	20.6	6.345	22,016	61.50	12.00	0.50	0.81%	178
1939	6,897	20.6	6.345	43,759	60.50	12.00	0.50	0.82%	359
1940	7,412	20.6	6.345	47,027	59.50	12.00	0.50	0.83%	390
1941	16,748	20.6	6.345	106,260	58.50	12.00	0.50	0.85%	903
1942	16,376	20.6	6.345	103,900	57.50	12.00	0.50	0.86%	894
1943	1,922	20.6	6.345	12,194	56.50	12.00	0.50	0.88%	107
1944	1,858	20.6	6.345	11,788	55.50	12.00	0.50	0.89%	105
1945	568	20.6	6.345	3,604	54.50	12.00	0.50	0.91%	33
1946	7,333	20.6	6.345	46,525	53.50	12.00	0.50	0.93%	433
1947	8,726	22.1	5.914	51,606	52.50	12.00	0.50	0.94%	485
1948	22,216	23.7	5.515	122,516	51.50	12.00	0.50	0.96%	1,176
1949	46,079	25.2	5.187	238,989	50.50	12.00	0.50	0.98%	2,342
1950	59,299	24.6	5.313	315,056	49.50	12.00	0.50	1.00%	3,151
1951	94,915	25.8	5.066	480,829	48.50	12.00	0.50	1.02%	4,904
1952	180,205	26.1	5.008	902,406	47.50	12.00	0.50	1.04%	9,385
1953	330,081	26.1	5.008	1,652,934	46.50	12.00	0.50	1.06%	17,521
1954	542,122	26.4	4.951	2,683,915	45.50	12.00	0.50	1.09%	29,255
1955	642,523	26.1	5.008	3,217,539	44.50	12.00	0.50	1.11%	35,715
1956	512,245	27.5	4.753	2,434,561	43.50	12.00	0.50	1.14%	27,754
1957	665,039	27.3	4.788	3,183,905	42.50	12.00	0.50	1.16%	36,933
1958	1,151,086	27.4	4.770	5,490,764	41.50	12.00	0.50	1.19%	65,340
1959	1,782,112	28.1	4.651	8,289,041	40.50	12.00	0.50	1.22%	101,126
1960	3,163,262	27.9	4.685	14,818,579	39.50	12.00	0.50	1.25%	185,232
1961	1,486,124	27.7	4.718	7,012,145	38.50	12.00	0.50	1.28%	89,755
1962	1,587,969	27.8	4.701	7,465,739	37.50	12.00	0.50	1.32%	98,548
1963	1,773,157	28.0	4.668	8,276,844	36.50	12.00	0.50	1.35%	111,737
1964	1,473,513	28.3	4.618	6,805,235	35.50	12.00	0.50	1.39%	94,593
1965	1,391,124	28.6	4.570	6,357,339	34.50	12.00	0.50	1.43%	90,910
1966	1,238,887	30.3	4.314	5,343,978	33.50	12.00	0.50	1.47%	78,556
1967	1,163,772	31.2	4.189	4,875,160	32.50	12.00	0.50	1.52%	74,102

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Aerial Cable Metal
Plant Sub-Account:	Aerial Cable Metal
Index Number:	2421
Field Code:	ACM
Survivor Curve:	R1
Average Service Life:	12

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1968	1,178,373	32.8	3.985	4,695,529	31.50	12.00	0.50	1.56%	73,250
1969	1,565,655	34.4	3.799	5,948,579	30.50	12.00	0.50	1.61%	95,772
1970	1,988,092	38.2	3.421	6,802,189	29.50	12.00	0.50	1.67%	113,597
1971	1,270,818	40.3	3.243	4,121,487	28.50	12.00	0.50	1.72%	70,890
1972	1,563,656	43.2	3.025	4,730,783	27.50	12.00	0.50	1.79%	84,681
1973	1,518,428	45.0	2.904	4,410,190	26.50	12.00	0.50	1.85%	81,589
1974	1,449,535	50.9	2.568	3,722,087	25.50	12.00	0.50	1.92%	71,464
1975	996,266	54.7	2.389	2,380,475	24.50	12.00	0.50	2.00%	47,609
1976	975,646	58.6	2.230	2,176,057	23.50	12.00	0.50	2.08%	45,262
1977	1,372,889	62.2	2.101	2,884,833	22.50	12.00	0.65	2.81%	81,064
1978	1,339,964	64.8	2.017	2,702,674	21.50	12.00	0.93	4.15%	112,161
1979	1,521,517	72.7	1.798	2,735,382	20.50	12.00	1.21	5.57%	152,361
1980	1,786,019	81.1	1.612	2,878,331	19.50	12.00	1.50	7.14%	205,513
1981	1,850,493	86.8	1.506	2,786,399	18.50	12.00	1.81	8.91%	248,268
1982	5,239,628	91.7	1.425	7,468,041	17.50	12.00	2.04	10.44%	779,664
1983	3,808,911	95.8	1.364	5,196,500	16.50	12.00	2.36	12.51%	650,082
1984	4,274,768	97.9	1.335	5,706,968	15.50	12.00	2.69	14.79%	844,061
1985	4,831,397	96.2	1.359	6,564,071	14.50	12.00	3.03	17.28%	1,134,271
1986	5,016,687	97.3	1.343	6,738,756	13.50	12.00	3.39	20.07%	1,352,468
1987	6,286,802	97.9	1.335	8,393,105	12.50	12.00	3.76	23.12%	1,940,486
1988	7,308,853	100.0	1.307	9,552,671	11.50	12.00	4.15	26.52%	2,533,368
1989	6,854,258	106.5	1.227	8,411,751	10.50	12.00	4.55	30.23%	2,542,872
1990	7,669,578	109.4	1.195	9,162,832	9.50	12.00	4.96	34.30%	3,142,851
1991	7,232,374	111.2	1.175	8,500,641	8.50	12.00	5.38	38.76%	3,294,848
1992	6,373,845	113.6	1.151	7,333,288	7.50	12.00	5.81	43.65%	3,200,980
1993	6,477,742	114.9	1.138	7,368,502	6.50	12.00	6.22	48.90%	3,603,197
1994	6,558,420	117.9	1.109	7,270,445	5.50	12.00	6.63	54.66%	3,974,025
1995	8,596,955	127.3	1.027	8,826,567	4.50	12.00	6.99	60.84%	5,370,084
1996	10,995,199	127.2	1.028	11,297,740	3.50	12.00	7.30	67.59%	7,636,142
1997	9,892,832	129.5	1.009	9,984,503	2.50	12.00	7.50	75.00%	7,488,377
1998	8,640,054	130.1	1.005	8,679,901	1.50	12.00	7.52	83.37%	7,236,433
1999	7,438,539	130.7	1.000	7,438,539	0.50	12.00	7.05	93.38%	6,946,108
	164,522,015		1.761	287,654,714				23.05%	66,318,369

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Aerial Cable Non Metal
Plant Sub-Account:	Aerial Cable Non Metal
Index Number:	2421
Field Code:	ACN
Survivor Curve:	SQ
Average Service Life:	14.5

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1991	155,980	111.2	1.175	183,333	8.50	14.50	6.50	43.33%	79,438
1992	140,282	113.6	1.151	161,398	7.50	14.50	7.50	50.00%	80,699
1993	273,612	114.9	1.138	311,237	6.50	14.50	8.50	56.67%	176,378
1994	1,220,475	117.9	1.109	1,352,978	5.50	14.50	9.50	63.33%	856,841
1995	1,882,152	127.3	1.027	1,932,422	4.50	14.50	10.50	70.00%	1,352,695
1996	1,822,299	127.2	1.028	1,872,441	3.50	14.50	11.50	76.67%	1,435,600
1997	249,916	129.5	1.009	252,232	2.50	14.50	12.50	83.33%	210,185
1998	378,780	130.1	1.005	380,527	1.50	14.50	13.50	90.00%	342,474
1999	58,984	130.7	1.000	58,984	0.50	14.50	14.50	96.67%	57,020
	6,182,480		1.052	6,505,551				70.58%	4,591,330

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Underground Cable Metal
Plant Sub-Account:	Underground Cable Metal
Index Number:	2422
Field Code:	UGM
Survivor Curve:	R1.5
Average Service Life:	15

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1925	10,103,864	19.5	4.867	49,172,138	74.50	15.00	0.50	0.67%	329,453
1926	28,503	19.5	4.867	138,715	73.50	15.00	0.50	0.68%	943
1927	22,833	19.5	4.867	111,121	72.50	15.00	0.50	0.68%	756
1928	74,154	19.5	4.867	360,883	71.50	15.00	0.50	0.69%	2,490
1929	177,061	19.5	4.867	861,697	70.50	15.00	0.50	0.70%	6,032
1930	30,722	19.5	4.867	149,514	69.50	15.00	0.50	0.71%	1,062
1931	347	19.5	4.867	1,689	68.50	15.00	0.50	0.72%	12
1932	700	19.5	4.867	3,407	67.50	15.00	0.50	0.74%	25
1933	12,406	19.5	4.867	60,376	66.50	15.00	0.50	0.75%	453
1934	34,034	19.5	4.867	165,632	65.50	15.00	0.50	0.76%	1,259
1935	10	19.5	4.867	49	64.50	15.00	0.50	0.77%	0
1936	7,585	19.5	4.867	36,914	63.50	15.00	0.50	0.78%	288
1937	59,532	19.5	4.867	289,722	62.50	15.00	0.50	0.79%	2,289
1938	13,749	19.5	4.867	66,912	61.50	15.00	0.50	0.81%	542
1939	18,544	19.5	4.867	90,247	60.50	15.00	0.50	0.82%	740
1940	69,954	19.5	4.867	340,443	59.50	15.00	0.50	0.83%	2,826
1941	113,280	19.5	4.867	551,296	58.50	15.00	0.50	0.85%	4,686
1942	27,054	19.5	4.867	131,663	57.50	15.00	0.50	0.86%	1,132
1943	56,594	19.5	4.867	275,424	56.50	15.00	0.50	0.88%	2,424
1944	0	19.5	4.867	0	55.50	15.00	0.00	0.00%	0
1945	3,742	19.5	4.867	18,211	54.50	15.00	0.50	0.91%	166
1946	10,785	19.5	4.867	52,487	53.50	15.00	0.50	0.93%	488
1947	289,931	25.8	3.678	1,066,452	52.50	15.00	0.50	0.94%	10,025
1948	82,986	27.3	3.476	288,475	51.50	15.00	0.50	0.96%	2,769
1949	45,482	27.8	3.414	155,260	50.50	15.00	0.50	0.98%	1,522
1950	41,680	26.2	3.622	150,971	49.50	15.00	0.50	1.00%	1,510
1951	189,856	29.9	3.174	602,586	48.50	15.00	0.50	1.02%	6,146
1952	280,364	30.2	3.142	881,011	47.50	15.00	0.50	1.04%	9,163
1953	499,955	30.1	3.153	1,576,270	46.50	15.00	0.50	1.06%	16,708
1954	662,931	30.3	3.132	2,076,309	45.50	15.00	0.50	1.09%	22,632
1955	1,269,698	33.3	2.850	3,618,449	44.50	15.00	0.50	1.11%	40,165
1956	1,361,537	36.0	2.636	3,589,163	43.50	15.00	0.50	1.14%	40,916
1957	1,887,240	34.7	2.735	5,161,357	42.50	15.00	0.50	1.16%	59,872
1958	1,556,081	32.8	2.893	4,502,198	41.50	15.00	0.50	1.19%	53,576
1959	1,518,548	33.6	2.824	4,288,994	40.50	15.00	0.50	1.22%	52,326
1960	2,977,477	35.0	2.711	8,073,216	39.50	15.00	0.50	1.25%	100,915
1961	1,741,187	33.7	2.816	4,903,224	38.50	15.00	0.50	1.28%	62,761
1962	1,535,930	33.5	2.833	4,351,038	37.50	15.00	0.50	1.32%	57,434
1963	1,494,917	34.3	2.767	4,136,082	36.50	15.00	0.50	1.35%	55,837
1964	1,955,126	35.8	2.651	5,182,722	35.50	15.00	0.50	1.39%	72,040
1965	2,328,906	38.7	2.452	5,710,935	34.50	15.00	0.50	1.43%	81,666
1966	1,980,655	41.3	2.298	4,551,190	33.50	15.00	0.50	1.47%	66,902

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account: Underground Cable Metal
Plant Sub-Account: Underground Cable Metal
Index Number: 2422
Field Code: UGM
Survivor Curve: R1.5
Average Service Life: 15

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1967	2,417,886	43.0	2.207	5,336,218	32.50	15.00	0.50	1.52%	81,111
1968	2,233,417	46.0	2.063	4,607,636	31.50	15.00	0.50	1.56%	71,879
1969	4,500,038	49.1	1.933	8,697,629	30.50	15.00	0.50	1.61%	140,032
1970	7,106,321	56.0	1.695	12,042,676	29.50	15.00	0.50	1.67%	201,113
1971	7,764,213	56.1	1.692	13,134,114	28.50	15.00	0.66	2.26%	296,831
1972	8,495,809	59.6	1.592	13,527,723	27.50	15.00	0.95	3.34%	451,826
1973	11,640,664	64.1	1.480	17,233,994	26.50	15.00	1.20	4.33%	746,232
1974	8,799,143	74.2	1.279	11,253,890	25.50	15.00	1.41	5.24%	589,704
1975	3,966,792	74.8	1.269	5,032,735	24.50	15.00	1.64	6.27%	315,552
1976	2,278,622	81.6	1.163	2,650,015	23.50	15.00	1.89	7.44%	197,161
1977	5,006,405	81.3	1.167	5,843,885	22.50	15.00	2.16	8.76%	511,924
1978	7,728,040	81.8	1.160	8,965,660	21.50	15.00	2.44	10.19%	913,601
1979	9,258,535	90.4	1.050	9,719,413	20.50	15.00	2.74	11.79%	1,145,919
1980	9,491,636	103.0	0.921	8,745,206	19.50	15.00	3.06	13.56%	1,185,850
1981	6,954,971	109.0	0.871	6,055,291	18.50	15.00	3.40	15.53%	940,387
1982	18,818,812	111.7	0.850	15,988,409	17.50	15.00	3.46	16.51%	2,639,686
1983	14,409,653	111.9	0.848	12,220,519	16.50	15.00	3.79	18.68%	2,282,793
1984	16,500,978	110.5	0.859	14,171,428	15.50	15.00	4.15	21.12%	2,993,006
1985	19,227,669	106.4	0.892	17,149,490	14.50	15.00	4.54	23.84%	4,088,439
1986	13,647,292	105.0	0.904	12,334,552	13.50	15.00	4.95	26.83%	3,309,360
1987	11,693,724	101.1	0.939	10,976,601	12.50	15.00	5.38	30.09%	3,302,859
1988	10,980,446	100.0	0.949	10,420,443	11.50	15.00	5.83	33.64%	3,505,437
1989	10,264,371	108.5	0.875	8,977,777	10.50	15.00	6.29	37.46%	3,363,075
1990	13,221,174	107.6	0.882	11,660,682	9.50	15.00	6.77	41.61%	4,852,010
1991	7,837,762	107.4	0.884	6,925,546	8.50	15.00	7.26	46.07%	3,190,599
1992	3,374,455	107.0	0.887	2,992,858	7.50	15.00	7.74	50.79%	1,520,072
1993	9,744,913	96.9	0.979	9,543,780	6.50	15.00	8.22	55.84%	5,329,247
1994	10,834,070	93.0	1.020	11,055,411	5.50	15.00	8.69	61.24%	6,770,334
1995	8,612,259	100.7	0.942	8,116,220	4.50	15.00	9.12	66.96%	5,434,621
1996	12,148,281	99.5	0.954	11,586,652	3.50	15.00	9.50	73.08%	8,467,525
1997	10,596,614	99.0	0.959	10,157,764	2.50	15.00	9.79	79.66%	8,091,675
1998	12,083,407	95.9	0.990	11,957,407	1.50	15.00	9.89	86.83%	10,382,616
1999	12,107,013	94.9	1.000	12,107,013	0.50	15.00	9.51	95.00%	11,501,662
	348,311,325		1.289	448,933,081				22.27%	99,987,089

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Underground Cable Non Metal
Plant Sub-Account:	Underground Cable Non Metal
Index Number:	2422
Field Code:	UGN
Survivor Curve:	SQ
Average Service Life:	13.1

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1984	288,498	110.5	0.859	247,769	15.50	13.10	0.50	3.13%	7,755
1985	6,049,156	106.4	0.892	5,395,347	14.50	13.10	0.50	3.33%	179,665
1986	5,318,470	105.0	0.904	4,806,884	13.50	13.10	0.50	3.57%	171,606
1987	2,610,677	101.1	0.939	2,450,576	12.50	13.10	0.50	3.85%	94,347
1988	3,986,987	100.0	0.949	3,783,651	11.50	13.10	1.50	11.54%	436,633
1989	5,868,439	108.5	0.875	5,132,856	10.50	13.10	2.50	19.23%	987,048
1990	4,228,942	107.6	0.882	3,729,801	9.50	13.10	3.50	26.92%	1,004,062
1991	9,292,290	107.4	0.884	8,210,785	8.50	13.10	4.50	34.62%	2,842,574
1992	5,209,729	107.0	0.887	4,620,591	7.50	13.10	5.50	42.31%	1,954,972
1993	7,494,771	96.9	0.979	7,340,080	6.50	13.10	6.50	50.00%	3,670,040
1994	6,567,885	93.0	1.020	6,702,068	5.50	13.10	7.50	57.69%	3,866,423
1995	7,574,220	100.7	0.942	7,137,969	4.50	13.10	8.50	65.38%	4,665,804
1996	9,478,340	99.5	0.954	9,040,145	3.50	13.10	9.50	73.08%	6,606,538
1997	4,347,677	99.0	0.959	4,167,622	2.50	13.10	10.50	80.77%	3,366,188
1998	6,069,150	95.9	0.990	6,005,864	1.50	13.10	11.50	88.46%	5,312,787
1999	2,598,651	94.9	1.000	2,598,651	0.50	13.10	12.50	96.15%	2,498,603
	86,983,882		0.935	81,370,658				46.29%	37,666,046

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Buried Cable Metal
Plant Sub-Account:	Buried Cable Metal
Index Number:	2423
Field Code:	BCM
Survivor Curve:	L1.5
Average Service Life:	12

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1925	16,781,018	26.2	4.721	79,229,463	74.50	12.00	0.50	0.67%	530,837
1926	0	26.2	4.721	0	73.50	12.00	0.00	0.00%	0
1927	0	26.2	4.721	0	72.50	12.00	0.00	0.00%	0
1928	0	26.2	4.721	0	71.50	12.00	0.00	0.00%	0
1929	0	26.2	4.721	0	70.50	12.00	0.00	0.00%	0
1930	0	26.2	4.721	0	69.50	12.00	0.00	0.00%	0
1931	0	26.2	4.721	0	68.50	12.00	0.00	0.00%	0
1932	0	26.2	4.721	0	67.50	12.00	0.00	0.00%	0
1933	0	26.2	4.721	0	66.50	12.00	0.00	0.00%	0
1934	0	26.2	4.721	0	65.50	12.00	0.00	0.00%	0
1935	0	26.2	4.721	0	64.50	12.00	0.00	0.00%	0
1936	7,347	26.2	4.721	34,688	63.50	12.00	0.50	0.78%	271
1937	227	26.2	4.721	1,072	62.50	12.00	0.50	0.79%	8
1938	1,621	26.2	4.721	7,653	61.50	12.00	0.50	0.81%	62
1939	0	26.2	4.721	0	60.50	12.00	0.00	0.00%	0
1940	917	26.2	4.721	4,330	59.50	12.00	0.50	0.83%	36
1941	77,853	26.2	4.721	367,573	58.50	12.00	0.50	0.85%	3,124
1942	360	26.2	4.721	1,700	57.50	12.00	0.50	0.86%	15
1943	0	26.2	4.721	0	56.50	12.00	0.00	0.00%	0
1944	0	26.2	4.721	0	55.50	12.00	0.00	0.00%	0
1945	1,304	26.2	4.721	6,157	54.50	12.00	0.50	0.91%	56
1946	1,438	26.2	4.721	6,789	53.50	12.00	0.50	0.93%	63
1947	422	28.0	4.418	1,864	52.50	12.00	0.50	0.94%	18
1948	3,157	29.8	4.151	13,105	51.50	12.00	0.50	0.96%	126
1949	13,274	31.8	3.890	51,635	50.50	12.00	0.50	0.98%	506
1950	3,053	31.0	3.990	12,182	49.50	12.00	0.50	1.00%	122
1951	4,491	32.4	3.818	17,146	48.50	12.00	0.50	1.02%	175
1952	90,573	32.9	3.760	340,543	47.50	12.00	0.50	1.04%	3,542
1953	61,457	33.2	3.726	228,983	46.50	12.00	0.50	1.06%	2,427
1954	289,617	33.7	3.671	1,063,075	45.50	12.00	0.50	1.09%	11,588
1955	183,970	33.3	3.715	683,396	44.50	12.00	0.50	1.11%	7,586
1956	467,951	35.2	3.514	1,644,476	43.50	12.00	0.50	1.14%	18,747
1957	235,224	34.6	3.575	840,960	42.50	12.00	0.50	1.16%	9,755
1958	203,113	34.7	3.565	724,066	41.50	12.00	0.50	1.19%	8,616
1959	303,936	35.7	3.465	1,053,134	40.50	12.00	0.50	1.22%	12,848
1960	864,521	34.6	3.575	3,090,788	39.50	12.00	0.50	1.25%	38,635
1961	1,506,464	33.7	3.671	5,529,662	38.50	12.00	0.50	1.28%	70,780
1962	1,582,619	33.5	3.693	5,843,880	37.50	12.00	0.50	1.32%	77,139
1963	2,797,817	33.4	3.704	10,361,975	36.50	12.00	0.50	1.35%	139,887
1964	2,876,176	33.1	3.737	10,748,730	35.50	12.00	0.50	1.39%	149,407
1965	2,500,066	33.3	3.715	9,287,032	34.50	12.00	0.75	2.13%	197,814
1966	3,449,044	35.5	3.485	12,018,218	33.50	12.00	0.89	2.59%	311,272

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Buried Cable Metal
Plant Sub-Account:	Buried Cable Metal
Index Number:	2423
Field Code:	BCM
Survivor Curve:	L1.5
Average Service Life:	12

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1967	3,423,961	36.7	3.371	11,540,708	32.50	12.00	1.08	3.22%	371,611
1968	4,237,437	38.7	3.196	13,544,469	31.50	12.00	1.21	3.70%	501,145
1969	8,621,190	40.3	3.069	26,462,561	30.50	12.00	1.35	4.24%	1,122,013
1970	12,589,243	45.5	2.719	34,226,140	29.50	12.00	1.49	4.81%	1,646,277
1971	13,167,320	46.8	2.643	34,803,365	28.50	12.00	1.64	5.44%	1,893,303
1972	14,394,976	49.9	2.479	35,684,540	27.50	12.00	1.79	6.11%	2,180,325
1973	23,839,108	52.0	2.379	56,709,570	26.50	12.00	1.94	6.82%	3,867,593
1974	13,708,583	60.0	2.062	28,262,529	25.50	12.00	2.11	7.64%	2,159,257
1975	8,081,522	62.8	1.970	15,918,539	24.50	12.00	2.28	8.51%	1,354,668
1976	8,725,061	67.7	1.827	15,942,246	23.50	12.00	2.47	9.51%	1,516,108
1977	12,205,282	69.5	1.780	21,723,646	22.50	12.00	2.66	10.57%	2,296,189
1978	17,926,079	70.4	1.757	31,497,954	21.50	12.00	2.86	11.74%	3,697,860
1979	19,841,627	78.6	1.574	31,226,581	20.50	12.00	3.07	13.03%	4,068,823
1980	20,308,573	88.2	1.402	28,482,659	19.50	12.00	3.28	14.40%	4,101,503
1981	21,514,590	95.1	1.301	27,984,803	18.50	12.00	3.51	15.95%	4,463,576
1982	51,271,767	98.6	1.255	64,323,708	17.50	12.00	3.38	16.19%	10,414,008
1983	39,276,005	100.0	1.237	48,584,418	16.50	12.00	3.57	17.79%	8,643,168
1984	54,795,139	100.9	1.226	67,176,994	15.50	12.00	3.75	19.48%	13,086,078
1985	61,048,223	99.0	1.249	76,279,446	14.50	12.00	3.94	21.37%	16,300,918
1986	52,561,210	100.6	1.230	64,630,434	13.50	12.00	4.11	23.34%	15,084,743
1987	59,235,149	98.8	1.252	74,163,845	12.50	12.00	4.28	25.51%	18,919,197
1988	47,995,660	100.0	1.237	59,370,631	11.50	12.00	4.44	27.85%	16,534,721
1989	41,562,213	105.2	1.176	48,871,157	10.50	12.00	4.60	30.46%	14,886,155
1990	34,783,244	105.2	1.176	40,900,069	9.50	12.00	4.76	33.38%	13,652,443
1991	35,150,580	106.8	1.158	40,712,797	8.50	12.00	4.94	36.76%	14,966,024
1992	36,373,359	109.4	1.131	41,127,829	7.50	12.00	5.15	40.71%	16,743,139
1993	33,832,425	107.4	1.152	38,967,141	6.50	12.00	5.40	45.38%	17,683,289
1994	44,771,976	110.0	1.125	50,348,122	5.50	12.00	5.72	50.98%	25,667,473
1995	70,643,417	122.1	1.013	71,569,129	4.50	12.00	6.12	57.63%	41,245,289
1996	91,871,543	121.3	1.020	93,689,282	3.50	12.00	6.58	65.28%	61,160,363
1997	93,237,720	123.6	1.001	93,313,155	2.50	12.00	7.08	73.90%	68,958,422
1998	79,163,363	123.5	1.002	79,291,563	1.50	12.00	7.63	83.57%	66,263,959
1999	91,958,160	123.7	1.000	91,958,160	0.50	12.00	8.19	94.25%	86,670,566
	1,256,424,735		1.355	1,702,502,465				33.11%	563,715,667

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Buried Cable Non Metal
Plant Sub-Account:	Buried Cable Non Metal
Index Number:	2423
Field Code:	BCN
Survivor Curve:	SQ
Average Service Life:	17.6

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1985	572,771	99.0	1.249	715,674	14.50	17.60	3.50	19.44%	139,127
1986	144,757	100.6	1.230	177,996	13.50	17.60	4.50	25.00%	44,499
1987	1,201,640	98.8	1.252	1,504,482	12.50	17.60	5.50	30.56%	459,770
1988	1,509,741	100.0	1.237	1,867,550	11.50	17.60	6.50	36.11%	674,372
1989	240,697	105.2	1.176	283,025	10.50	17.60	7.50	41.67%	117,936
1990	1,871,908	105.2	1.176	2,201,093	9.50	17.60	8.50	47.22%	1,039,356
1991	3,910,865	106.8	1.158	4,529,719	8.50	17.60	9.50	52.78%	2,390,786
1992	963,481	109.4	1.131	1,089,420	7.50	17.60	10.50	58.33%	635,459
1993	1,176,352	107.4	1.152	1,354,886	6.50	17.60	11.50	63.89%	865,637
1994	1,228,278	110.0	1.125	1,381,254	5.50	17.60	12.50	69.44%	959,143
1995	2,358,672	122.1	1.013	2,389,580	4.50	17.60	13.50	75.00%	1,792,185
1996	1,332,090	121.3	1.020	1,358,446	3.50	17.60	14.50	80.56%	1,094,364
1997	252,319	123.6	1.001	252,523	2.50	17.60	15.50	86.11%	217,448
1998	196,529	123.5	1.002	196,847	1.50	17.60	16.50	91.67%	180,450
1999	284,557	123.7	1.000	284,557	0.50	17.60	17.50	97.22%	276,646
	17,244,657		1.136	19,587,055				55.58%	10,887,179

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Submarine Cable Metal
Plant Sub-Account:	Submarine Cable Metal
Index Number:	2424
Field Code:	SBM
Survivor Curve:	SQ
Average Service Life:	15

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1981	2,572	101.5	1.256	3,232	18.50	15.00	0.50	2.63%	85
1982	0	104.6	1.219	0	17.50	15.00	0.00	0.00%	0
1983	0	104.6	1.219	0	16.50	15.00	0.00	0.00%	0
1984	0	105.2	1.212	0	15.50	15.00	0.00	0.00%	0
1985	0	103.2	1.236	0	14.50	15.00	0.00	0.00%	0
1986	0	101.9	1.252	0	13.50	15.00	0.00	0.00%	0
1987	0	99.3	1.284	0	12.50	15.00	0.00	0.00%	0
1988	0	100.0	1.275	0	11.50	15.00	0.00	0.00%	0
1989	0	106.2	1.201	0	10.50	15.00	0.00	0.00%	0
1990	0	106.5	1.197	0	9.50	15.00	0.00	0.00%	0
1991	0	109.3	1.167	0	8.50	15.00	0.00	0.00%	0
1992	0	112.4	1.135	0	7.50	15.00	0.00	0.00%	0
1993	0	117.0	1.090	0	6.50	15.00	0.00	0.00%	0
1994	0	122.2	1.044	0	5.50	15.00	0.00	0.00%	0
1995	0	127.1	1.003	0	4.50	15.00	0.00	0.00%	0
1996	0	126.2	1.010	0	3.50	15.00	0.00	0.00%	0
1997	0	128.2	0.995	0	2.50	15.00	0.00	0.00%	0
1998	0	127.5	1.000	0	1.50	15.00	0.00	0.00%	0
1999	0	127.5	1.000	0	0.50	15.00	0.00	0.00%	0
	2,572		1.256	3,232				2.63%	85

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Intra Building Cable Non Metal
Plant Sub-Account:	Intra Building Cable Non Metal
Index Number:	2426
Field Code:	IBN
Survivor Curve:	O1
Average Service Life:	11.5

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1985	16,089	99.9	1.222	19,664	14.50	11.50	3.94	21.37%	4,202
1986	14,640	100.8	1.211	17,734	13.50	11.50	4.34	24.33%	4,315
1987	4,417	99.1	1.232	5,442	12.50	11.50	4.73	27.45%	1,494
1988	21,088	100.0	1.221	25,748	11.50	11.50	5.10	30.72%	7,910
1989	6,347	105.4	1.158	7,353	10.50	11.50	5.45	34.17%	2,512
1990	14,010	106.9	1.142	16,002	9.50	11.50	5.78	37.83%	6,054
1991	19,609	108.1	1.130	22,149	8.50	11.50	6.08	41.70%	9,236
1992	17,812	110.3	1.107	19,718	7.50	11.50	6.34	45.81%	9,033
1993	30,377	108.8	1.122	34,090	6.50	11.50	6.57	50.27%	17,137
1994	39,320	111.7	1.093	42,981	5.50	11.50	6.74	55.07%	23,670
1995	70,539	118.4	1.031	72,743	4.50	11.50	6.86	60.39%	43,930
1996	90,088	119.0	1.026	92,435	3.50	11.50	6.88	66.28%	61,266
1997	52,137	122.1	1.000	52,137	2.50	11.50	6.77	73.03%	38,076
1998	56,841	121.2	1.007	57,263	1.50	11.50	6.43	81.08%	46,429
1999	127,533	122.1	1.000	127,533	0.50	11.50	5.56	91.75%	117,012
	580,847		1.055	612,992				63.99%	392,274

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Intra Building Cable Metal
Plant Sub-Account:	Intra Building Cable Metal
Index Number:	2426
Field Code:	IBM
Survivor Curve:	L2
Average Service Life:	19

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1925	3,210,926	22.2	5.500	17,660,093	74.50	19.00	0.50	0.67%	118,323
1926	179	22.2	5.500	985	73.50	19.00	0.50	0.68%	7
1927	0	22.2	5.500	0	72.50	19.00	0.00	0.00%	0
1928	2,010	22.2	5.500	11,055	71.50	19.00	0.50	0.69%	76
1929	2,658	22.2	5.500	14,619	70.50	19.00	0.50	0.70%	102
1930	2,658	22.2	5.500	14,619	69.50	19.00	0.50	0.71%	104
1931	1,184	22.2	5.500	6,512	68.50	19.00	0.50	0.72%	47
1932	577	22.2	5.500	3,174	67.50	19.00	0.50	0.74%	23
1933	550	22.2	5.500	3,025	66.50	19.00	0.50	0.75%	23
1934	447	22.2	5.500	2,459	65.50	19.00	0.50	0.76%	19
1935	301	22.2	5.500	1,656	64.50	19.00	0.50	0.77%	13
1936	4,325	22.2	5.500	23,788	63.50	19.00	0.50	0.78%	186
1937	1,004	22.2	5.500	5,522	62.50	19.00	0.50	0.79%	44
1938	1,296	22.2	5.500	7,128	61.50	19.00	0.50	0.81%	58
1939	1,292	22.2	5.500	7,106	60.50	19.00	0.50	0.82%	58
1940	1,526	22.2	5.500	8,393	59.50	19.00	0.50	0.83%	70
1941	505	22.2	5.500	2,778	58.50	19.00	0.50	0.85%	24
1942	2,657	22.2	5.500	14,614	57.50	19.00	0.50	0.86%	126
1943	1,930	22.2	5.500	10,615	56.50	19.00	0.50	0.88%	93
1944	1,391	22.2	5.500	7,651	55.50	19.00	0.50	0.89%	68
1945	1,531	22.2	5.500	8,421	54.50	19.00	0.50	0.91%	77
1946	3,497	22.2	5.500	19,234	53.50	19.00	0.50	0.93%	179
1947	937	25.1	4.865	4,558	52.50	19.00	0.50	0.94%	43
1948	8,187	26.8	4.556	37,300	51.50	19.00	0.50	0.96%	358
1949	4,257	28.2	4.330	18,432	50.50	19.00	0.93	1.81%	334
1950	3,468	27.2	4.489	15,568	49.50	19.00	0.99	1.96%	305
1951	14,286	29.3	4.167	59,533	48.50	19.00	1.08	2.18%	1,298
1952	17,921	29.6	4.125	73,924	47.50	19.00	1.25	2.56%	1,892
1953	14,047	29.6	4.125	57,944	46.50	19.00	1.41	2.94%	1,704
1954	36,547	29.9	4.084	149,244	45.50	19.00	1.57	3.34%	4,985
1955	47,238	30.5	4.003	189,107	44.50	19.00	1.75	3.78%	7,148
1956	49,594	32.4	3.769	186,896	43.50	19.00	1.93	4.25%	7,943
1957	81,145	31.8	3.840	311,566	42.50	19.00	2.11	4.73%	14,737
1958	58,022	31.4	3.889	225,621	41.50	19.00	2.29	5.23%	11,800
1959	85,842	32.2	3.792	325,506	40.50	19.00	2.48	5.77%	18,782
1960	103,270	32.3	3.780	390,380	39.50	19.00	2.67	6.33%	24,711
1961	188,006	31.7	3.852	724,149	38.50	19.00	2.87	6.94%	50,256
1962	157,582	31.6	3.864	608,885	37.50	19.00	3.07	7.57%	46,093
1963	200,814	31.8	3.840	771,050	36.50	19.00	3.27	8.22%	63,380
1964	276,275	32.2	3.792	1,047,614	35.50	19.00	3.48	8.93%	93,552
1965	191,604	33.1	3.689	706,793	34.50	19.00	3.69	9.66%	68,276
1966	224,625	35.2	3.469	779,168	33.50	19.00	3.90	10.43%	81,267

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Intra Building Cable Metal
Plant Sub-Account:	Intra Building Cable Metal
Index Number:	2426
Field Code:	IBM
Survivor Curve:	L2
Average Service Life:	19

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1967	276,534	36.4	3.354	927,604	32.50	19.00	4.12	11.25%	104,355
1968	251,647	38.5	3.171	798,080	31.50	19.00	4.35	12.13%	96,807
1969	338,233	40.5	3.015	1,019,710	30.50	19.00	4.58	13.06%	133,174
1970	581,035	45.6	2.678	1,555,798	29.50	19.00	4.82	14.04%	218,434
1971	632,592	46.9	2.603	1,646,897	28.50	19.00	5.06	15.08%	248,352
1972	694,148	50.1	2.437	1,691,726	27.50	19.00	5.31	16.18%	273,721
1973	953,851	52.6	2.321	2,214,167	26.50	19.00	5.56	17.34%	383,937
1974	1,020,386	60.4	2.022	2,062,734	25.50	19.00	5.81	18.56%	382,843
1975	789,036	63.0	1.938	1,529,227	24.50	19.00	6.06	19.83%	303,246
1976	760,195	68.1	1.793	1,362,993	23.50	19.00	6.31	21.17%	288,546
1977	666,764	69.9	1.747	1,164,691	22.50	19.00	6.56	22.57%	262,871
1978	844,517	71.3	1.712	1,446,221	21.50	19.00	6.80	24.03%	347,527
1979	1,217,841	79.5	1.536	1,870,420	20.50	19.00	7.04	25.56%	478,079
1980	1,086,741	89.4	1.366	1,484,240	19.50	19.00	7.28	27.18%	403,416
1981	1,263,681	95.7	1.276	1,612,283	18.50	19.00	7.52	28.90%	465,950
1982	2,204,156	99.5	1.227	2,704,798	17.50	19.00	6.50	27.08%	732,459
1983	1,968,564	101.5	1.203	2,368,095	16.50	19.00	6.64	28.69%	679,407
1984	2,095,785	102.1	1.196	2,506,321	15.50	19.00	6.79	30.46%	763,425
1985	1,907,930	99.9	1.222	2,331,914	14.50	19.00	6.96	32.43%	756,240
1986	2,579,266	100.8	1.211	3,124,289	13.50	19.00	7.15	34.62%	1,081,629
1987	2,107,502	99.1	1.232	2,596,630	12.50	19.00	7.38	37.12%	963,869
1988	1,405,370	100.0	1.221	1,715,957	11.50	19.00	7.66	39.98%	686,040
1989	1,202,638	105.4	1.158	1,393,189	10.50	19.00	7.99	43.21%	601,997
1990	1,040,743	106.9	1.142	1,188,725	9.50	19.00	8.40	46.93%	557,869
1991	836,003	108.1	1.130	944,274	8.50	19.00	8.87	51.07%	482,240
1992	624,207	110.3	1.107	690,985	7.50	19.00	9.43	55.70%	384,879
1993	479,939	108.8	1.122	538,608	6.50	19.00	10.04	60.70%	326,935
1994	508,226	111.7	1.093	555,545	5.50	19.00	10.69	66.03%	366,826
1995	797,377	118.4	1.031	822,295	4.50	19.00	11.37	71.64%	589,092
1996	999,356	119.0	1.026	1,025,390	3.50	19.00	12.07	77.52%	794,882
1997	1,316,707	122.1	1.000	1,316,707	2.50	19.00	12.82	83.68%	1,101,820
1998	1,187,630	121.2	1.007	1,196,449	1.50	19.00	13.63	90.09%	1,077,881
1999	1,377,986	122.1	1.000	1,377,986	0.50	19.00	14.52	96.67%	1,332,099
	41,022,697		1.836	75,301,628				24.29%	18,289,429

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Aerial Wire
Plant Sub-Account:	Aerial Wire
Index Number:	2431
Field Code:	AWZ
Survivor Curve:	L0
Average Service Life:	8.9

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1952	2	24.1	5.502	11	47.50	8.90	0.50	1.04%	0
1953	9	25.6	5.180	47	46.50	8.90	0.50	1.06%	0
1954	143	26.4	5.023	718	45.50	8.90	0.50	1.09%	8
1955	741	26.8	4.948	3,666	44.50	8.90	0.50	1.11%	41
1956	1,358	27.9	4.753	6,454	43.50	8.90	0.50	1.14%	74
1957	2,816	27.5	4.822	13,578	42.50	8.90	0.50	1.16%	158
1958	4,306	28.1	4.719	20,319	41.50	8.90	0.50	1.19%	242
1959	7,198	28.5	4.653	33,490	40.50	8.90	0.50	1.22%	409
1960	10,634	29.0	4.572	48,623	39.50	8.90	0.50	1.25%	608
1961	15,063	29.1	4.557	68,638	38.50	8.90	0.50	1.28%	879
1962	22,914	27.9	4.753	108,903	37.50	8.90	0.50	1.32%	1,438
1963	8,958	27.4	4.839	43,351	36.50	8.90	0.50	1.35%	585
1964	10,465	27.7	4.787	50,096	35.50	8.90	0.50	1.39%	696
1965	11,897	28.0	4.736	56,341	34.50	8.90	0.50	1.43%	806
1966	17,683	29.2	4.541	80,300	33.50	8.90	0.50	1.47%	1,180
1967	17,113	30.7	4.319	73,915	32.50	8.90	0.85	2.55%	1,885
1968	14,513	32.9	4.030	58,493	31.50	8.90	1.04	3.20%	1,872
1969	15,499	35.8	3.704	57,407	30.50	8.90	1.13	3.57%	2,049
1970	25,847	39.0	3.400	87,880	29.50	8.90	1.23	4.00%	3,515
1971	52,648	40.4	3.282	172,800	28.50	8.90	1.35	4.52%	7,811
1972	61,680	42.1	3.150	194,270	27.50	8.90	1.48	5.11%	9,927
1973	76,698	43.5	3.048	233,797	26.50	8.90	1.61	5.73%	13,397
1974	104,357	52.6	2.521	263,075	25.50	8.90	1.75	6.42%	16,889
1975	84,346	56.2	2.359	199,009	24.50	8.90	1.89	7.16%	14,249
1976	66,339	59.4	2.232	148,090	23.50	8.90	2.04	7.99%	11,832
1977	69,286	63.6	2.085	144,455	22.50	8.90	2.20	8.91%	12,871
1978	84,235	66.0	2.009	169,236	21.50	8.90	2.36	9.89%	16,737
1979	146,536	70.7	1.876	274,833	20.50	8.90	2.53	10.99%	30,204
1980	290,279	80.1	1.655	480,537	19.50	8.90	2.70	12.16%	58,433
1981	185,916	84.1	1.577	293,133	18.50	8.90	2.88	13.47%	39,485
1982	143,795	89.0	1.490	214,238	17.50	8.90	3.07	14.92%	31,964
1983	224,529	92.1	1.440	323,263	16.50	8.90	3.27	16.54%	53,468
1984	129,208	96.1	1.380	178,283	15.50	8.90	3.47	18.29%	32,608
1985	189,299	95.2	1.393	263,666	14.50	8.90	3.69	20.29%	53,498
1986	230,446	92.8	1.429	329,280	13.50	8.90	3.92	22.50%	74,088
1987	279,286	95.9	1.383	386,166	12.50	8.90	4.16	24.97%	96,426
1988	262,649	100.0	1.326	348,273	11.50	8.90	4.41	27.72%	96,541
1989	242,953	107.0	1.239	301,080	10.50	8.90	4.67	30.78%	92,672
1990	321,305	109.8	1.208	388,024	9.50	8.90	4.95	34.26%	132,937
1991	428,579	109.4	1.212	519,466	8.50	8.90	5.24	38.14%	198,124
1992	300,726	111.5	1.189	357,635	7.50	8.90	5.55	42.53%	152,102
1993	464,730	114.0	1.163	540,554	6.50	8.90	5.88	47.50%	256,763

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Aerial Wire
Plant Sub-Account:	Aerial Wire
Index Number:	2431
Field Code:	AWZ
Survivor Curve:	L0
Average Service Life:	8.9

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1994	489,839	117.5	1.129	552,789	5.50	8.90	6.23	53.11%	293,586
1995	467,106	126.5	1.048	489,630	4.50	8.90	6.59	59.42%	290,938
1996	592,855	127.2	1.042	618,023	3.50	8.90	6.99	66.63%	411,789
1997	993,241	130.1	1.019	1,012,327	2.50	8.90	7.42	74.80%	757,221
1998	782,855	131.5	1.008	789,404	1.50	8.90	7.91	84.06%	663,573
1999	846,076	132.6	1.000	846,076	0.50	8.90	8.52	94.46%	799,203
	8,798,956		1.346	11,843,641				39.99%	4,735,781

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Conduit Systems
Plant Sub-Account:	Conduit Systems
Index Number:	2441
Field Code:	UCZ
Survivor Curve:	SQ
Average Service Life:	56.6

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1925	13,801,685	10.4	10.615	146,510,195	74.50	56.60	0.50	0.67%	981,618
1926	191,186	10.4	10.615	2,029,513	73.50	56.60	0.50	0.68%	13,801
1927	81,099	10.4	10.615	860,897	72.50	56.60	0.50	0.68%	5,854
1928	293,773	10.4	10.615	3,118,513	71.50	56.60	0.50	0.69%	21,518
1929	304,723	10.4	10.615	3,234,752	70.50	56.60	0.50	0.70%	22,643
1930	166,778	10.4	10.615	1,770,413	69.50	56.60	0.50	0.71%	12,570
1931	3,265	10.4	10.615	34,659	68.50	56.60	0.50	0.72%	250
1932	6,869	10.4	10.615	72,917	67.50	56.60	0.50	0.74%	540
1933	103,398	10.4	10.615	1,097,610	66.50	56.60	0.50	0.75%	8,232
1934	794	10.4	10.615	8,429	65.50	56.60	0.50	0.76%	64
1935	3,241	10.4	10.615	34,404	64.50	56.60	0.50	0.77%	265
1936	83,574	10.4	10.615	887,170	63.50	56.60	0.50	0.78%	6,920
1937	8,254	10.4	10.615	87,619	62.50	56.60	0.50	0.79%	692
1938	0	10.4	10.615	0	61.50	56.60	0.00	0.00%	0
1939	11,619	10.4	10.615	123,340	60.50	56.60	0.50	0.82%	1,011
1940	4,056	10.4	10.615	43,056	59.50	56.60	0.50	0.83%	357
1941	57,168	10.4	10.615	606,860	58.50	56.60	0.50	0.85%	5,158
1942	271	10.4	10.615	2,877	57.50	56.60	0.50	0.86%	25
1943	43,114	10.4	10.615	457,672	56.50	56.60	0.50	0.88%	4,028
1944	61	10.4	10.615	648	55.50	56.60	1.50	2.63%	17
1945	33,299	10.4	10.615	353,482	54.50	56.60	2.50	4.39%	15,518
1946	51,477	10.4	10.615	546,448	53.50	56.60	3.50	6.14%	33,552
1947	824,542	11.8	9.356	7,714,359	52.50	56.60	4.50	7.89%	608,663
1948	448,638	12.7	8.693	3,899,971	51.50	56.60	5.50	9.65%	376,347
1949	128,422	13.3	8.301	1,065,999	50.50	56.60	6.50	11.40%	121,524
1950	132,321	13.6	8.118	1,074,135	49.50	56.60	7.50	13.16%	141,356
1951	205,453	14.3	7.720	1,586,155	48.50	56.60	8.50	14.91%	236,496
1952	1,471,458	15.0	7.360	10,829,931	47.50	56.60	9.50	16.67%	1,805,349
1953	484,165	15.7	7.032	3,404,574	46.50	56.60	10.50	18.42%	627,123
1954	325,476	16.2	6.815	2,218,059	45.50	56.60	11.50	20.18%	447,604
1955	1,487,507	16.5	6.691	9,952,774	44.50	56.60	12.50	21.93%	2,182,643
1956	1,103,111	17.5	6.309	6,959,055	43.50	56.60	13.50	23.68%	1,647,904
1957	1,167,969	18.1	6.099	7,123,966	42.50	56.60	14.50	25.44%	1,812,337
1958	1,150,898	18.8	5.872	6,758,465	41.50	56.60	15.50	27.19%	1,837,627
1959	1,385,419	19.1	5.780	8,007,867	40.50	56.60	16.50	28.95%	2,318,277
1960	5,177,676	19.3	5.720	29,617,380	39.50	56.60	17.50	30.70%	9,092,536
1961	876,340	19.5	5.662	4,961,433	38.50	56.60	18.50	32.46%	1,610,481
1962	1,141,055	19.9	5.548	6,330,275	37.50	56.60	19.50	34.21%	2,165,587
1963	1,030,861	20.1	5.493	5,662,043	36.50	56.60	20.50	35.96%	2,036,070
1964	1,607,653	20.7	5.333	8,574,149	35.50	56.60	21.50	37.72%	3,234,169
1965	1,343,925	21.2	5.208	6,998,553	34.50	56.60	22.50	39.47%	2,762,329
1966	1,393,341	21.9	5.041	7,023,966	33.50	56.60	23.50	41.23%	2,895,981

Based on Staff Witness Dunkel Methodology

U S West Communications - Arizona
Reproduction Cost New Less Depreciation
Telephone Plant in Service as of December 31, 1999

Plant Account:	Conduit Systems
Plant Sub-Account:	Conduit Systems
Index Number:	2441
Field Code:	UCZ
Survivor Curve:	SQ
Average Service Life:	56.6

Year of Placing	Original Cost as of 12/31/1999	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/1999	Life Expectancy When New	Life Expectancy 12/31/1999	Condition Percent	Reproduction Cost New Less Depreciation
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1967	979,999	23.5	4.698	4,603,910	32.50	56.60	24.50	42.98%	1,978,761
1968	1,266,694	24.8	4.452	5,638,831	31.50	56.60	25.50	44.74%	2,522,813
1969	2,221,055	26.5	4.166	9,252,999	30.50	56.60	26.50	46.49%	4,301,719
1970	5,529,001	28.3	3.901	21,568,965	29.50	56.60	27.50	48.25%	10,407,026
1971	4,298,951	31.1	3.550	15,260,585	28.50	56.60	28.50	50.00%	7,630,292
1972	2,010,842	33.5	3.296	6,626,775	27.50	56.60	29.50	51.75%	3,429,356
1973	5,706,420	36.0	3.067	17,499,688	26.50	56.60	30.50	53.51%	9,364,083
1974	5,478,486	41.0	2.693	14,751,826	25.50	56.60	31.50	55.26%	8,151,859
1975	1,788,606	45.9	2.405	4,302,007	24.50	56.60	32.50	57.02%	2,453,004
1976	955,288	50.0	2.208	2,109,276	23.50	56.60	33.50	58.77%	1,239,621
1977	1,307,219	53.0	2.083	2,722,962	22.50	56.60	34.50	60.53%	1,648,209
1978	2,324,227	56.6	1.951	4,533,475	21.50	56.60	35.50	62.28%	2,823,448
1979	3,812,204	63.6	1.736	6,617,411	20.50	56.60	36.50	64.04%	4,237,790
1980	2,370,954	69.3	1.593	3,777,104	19.50	56.60	37.50	65.79%	2,484,957
1981	1,289,144	74.6	1.480	1,907,795	18.50	56.60	38.50	67.54%	1,288,525
1982	10,721,108	79.3	1.392	14,925,729	17.50	56.60	39.50	69.30%	10,343,530
1983	7,567,337	81.3	1.358	10,275,941	16.50	56.60	40.50	71.05%	7,301,056
1984	7,318,527	83.8	1.317	9,641,592	15.50	56.60	41.50	72.81%	7,020,043
1985	9,719,510	84.9	1.300	12,638,797	14.50	56.60	42.50	74.56%	9,423,487
1986	10,029,070	94.9	1.163	11,667,116	13.50	56.60	43.50	76.32%	8,904,343
1987	10,390,992	95.3	1.158	12,037,414	12.50	56.60	44.50	78.07%	9,397,609
1988	14,944,764	100.0	1.104	16,499,019	11.50	56.60	45.50	79.82%	13,169,517
1989	18,480,841	102.4	1.078	19,924,657	10.50	56.60	46.50	81.58%	16,254,535
1990	24,324,507	97.9	1.128	27,430,292	9.50	56.60	47.50	83.33%	22,857,662
1991	14,723,785	98.9	1.116	16,435,853	8.50	56.60	48.50	85.09%	13,985,267
1992	8,213,696	99.5	1.110	9,113,488	7.50	56.60	49.50	86.84%	7,914,153
1993	12,523,401	100.1	1.103	13,812,023	6.50	56.60	50.50	88.60%	12,237,452
1994	10,642,242	100.5	1.099	11,690,582	5.50	56.60	51.50	90.35%	10,562,441
1995	13,555,914	108.6	1.017	13,780,598	4.50	56.60	52.50	92.11%	12,693,309
1996	19,218,864	106.0	1.042	20,016,628	3.50	56.60	53.50	93.86%	18,787,607
1997	12,009,826	109.4	1.009	12,119,605	2.50	56.60	54.50	95.61%	11,587,554
1998	13,830,109	110.3	1.001	13,842,648	1.50	56.60	55.50	97.37%	13,478,586
1999	7,377,970	110.4	1.000	7,377,970	0.50	56.60	56.50	99.12%	7,313,044
	305,067,487		2.216	676,048,139				46.78%	316,287,695

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 AFFIDAVIT OF NANCY HELLER HUGHES
STATE OF WASHINGTON	)	
COUNTY OF KING	)	
	:	SS
	)	

Nancy Heller Hughes, of lawful age being first duly sworn, deposes and states:

1. My name is Nancy Heller Hughes. I am Senior Director of R. W. Beck, Inc., in Seattle, Washington.

2. Attached hereto and made a part hereof for all purposes is my rejoinder testimony consisting of pages 1 through 7, and one exhibit numbered NHH-1.

3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct to the best of my knowledge and belief.

Nancy Heller Hughes

Nancy Heller Hughes

SUBSCRIBED AND SWORN to before me this 15th day of September 2000.

Linda L. Ross

Notary Public

My Commission Expires:

4-5-02

LINDA L. ROSS
STATE OF WASHINGTON
NOTARY PUBLIC
MY COMMISSION EXPIRES 4-05-02

BEFORE THE ARIZONA CORPORATION COMMISSION

EXHIBIT
Q-35
Admitted

IN THE MATTER OF THE APPLICATION OF U S WEST COMMUNICATIONS, INC., A COLORADO 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-01051B-99-0105

REJOINDER TESTIMONY OF

CARL INOUYE

ON BEHALF OF

QWEST CORPORATION

SEPTEMBER 19, 2000

REJOINDER TESTIMONY OF CARL INOUYE

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IDENTIFICATION OF WITNESS

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Carl Inouye and my business address is 1600 7th Avenue, Seattle, Washington, 98191.

Q. ARE YOU THE SAME CARL INOUYE THAT PROVIDED REBUTTAL TESTIMONY IN THIS DOCKET?

A. Yes, I am.

PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose is to respond to the surrebuttal testimony of Mr. Shooshan filed on behalf of the Arizona Commission Staff ("Staff"). I will first respond to Mr. Shooshan's testimony as it relates to Staff's proposed price regulation plan and then to his testimony on the Qwest ("Qwest" or "Company") proposed plan.

Q. PLEASE GIVE AN OVERVIEW OF QWEST'S RESPONSE TO MR. SHOOSHAN'S SURREBUTTAL TESTIMONY.

A. Qwest is encouraged that Staff and the Company can agree that price regulation is appropriate. Staff's plan, however, is not a step forward for the simple reason that it requires access charge rate reductions, makes other rate reductions likely, and puts "hard caps" on specific services. In exchange, Staff's plan provides Qwest with no new pricing flexibility on existing services and little improvement in the prospect for new pricing flexibility during the term of the plan.

On the other hand, the Qwest plan gives Arizona customers assurance that the Company will not use pricing flexibility in Basket 1, Basic and Essential Services, to increase earnings while providing Qwest with a reasonable opportunity to rebalance rates. The Qwest plan features an overall price cap on the services in Basket 3, whereas, Staff's plan has no cap. The Qwest plan offers a much greater likelihood of permanently de-linking customer rates from ROR regulation, whereas, Staff's plan offers no permanent de-linking. And, the Qwest plan provides an efficient and streamlined mechanism to move services from Basket 1 to Basket 3 in response to increasing competition. By contrast, Staff's plan relies upon the time consuming, resource intensive, and litigious traditional regulatory process.

All in all, the Qwest plan is a much fairer price regulation plan.

RESPONSE TO MR. SHOOSHAN'S PROPOSED PLAN

Pricing Flexibility and Basket 3

Q. MR. SHOOSHAN STATES THAT THE INTENT OF STAFF'S PLAN IS TO PROVIDE QWEST WITH THE "SAME" PRICING FLEXIBILITY AS ITS COMPETITORS. (SHOOSHAN SURREBUTTAL, P. 3, L. 8-9) HAS HE ACCOMPLISHED THAT?

A. No. For example, competitors offer 1FR and 1FB local exchange service to residential and business customers in the Qwest service territories. These competitors may change their prices and terms and conditions without a regulatory proceeding before the Commission. Nowhere in Staff's proposed plan is Qwest granted the same pricing flexibility as competitors.

Q. WHAT IS YOUR PRINCIPLE POINT ABOUT STAFF'S PROPOSED PLAN AND HOW HAS IT BEEN ADDRESSED IN MR. SHOOSHAN'S SURREBUTTAL TESTIMONY?

A. My principal point in rebuttal testimony is that Staff's plan "does not provide Qwest with any new pricing flexibility for its existing services" and offers little prospects for increased flexibility. (Inouye Rebuttal, p. 2, 3-7)

Mr. Shooshan states in his testimony that price regulation "provides the incumbent with a **greater flexibility** to respond to competitors." (Shooshan Testimony, p. 7, L10-11, emphasis added) Nevertheless, Staff's plan does not provide greater pricing flexibility.[1] Furthermore, Staff's plan relies on the existing

[1] I also testified that Staff's proposed plan actually took away from Qwest's existing pricing flexibility. Mr. Shooshan's surrebuttal testimony clarifies that that was not his intent when he constructed Attachment 1 to his testimony by assigning the Qwest services to either Basket 1, Basket 2, or Basket 3.

1 regulatory process to determine whether Qwest would be granted new pricing
2 flexibility.
3
4 It is reasonable that any price regulation plan provide Qwest with greater pricing
5 flexibility at the outset of the plan. Furthermore, it is reasonable that any
6 mechanism relied upon during price regulation to provide additional pricing
7 flexibility should be streamlined. My rebuttal testimony demonstrated that Mr.
8 Shooshan's plan provided no new pricing flexibility for existing service and little
9 prospect for improvement during the life of the plan, points that Mr. Shooshan
10 now concedes in his surrebuttal testimony.
11
12 In his surrebuttal testimony, Mr. Shooshan concedes that Staff's plan provides
13 no meaningful pricing flexibility and opportunity to rebalance rates in Basket 1.
14 (Shooshan Surrebuttal, p. 16, L. 23-27) In responding to my point that Staff's
15 plan provides little prospect for increased pricing flexibility during the term of the
16 plan (Inouye Rebuttal, p. 5-6), Mr. Shooshan states he would not object to
17 applying a "less rigorous test" to determine whether increased pricing flexibility
18 should be granted. (Shooshan Surrebuttal, fn. 17)
19
20 In both of the above instances, Mr. Shooshan fails to offer concrete proposals to
21 fix the flaws in Staff's plan and does not modify the terms of Staff's plan.
22
23 The obvious fix is to simply apply the test Mr. Shooshan supports for determining
24 whether Qwest should be granted greater pricing flexibility and to do so in this
25 docket. The test Mr. Shooshan supports is that "at least one competitor exist."

(Shooshan Testimony, p. 11, L. 21-25) Staff should simply check documents filed with the Commission by CLECs to determine where and which services CLECs offer. Or, Staff should verify the same information by simply calling the CLECs.[2]

If Mr. Shooshan's test was applied in this docket, I believe the Basket 3 list of services would appear substantially as in my Exhibit CTI-1, attached to my rebuttal testimony. No time consuming, resource intensive and litigious regulatory proceeding is necessary to verify that Mr. Shooshan's test has been met.

Q. WOULD APPLYING MR. SHOOSHAN'S TEST IN THIS DOCKET ELIMINATE A SIGNFICANT DIFFERENCE BETWEEN THE STAFF AND QWEST PRICE REGULATION PLANS?

A. Yes. I believe that applying Mr. Shooshan's test now in this docket would substantially eliminate one of the important differences between Staff's and Qwest's price regulation plans, i.e., the distribution of services between Basket 1 and Basket 3.

[2] The latter is exactly the process employed by the Oregon Commission. (Oregon Public Utility Commission, Telecommunications Division Interoffice Correspondence, Marlene Gorsuch to Commissioners Eachus, Smith, and Hamilton, March 28, 2000, attached as Rejoinder Exhibit CTI-1. See also, Inouye Rebuttal, p. 13.

1 *Access Service*

2 **Q. MR. SHOOSHAN OPPOSES OFFSETTING REDUCTIONS IN ACCESS**
3 **CHARGES WITH INCREASES IN BASIC LOCAL EXCHANGE SERVICES. DO**
4 **YOU AGREE?**

5 A. No. Staff's plan requires access charge reductions without offsetting price
6 increases of other services or without any upward pricing flexibility provided
7 elsewhere in the plan. This portion of Staff's plan amounts to a diminishment of
8 any increased revenues granted by the Commission in the revenue requirement
9 and rate design portions of this docket.[3] This is simply unreasonable.
10
11 As will be discussed later in this testimony, the evidence of the past 5 years
12 suggests that access charge revenue reductions would not likely be offset by
13 efficiency improvements. (See the sub-section "Price Indexing Basket 1")
14
15 *Pricing Flexibility in Basket 1*
16
17 **Q. MR. SHOOSHAN STATES THAT THE "HARD CAP" IS A LEGITIMATE TOOL**
18 **FOR "PROTECTING" CUSTOMERS WHO "RELY" ON QWEST BASIC**
19 **SERVICES. (SHOOSHAN SURREBUTTAL, P. 16, L. 20-22) DO YOU AGREE?**

20 A. No, I do not. It is incongruous that basic services priced below cost would be
21 hard capped while access services, which are priced above cost, would have
22 programmed rate reductions. Fairness and equity would deem that the two be
23 treated similarly, which the Qwest plan does by putting both classes of services
24 in Basket 1.
25

[3] It should be noted that under ROR regulation, reduction of access charges could not be achieved without offsetting price increases of other services, unless a revenue requirement reduction was demonstrated.

1 Furthermore, the fact that customers "rely" on Qwest basic services does not
2 justify Mr. Shooshan's broad inclusion of services in Staff's Basket 1. Customers
3 may "rely" on Qwest basic services, while at the same time have the alternative
4 of substituting the Qwest services with that of CLECs. Staff's "hard cap" is not
5 necessary to "protect" customers when CLEC alternatives exist.
6
7 Applying in this docket the "less rigorous" test Mr. Shooshan proposes for
8 determining whether pricing flexibility should be provided would eliminate the
9 unfairness of hard capping services when customers have CLEC alternatives.
10 As discussed above, the test could be applied quickly and efficiently in this
11 docket and would resolve a significant difference between the Staff and Qwest
12 plans.
13
14 **Q. DOES MR. SHOOSHAN CONCEDE THAT HIS "HARD CAP" WILL TOO**
15 **"TIGHTLY CONSTRAIN" QWEST?**
16 A. Yes. In his testimony, Mr. Shooshan claimed that his price regulation proposal
17 does provide pricing flexibility in Basket 1. In surrebuttal, Mr. Shooshan
18 concedes the point that no meaningful rebalancing or pricing flexibility is
19 provided in Basket 1.[4] (Shooshan Surrebuttal, p. 16-17; Inouye Rebuttal, p. 6-7)

[4] Mr. Shooshan contradicts himself in his surrebuttal testimony beginning at page 5, L. 22, to page 6, L.6. and that at pages 16-17. In conceding my testimony that no Basket 1 service price could be increased above its existing level and, therefore, no meaningful rebalancing or pricing flexibility is being offered, Mr. Shooshan cannot also testify, as he does beginning at page 5, that Dr. Taylor is incorrect in stating that no Basket 1 service price could be increased. Furthermore, Mr. Shooshan's surrebuttal testimony on pages 5-6 that the hard cap applies only to "basic" services in Basket 1 and not to other non-basic services in Basket 1 is misleading and an inconsequential point. The only non-basic services in Basket 1 are "existing service packages," much of which Qwest already has pricing flexibility that Mr. Shooshan concedes at page 16 were never meant to be included in Basket 1. Whatever existing service packages left in Basket 1 would be so small in the weighted averaged price of the entire basket as to be inconsequential.

Nevertheless, Mr. Shooshan makes no modifications to bring his proposed price regulation plan in conformity with his original testimony.

Q. WOULD IT BE REASONABLE FOR THE COMMISSION TO ADOPT A PRICE REGULATION PLAN MR. SHOOSHAN ADMITS IS FLAWED?

A. No, it would not be. As I demonstrated in my rebuttal testimony, there is no opportunity in Staff's proposed plan to rebalance the rates of services in Basket 1. Furthermore, I demonstrated that the price index formula is flawed against the Company's interests. Mr. Shooshan concedes these points.

Mr. Shooshan suggests that the Commission correct these flaws by modifying the range of services that are subject to the "hard cap" and adjust the price cap formula. He does not state what specifically the Commission should adopt.

Q. HOW SHOULD THESE FLAWS IN STAFF'S PLAN BE FIXED?

A. The fixes should be the placement of access services in Basket 1 and the substitution of an overall weighted average price cap for the entirety of Basket 1 in place of the service specific "hard caps." Additionally, the range of services should be limited to that I proposed in my Exhibit CTI-2, which would closely reflect the result of applying Mr. Shooshan's "less rigorous" test discussed above. These "fixes" are exactly the features of the Qwest price regulation plan.

Service Quality

Q. MR SHOOSHAN JUSTIFIES A SERVICE QUALITY COMPONENT WITH AN ANALOGY OF A "SWORD" TO HOLD OVER THE COMPANY TO INDUCE PERFORMANCE. HOW DO YOU RESPOND?

A. The point in my rebuttal testimony is that the three service areas Mr. Shooshan expressed a concern (access to centers, held orders, and out of service repair) all had the level of customer payments increased less than 2 months before Mr. Shooshan's testimony was filed. To use Mr. Shooshan's analogy, those increased customer payments are the "sword of Damocles" currently being held over the Company's head to induce it to perform.

Q. MR. SHOOSHAN STATES THAT CUSTOMERS NEED TO BE ASSURED THAT PRICES MORE CLOSELY MATCH THE QUALITY OF SERVICE RECEIVED. HAS MR. SHOOSHAN DEMONSTRATED THAT SUCH HAS NOT ALREADY BEEN ACHIEVED?

A. No, he has not. Mr. Shooshan has presented no evidence that the customer payments currently required by the Commission do not already provide a reasonable match between price and service quality. Without such evidence, Mr. Shooshan has no support or basis to claim that additional customer payments should be included in any price regulation plan.

Q. IS THE EVIDENCE MR. SHOOSHAN PRESENTS FROM OTHER STATES SUPPORTIVE?

A. No. It is irrelevant that 13 other states developed service quality payments in conjunction with their price regulation plans without the knowledge of whether those plans were developed in a situation in which service quality standards and defined levels of customer payments already exist, as they do in Arizona.

Term of the Plan

Q. IS THE TERM OF THE PLAN LINKED TO THE REVENUE REQUIREMENT OUTCOME OF THIS DOCKET?

A. Yes, it is. As I stated in my rebuttal testimony, year 2000 earnings point to a significant decline in earnings. Given the earnings trend and Staff's revenue requirement proposal in this docket, Qwest is unable to commit to a price regulation plan longer than the initial 3-year term in the Qwest proposed plan.

Q. IS MR. SHOOSHAN CORRECT THAT UNCERTAINTY WILL BE REMOVED WHEN THE COMMISSION DETERMINES REVENUE REQUIREMENT IN THIS DOCKET? (SHOOSHAN SURREBUTTAL, P. 13)

A. No. Undertaking a price regulation plan of defined length involves uncertainties that are not limited to the starting point revenue requirement from a rate case. As I stated in my rebuttal testimony, the Company is uncertain about the trend in earnings, given service improvement initiatives. Furthermore, an acceptable revenue requirement to start a price regulation is not a definitive number. Qwest recognizes that there may be tradeoffs between the level of revenue requirement and the term of the plan. For these reasons, Qwest proposes a 3-year initial term plan with a renewal option.

Q. IS THE ISSUE OVER THE TERM OF THE PLAN OR OVER WHO HAS THE OPTION TO DETERMINE WHETHER TO EXTEND THE PLAN?

A. Given Mr. Shooshan's testimony that he does not strongly object if the plan was shorter than 5 years (Shooshan Surrebuttal, p. 13, L. 16-17), it appears the issue is over who has the option to determine whether to extend the plan. The fact of the matter should be that if Staff was comfortable with a 5 year plan, it should not

object to the modification that at 3 years Qwest would have the option to end the plan.[5] If Qwest were to renew, the plan would ultimately have at least the 5-year duration Staff proposed. If Qwest did not renew, the duration would be shorter.

Given the current financial trends, the 3-year initial term with the option to renew does nothing more than make the election into price regulation by Qwest more likely.

Q. WHICH PRICE REGULATION PLAN HAS THE BETTER PROVISIONS GOVERNING WHAT HAPPENS AT THE END OF THE PLAN?

A. I would submit that the Qwest price regulation plan has better provisions than does Staff's plan.

Under Staff's plan, Qwest would have the right to decide whether to opt into an extension of the existing price regulation plan, a modified or new plan, or return to ROR regulation.[6] The Commission may decide to extend the plan, make modifications, or offer a new plan. But, Qwest would not be bound to accept the Commission's decision. Absent such an election, Qwest would return to ROR regulation.

[5] If the 3 year renewal, for a total of 6 years, as compared to Staff"s 5 years, is an issue, Qwest would agree that the renewal term would be 2 years.

[6] Mr. Shooshan states that the Staff plan anticipates that the Commission would decide whether and for how long to extend the plan beyond the initial proposed 5-year term and cites page 3 of his initial testimony. Nothing at page 3 describes how the Commission would have this exclusive right. It is Qwest's position that price regulation cannot be imposed upon the Company. Therefore, Qwest would have the rights described above, absent any provision that provided otherwise.

The Qwest plan includes a provision that eliminates the possibility of returning to ROR if Qwest renews the plan after the initial 3-year term.[7]

[7] Conditioned only upon the Commission and FCC having granted 271 approval.

RESPONSE TO MR. SHOOSHAN'S TESTIMONY ON THE QWEST PROPOSED PLAN

Q. PLEASE DESCRIBE HOW THIS SECTION RELATES TO THE PRIOR SECTION.

A. Because of the common elements in the Staff and Qwest proposed price regulation plans, it is unavoidable that this rejoinder testimony has not already addressed in the prior section some of Mr. Shooshan's surrebuttal testimony on the Qwest proposed plan. So as to avoid duplication, I will not duplicate testimony in this section and limit my testimony to new subjects.

Residential and Business Lines Beyond the Primary Line

Q. DOES MR. SHOOSHAN AGREE THAT RESIDENTIAL AND BUSINESS LINES BEYOND THE PRIMARY LINE SHOULD BE PLACED IN BASKET 3?

A. No. However, Mr. Shooshan states that it is a "closer call...at this time." Mr. Shooshan recognizes that these lines are "non-essential" and that at least some customers have options, but states that the Commission should make the decision whether basic service lines beyond the primary line should be included in Basket 3 in a separate proceeding. (Shooshan Surrebuttal, p. 15)

Q. IS A SEPARATE PROCEEDING NECESSARY OR REASONABLE?

A. No, it is not. Mr. Shooshan testifies that he "would not object" to his "less rigorous" test being relied upon to determine whether services should be moved to Basket 3 and that such a test should be the existence of at least one competitor. (Shooshan Surrebuttal, p. 15, fn. 17; Shooshan Testimony, p. 11) As discussed above, Mr. Shooshan's test should be applied in this docket. A

separate proceeding is not necessary to verify the existence of at least one competitor. Such verification could be done quickly and efficiently by Staff by checking documents filed with the Commission by CLECs, or by calling the CLECs.

Q. WHAT WOULD BE THE OUTCOME OF SUCH A VERIFICATION?

A. I believe that the verification would result in substantial residential and business basic local services, beyond the primary line, being placed in Basket 3.

Wholesale Services

Q. MR SHOOSHAN STATES THAT IT APPEARS DISAGREEMENT OVER WHOLESALE SERVICES IS LIMITED TO THE PLACEMENT OF ACCESS SERVICES IN BASKET 1 OR BASKET 2. (SHOOSHAN SURREBUTTAL, P. 15, FN 16) DO YOU AGREE?

A. Yes. Qwest does not see the need for a separate basket for wholesale services because different pricing rules apply. With Staff's acknowledgement that special access has been merged into the Private Line tariff, which has been previously classified as competitive, the only difference appears to be the placement of switched access services. The placement of access services in the appropriate basket was addressed in the sub-section "Access Service."

Inflation Indexing Basket 1

Q. MR. SHOOSHAN SPECULATES THAT THE ABSENCE OF INFLATION INDEXING FOR BASKET 1 RELATES TO MR. TAYLOR'S TESTIMONY ON THE PRODUCTIVITY FACTOR. IS THAT TRUE?

A. No, I do not believe that would be accurate. Qwest's proposal to dispense with inflation indexing of the overall weighted average price of the Basket 1 services reflects the point of view that at current levels of inflation, what an appropriate productivity factor should be, and a 3-6 year duration, inflation indexing would be more trouble than its worth. Plus, the way in which Mr. Shooshan proposes to use inflation indexing in combination with "hard caps" makes the application of inflation indexing unfair by working downward, but not upward. (Inouye Rebuttal, p. 7, fn. 6) Mr. Shooshan concedes the latter point. (Shooshan Surrebuttal, p. 16) Given the above, inflation indexing was simply not included in the Qwest proposed price regulation plan.

Q. DOES THE ELMINATION OF INFLATION INDEXING DENY ARIZONA CUSTOMERS THE BENEFIT OF INCREASED EFFICIENCIES QWEST COULD BE EXPECTED TO ACHIEVE UNDER PRICE REGULATION? (SHOOSHAN SURREBUTTAL, P. 16, L. 13-16)

A. No. Mr. Shooshan's premise that Qwest can be expected to be more efficient under Staff's 5-year price regulation plan is a false one. There appears to be little reason to believe the incentive to be cost efficient under Staff's plan would be significantly different than under ROR regulation, given that the term of price regulation closely matches the usual regulatory lag under ROR regulation. Arizona rate cases are fairly infrequent, 5 years being the regulatory lag since the last rate case. Mr. Shooshan's premise that Qwest can be expected to be more efficient in Arizona lacks support.

Furthermore, there is no evidence that the efficiency gains would be large enough to support Mr. Shooshan's contention that inflation indexing would result

in a benefit to customers, as opposed to a detriment. In the last U S WEST rate case, the Commission granted a $31.6 million rate increase,[8] subsequently increased to $59.3 million after court appeals were exhausted. In this case, Staff's revenue requirement witnesses are proposing another rate increase, albeit small.[9] The period since the last rate case matches the period of the data Mr. Shooshan relies upon to calculate his productivity factor. His productivity factor, therefore, aligns with Staff's revenue requirement position. Since the Company's cost efficiency has not been great enough to enable Staff's revenue requirement witnesses to propose a rate reduction, then logically Mr. Shooshan cannot claim that inflation indexing will benefit customers through a reduction of the overall price cap of Basket 1.

Furthermore, Mr. Shooshan's proposed "consumer productivity dividend" is unjustified because it also relies upon the premise that Qwest has greater incentive to be cost efficient under price regulation.

Basket 3 Price Cap

Q. MR. SHOOSHAN SEES ADVANTAGES IN THE QWEST PROPOSED BASKET 3 OVERALL PRICE CAP. DO YOU AGREE?

A. Yes. From a the point of view of customer protection, the Qwest proposal is more advantageous than the Staff proposal.

---

[8] Arizona Corporation Commission, Decision No. 58927, Docket No. E-1051-93-183, January 3, 1995.

[9] The Commission has yet to rule in favor of Staff's proposed rate increase, or on Qwest's proposed larger rate increase.

Q. MR. SHOOSHAN QUESTIONS WHETHER PRICE REDUCTIONS WOULD BE FILED WITH THE COMMISSION. PLEASE COMMENT.

A. It is the Company's proposal that notice would be given to the Commission when prices are reduced.

Competitive Zones

Q. MR. SHOOSHAN POINTS OUT THAT OREGON IS USING COMPETITIVE ZONES IN THE CONTEXT OF "TRUE" PRICE REGULATION. (SHOOSHAN SURREBUTTAL, P. 17) IS THAT STATEMENT COMPLETE?

A. No, it is not. The competitive zone statute was passed by the Oregon legislature in 1993 with the Oregon Public Utility Commission's support. At the time, U S WEST was regulated by the Oregon Commission under the terms of an alternative form of regulation that was similar in many aspects to both Staff's and Qwest's proposed price regulation plans. The Oregon Commission saw no reason why competitive zones were not compatible with the alternative form of regulation then in effect.[10]

Q. PLEASE COMMENT ON MR. SHOOSHAN'S CLAIM THAT QWEST'S PROPOSED PLAN IS NOTHING MORE THAN A PROPOSAL TO EXTEND REGULATORY LAG FOR 3 YEARS UNTIL QWEST CAN DECIDE TO GO BACK TO RATE OF RETURN REGULATION. (SHOOSHAN SURREBUTTAL, P. 17)

A. It appears Mr. Shooshan claims Qwest's motive in proposing a price regulation plan is to lock in 3 years of regulatory lag. As I stated in my rebuttal testimony,

[10] It is also significant that from 1996 to 1999, U S WEST was ROR regulated by the Oregon Commission. Again, there was no incompatibility between the operation of competitive zones and ROR regulation.

the Company's Arizona intrastate earnings have dipped significantly. (Inouye Rebuttal, p. 14-15) Qwest's proposal for a 3-year initial term, plus 3-year renewal, is an attempt to find reasonable conditions to undertake price regulation. It would be irresponsible for the Company to undertake a 5-year plan without more significant increased revenues than it might take in a 3-year plan. As I stated earlier in this testimony, a 3-year initial term with a 3-year renewal makes it more likely that Qwest would move forward on price regulation in Arizona.

Exogenous Factors

Q. DO YOU AGREE WITH MR. SHOOSHAN'S CONCERN ABOUT THE STANDARD FOR EXOGENOUS STANDARDS?

A. To the extent that Mr. Shooshan believes that some sort of "de minimis" threshold should be met before an exogenous factor is applied, he should define such an amount. I would point out that no exogenous price increases or decreases would occur without the Commission's approval.

Q. SHOULD EXOGENOUS FACTORS BE LIMITED TO TAX LAW, ACCOUNTING, AND REGULATORY CHANGES?

A. No. The key is cost changes that are beyond the control of Qwest. I see no reason to limit the universe at this time to tax laws, accounting, and regulatory changes. I would agree, however, that those are the usual suspects for exogenous changes.

Q. DOES THIS CONCLUDE YOUR TESTMONY?

A. Yes.

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF U S WEST COMMUNICATIONS, INC., A COLORADO 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-01051B-99-0105

REJOINDER EXHIBITS OF

CARL INOUYE

ON BEHALF OF

QWEST CORPORATION

SEPTEMBER 19, 2000

ARIZONA CORPORATION COMMISSION
DOCKET NO. T-01051B-99-0105
QWEST CORPORATION - CTI-1
EXHIBITS OF CARL INOUYE
SEPTEMBER 19, 2000

PUBLIC UTILITY COMMISSION

Telecommunications Division

Interoffice Correspondence

RECEIVED
MAR 30 2000
Kay original

DATE: March 28, 2000

TO: Commissioners Eachus, Smith, and Hamilton
Through Dave Booth and Phil Nyegaard

FROM: Marlene Gorsuch MEG

SUBJECT: U S WEST Communications – Pricing Flexibility

The purpose of this report is to notify the Commission that the criteria have been met for U S WEST Communications to receive pricing flexibility, pursuant to ORS 759.050(5), in forty-nine additional telephone exchanges.

The Commission first set criteria for GTE Northwest (GTE) and U S WEST Communications (USWC) to receive pricing flexibility in Order No. 96-021, dockets CP 1, CP 14, and CP 15. The criteria have been repeated since January 1996 in orders by which the Commission granted authority to competitive providers to provide local exchange service in competition with the incumbents. USWC has met the criteria for pricing flexibility for switched service in several exchanges, as summarized here:

1. Many competitive local exchange carriers (CLEC's) have certificates of authority to provide service in all USWC exchanges.

2. USWC has filed a tariff for interim local number portability, and the Commission has approved the tariff.

3. Staff has notified the Commission that a mutual exchange of telephone traffic exists between USWC and a CLEC in each of several exchanges.

We use different criteria for dedicated transmission service, i.e. private line service. On several occasions, the Commission has granted to USWC, as well as GTE, Sprint/United, and CenturyTel, pricing flexibility for dedicated transmission throughout their service areas.

USWC advised the PUC staff by letter dated March 8, 2000, that a mutual exchange of traffic exists in forty-nine exchanges:

Albany	Grants Pass	Pendleton
Ashland	Hermiston	Phoenix/Talent
Astoria	Independence/Monmouth	Prineville
Athena/Weston	Jacksonville	Rainier
Baker	Jefferson	Redmond
Bend	Junction City	Rogue River
Blue River	Klamath Falls	Roseburg
Camp Sherman	Lapine	St. Helens
Central Point	Leaburg	Seaside
Corvallis	Lowell	Siletz
Cottage Grove	Madras	Sisters
Culver	Medford	Stanfield
Dallas	Milton-Freewater	Toledo
Falls City	Newport	Umatilla
Florence	Oakland/Sutherlin	Veneta
Gold Hill	Oakridge	Warrenton
		Woodburn/Hubbard

Staff contacted the competing CLECs: ATI, BG ENTERPRISES, FRONTIER (GLOBAL CROSSINGS), RIO COMMUNICATIONS, STERLING INTERNATIONAL (1-800-RECONEX), SUNRIVER TELCOM, TELNET, and UNITED COMMUNICATIONS. They confirmed USWC's information.

By this report staff notifies the Commission that a mutual exchange of traffic exists between USWC and an authorized CLEC in the above forty-nine exchanges. Therefore, USWC now gets pricing flexibility for switched service in those exchanges. No Commission action is required.

On the attached pages are shown the exchanges where USWC and GTE have pricing flexibility pursuant to ORS 759.050 and Order No. 96-021. There are now only seven exchanges where USWC does not have pricing flexibility: Cannon Beach, Harrisburg, Mapleton, Marcola, Sumpter, Walla Walla (Stateline), and Westport.

cc: Mike Weirich, Assistant Attorney General
Don Mason, U S West Communications
Kay Barley, U S West Communications

Pricing Flexibility

U S WEST Communications has pricing flexibility in the following exchanges pursuant to ORS 759.050 and Order No. 96-021, dockets CP 1, CP 14, and CP 15.

U S WEST

Albany
Ashland
Astoria
Athena/Weston
Baker
Bend
Blue River
Burlington
Camp Sherman
Central Point
Corvallis
Cottage Grove
Culver
Dallas
Eugene/Springfield
Falls City
Florence
Gold Hill
Grants Pass
Hermiston
Independence/Monmouth
Jacksonville
Jefferson
Junction City
Klamath Falls
Lake Oswego
Lapine
Leaburg
Lowell
Madras
Medford
Milton-Freewater
Newport
North Plains
Oak Grove/Milwaukie
Oakland/Sutherlin
Oakridge
Oregon City
Pendleton
Phoenix/Talent
Portland
Prineville
Rainier
Redmond
Rogue River
Roseburg
Salem
St. Helens
Seaside
Siletz
Sisters
Stanfield
Toledo
Umatilla
Veneta
Warrenton
Woodburn/Hubbard

March 28, 2000

Pricing Flexibility

GTE Northwest has pricing flexibility in the following exchanges pursuant to ORS 759.050 and Order No. 96-021, dockets CP 1, CP 14, and CP 15.

GTE Northwest

Bandon
Beaverton
Brookings
Coos Bay
Coquille
Cove
Elgin
Enterprise
Forest Grove
Gold Beach
Gresham
Hillsboro
Hoodland
Imbler
Joseph
La Grande
McMinnville
Murphy/Provolt
Newberg
Scholls
Sherwood
Stafford (Wilsonville)
Tigard
Union
Wallowa

March 28, 2000

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 APPPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN.	)	DOCKET NO. T-1051B-99-105 AFFIDAVIT OF CARL INOUYE
STATE OF WASHINGTON	) :	ss
COUNTY OF KING	)	

Carl Inouye, of lawful age being first duly sworn, depose and states:

1. My name is Carl Inouye. I am Lead Director – Financial Advocacy for Qwest Corporation in Seattle, Washington. I have caused to be filed written testimony and exhibit in support of Qwest in Docket No. T-01051B-99-105

2. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct to the best of my knowledge and belief.

Further affiant sayeth not.

Carl Inouye

Carl Inouye

SUBSCRIBED AND SWORN to before me this 14th day of September, 2000, 2000.

Elizabeth M Weber

Notary Public residing at
Seattle, Washington.

My Commission Expires: 09/15/02

BEFORE THE

ARIZONA CORPORATION COMMISSION

EXHIBIT
Q-36
Admitted

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	)	DOCKET NO. T-01051B-99-0105

REJOINDER TESTIMONY OF

ANN KOEHLER-CHRISTENSEN

QWEST CORPORATION

SEPTEMBER 19, 2000

REJOINDER TESTIMONY OF ANN KOEHLER-CHRISTENSEN

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IDENTIFICATION OF WITNESS

Q. PLEASE STATE YOUR NAME, OCCUPATION AND BUSINESS ADDRESS.

A. My name is Ann Koehler-Christensen, Qwest Corporation (Qwest or the Company), formerly U S WEST Communications, employs me as a Finance Analyst – Regulatory Finance. My business address is 1600 7th Avenue, Room 3008, Seattle, Washington. 98191.

Q. HAVE YOU FILED TESTIMONY PREVIOUSLY IN THIS DOCKET?

A. Yes, I filed direct testimony on January 8, 1999, supplemental testimony of May 2, 2000 and rebuttal testimony on August 21, 2000.

PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to respond to the testimony filed by Michael Brosch on behalf of Staff, Hugh Larkin on behalf of RUCO, Richard Lee on behalf of the DOD and Lee Selwyn and Susan Gately on behalf of AT&T with respect to their surrebuttal testimony on the Yellow Pages imputation.

REJOINDER OF STAFF, RUCO AND THE DOD

Q. WHAT IS THE AMOUNT OF IMPUTATION RECOMMENDED BY STAFF, RUCO AND THE DOD?

A. The imputation recommended is $41.3 million. This imputation is based on the presumptive $43 million less the fees paid to the Company by DEX for the listings and other services received.

Q. HAS ANY EVIDENCE BEEN PROVIDED TO SHOW THAT $41.3 MILLION IS THE VALUE OF THE SERVICES RECEIVED BY THE COMPANY FROM DEX?

A. No. Mr. Larkin provides no evidence whatsoever. Mr. Brosch maintains that he has provided an analysis that demonstrates a value of greater than $41.3 million that he claims is not based on DEX net income or any determination of rate of return. His "method" however has nothing to do with the value of services, it simply takes the presumptive $43 million and increases it based on the growth of DEX's revenues and net income. Mr. Lee claims that "while the Commission must <u>consider</u> the fees and value of services received by Qwest <u>from</u> DEX, the basis for imputation is the value of the directory function transferred <u>to</u> DEX." He takes this position notwithstanding that it is directly contrary to the decision of the Arizona Appellate Court, which states:

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.

Q. DOES MR. BROSCH PROVIDE ANY OTHER INFORMATION THAT IS BASED ON VALUE OF SERVICES RECEIVED BY THE COMPANY FROM DEX?

A. No, he does not. Mr. Brosch claims that DEX obtains unique benefits from its affiliation with the Company, hypothetical bidding scenarios, and White Pages advertising. None of these claims is relevant under the Settlement Agreement.

REJOINDER OF AT&T

Q. WHAT IMPUTATION METHODOLOGY DOES DR. SELWYN RECOMMEND?

A. Dr. Selwyn recommends an imputation method that captures what he claims to be all the profits of DEX. He claims that all the profits of DEX represent the value of the services provided. He questions the "veracity and validity" of my statement that the Arizona Court of appeals has already determined that the profits of DEX are not an appropriate basis for an imputation.

Q. IS THE TRANSFER OF THE YELLOW PAGES OPERATION AN ISSUE IN THIS STATE?

A. No, it is not, although Dr. Selwyn has stated that no transfer of the Yellow Pages business has taken place. To support this claim he introduced a case from the state of Washington, which is irrelevant in Arizona. He relies on a Washington Commission Decision rather than on the 1996 Arizona Court of Appeals Opinion. The Arizona Court of Appeals ruled:

> The Commission unequivocally agreed in 1988 to accept the transfer of directory publication to an unregulated subsidiary. It is wholly inconsistent with this agreement to impute to U S West all of USWD's profits exceeding the rate of return USWD would have been permitted to receive had it remained regulated and to seek thereby for "ratepayers the same benefit from the directory publishing business as they had before the assets were transferred." By such a methodology the Commission in effect pretends that the transfer it previously accepted did not occur.

Dr. Selwyn's testimony with respect to the transfer of the directory business and the profits of DEX should be disregarded because it altogether ignores the settlement agreement.

Q. DOES DR. SELWYN PROVIDE ANY RATIONALE FOR CONTINUING TO RECOMMEND THAT ALL THE PROFITS OF DEX SHOULD BE USED AS THE IMPUTATION METHOD?

A. Dr. Selwyn maintains that DEX is a monopoly and faces no competition. He disputes the competitive information I provided in my rebuttal testimony by addressing the number of directories distributed by the other publishers in Arizona. The existence or lack of competition is not part of the Settlement Agreement that controls the imputation level in Arizona. However, Dr. Selwyn has again incorrectly analyzed the level of competition based on his representation of distribution.

Q. PLEASE EXPLAIN THE PROBLEM WITH DR. SELWYN'S REPRESENTATION OF THE NUMBER OF DIRECTORIES DISTRIBUTED.

A. Dr. Selwyn fails to look at the individual directory markets. He claims the competitive impact of the other directory publishers is inconsequential without considering the impact of all the competitors or the impact on individual markets. In total DEX distributes approximately 60% of the directories distributed in Arizona. I have reviewed the Yellow Pages Publisher Association (YPPA) data provided by Dr. Selwyn as Attachment 3 to his surrebuttal testimony by DEX directory and the circulation data tells a far different story.

In total DEX distributes approximately 60% of the directories distributed in Arizona. Of the 21 directories published by DEX in Arizona[1], only three DEX directories have no direct competition. Based on distribution, these directories equate to approximately 4% of DEX's circulation. The data is as follows:

DEX Directory	DEX Dist.	Other Dist.	Competitive Directory	Publ.
1 **Greater SW Valley**	33,710	0	None	
2 **Tucson Central**	102,286	0	None	
3 **Wickenburg**	29,768	0	None	

Seven of DEX's 21 Arizona directories compete with directories published by only one publisher, Phone Directories Company (PDC). DEX's circulation exceeds PDC's circulation in only two of these seven markets and on average DEX distributes about 47% of the directories in these markets. The data on these markets is as follows:

DEX Directory	DEX Dist.	Other Dist.	Competitive Directory	Publ.
1 **Casa Grande**	41,827	24,500	Casa Grande	PDC
		25,000	So Central Arizona	PDC
	41,827	**49,500**		
2 **Clifton-Safford**	17,436	33,000	Southeastern Arizona	PDC
3 **Cochise County**	75,526	33,000	Sierra Vista	PDC
		33,000	Southeastern Arizona	PDC
	75,526	**66,000**		
4 **Globe**	20,715	25,000	So Central Arizona	PDC
		25,000	Apache Junction	PDC
	20,715	**50,000**		
5 **Payson**	18,284	21,500	Payson	PDC
6 **Winslow**	13,591	38,000	NE Arizona-Holbrook	PDC
7 **Yuma**	102,999	65,000	Yuma Metro	PDC

[1] 14 of the 21 DEX directories in Arizona are published on behalf of Qwest. 7 of these cover

Four of DEX's directories each compete with directories published by two other publishers.[2] DEX distributes from 31% to 44% of the total directories in these markets.

DEX Directory	DEX Dist.	Other Dist.	Competitive Directory	Publ.
1 **Nogales-Green Valley**	37,031	21,500	Nogales-Santa Cruz	PDC
		25,415	Green Valley	SWG
	37,031	**46,915**		
2 **Prescott**	68,214	55,000	Prescott-Verde Valley	PDC
		52,000	Prescott &TriCity AW	JHZ
	68,214	**107,000**		
3 **Tucson East**	181,265	316,000	Tucson Regional	WPZ
		8,119	Sun City-Visto-Sdlbk	SWG
	181,265	**324,119**		
4 **Tucson North-NW**	153,639	316,000	Tucson Regional	WPZ
		25,000	So Central Arizona	PDC
	153,639	**341,000**		

Finally, the remaining seven directories published by DEX compete with multiple directories published by several different publishers.[3]

DEX Directory	DEX Dist.	Other Dist.	Competitive Directory	Publ.
1 **East Valley**	442,572	25,000	Apache Junction	PDC
		185,000	Mesa	NDC
		215,000	Tempe	NDC
		24,500	Casa Grande	PDC
		25,000	So Central Arizona	PDC
		37,370	Apache Junction	SD
		75,520	Chandler-Gilbert	SD
		115,000	Mesa	SD
		84,000	Tempe	SD
		34,736	Ahwatukee	SWG
	442,572	**796,126**		

areas to be sold in the rural exchange sales

[2] PDC is Phone Directories Company, SWG is Southwestern Bell Advertising Group, JHZ is J. H. Zerbey Newspapers, Inc., and WPZ is WorldPages.com

[3] SD is Southern Directory Co., WVA is West Vista Advertising Services of Texas, LMB is L. M. Berry & Co., and VZ is Verizon Information Services.

1

DEX Directory	DEX Dist.	Other Dist.	Competitive Directory	Publ.
2 **Flagstaff**	126,848	51,500	Flagstaff	PDC
		19,900	Page Lk Powell Kane	PDC
		38,000	NE Arizona-Holbrook	PDC
		36,300	Sedona Verde Valley	PDC
		80,000	Flagstaff-N Arizona	JHZ
		22,000	Page-Lake Powell	WVA
	126,848	**247,700**		
3 **Greater NW Valley**	384,802	30,000	Carefree-Cave Creek	SD
		62,456	Sun City-Sun City West	SWG
		N/A	CaveCreek-Crfree-Ant	NDC
		N/A	Phoenix North	NDC
		N/A	Bellaire-West Univ	SD
	384,802	**92,456**		
4 **Mohave County**	105,516	142,697	Mohave County	LMB
		28,500	Kingman	PDC
		41,500	Lower Colorado River	PDC
		38,085	Parker	VZ
	105,516	**250,782**		
5 **Phoenix**	1,336,405	25,000	Apache Junction	PDC
		185,000	Mesa	NDC
		215,000	Tempe	NDC
		165,000	Scottsdale C Phoenix	NDC
		60,000	Scottsdale North	NDC
		30,000	Carefree-Cave Creek	SD
		75,520	Chandler-Gilbert	SD
		12,000	Fountain Hills	SD
		115,000	Mesa	SD
		12,000	Paradise Valley	SD
		84,000	Tempe	SD
		34,736	Ahwatukee	SWG
		62,456	Sun City-Sun City West	SWG
		N/A	CaveCreek-Crfree-Ant	NDC
		N/A	Phoenix North	NDC
		N/A	Bellaire-West Univ	SD
	1,336,405	**1,050,712**		
6 **Scottsdale**	238,602	165,000	Scottsdale C Phoenix	NDC
		60,000	Scottsdale North	NDC
		30,000	Carefree-Cave Creek	SD
		12,000	Fountain Hills	SD
		12,000	Paradise Valley	SD
		N/A	CaveCreek-Crfree-Ant	NDC
	238,602	**279,000**		
7 **Tucson**	464,541	316,000	Tucson Regional	WPZ
		25,000	So Central Arizona	PDC
		8,119	Sun City-Visto-Sdlbk	SWG
	464,541	**349,119**		

For the most part the competitive publishers publish directories that cover a smaller geographical area and distribute fewer copies, but this does not mean these directories present inconsequential competition, since the total market needs to be considered.

When viewed by directory market, DEX averages about 50% of the distribution in the Arizona markets in which DEX publishes directories. DEX does not have a monopoly as Dr. Selwyn tries to portray.

Q. WHAT ABOUT THE BENEFITS OF AFFILIATION DISCUSSED BY DR. SELWYN?

A. As I explained previously, this is not relevant. In my rebuttal testimony I discussed the unfounded claims that DEX enjoys uncompensated benefits of affiliation. For the most part, these claims are based on a benefit gained from a common corporate name. It is not appropriate for the regulated company to be compensated by an affiliated company for this benefit, as the benefit is conferred by the parent company and not by the regulated company.

Q. PLEASE EXPLAIN WHY AT&T WAS IN ERROR BY APPLYING THE REVENUE CONVERSION FACTOR TO DR. SELWYN'S PRE-TAX DIRECTORY PROFIT CALCULATION.

A. A gross revenue conversion factor is designed to convert post-tax net income to pre-tax income or revenue. The Company provided the development of the factor in response to AT&T 11-094 Attachment A, file GAREX-MAY00.xls in tab GAR-S3. The factor is primarily developed to capture the taxes as well as the uncollectible portion of revenues[4] that represent the difference between net operating income and net revenues.

Q. IS MS. GATELY CORRECT WHEN SHE SAYS IT IS NOT NECESSARY TO MAKE A DETERMINATION AS TO WHETHER THE REVENUE FACTOR APPLIES TO THIS OR NOT?

A. I'm unclear of her intent at this part of her surrebuttal testimony.[5] I believe she is still addressing the Yellow Pages imputation issue, although at line 21 she refers to it as the "imputed Directory Assistance revenues." The problem with this statement is that in order to include the directory imputation in such a composite calculation, it must be first be *reduced* to a net income number, if it is to be included in a composite gross up. It is incorrect to do it any other way.

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[4] There are actually no uncollectibles associated with a revenue imputation such as the Yellow Pages imputation, however, this issue has never been challenged by the Company.
[5] Gately surrebuttal, page 14, line 20-26

CONCLUSION

Q. PLEASE SUMMARIZE YOUR REJOINDER TESTIMONY.

A. Staff, RUCO and the DOD recommend an imputation of $41.3 million based on the presumptive level of $43 million less the $1.7 million in fees received from DEX. Although they maintain that the value of the relationship is at least as great as this, they provide no evidence. My supplemental testimony is the only testimony in this case that provides evidence of the value of the fees and the services provided by DEX to Qwest as required by the Settlement Agreement and the Arizona Court of Appeals. AT&T, on the hand, advocates an inaccurate calculation of the profits of DEX, which has been clearly rejected by the Appellate Court, and further recommends adding in an additional 70% to cover taxes, although AT&T's witnesses acknowledge that their base number is a pretax amount. The Commission should reject AT&T's proposal outright as well as the adjustments set forth by the Staff, RUCO and DOD on this issue. DEX pays Qwest fees for the all the services it receives from Qwest and the Publishing Agreement between DEX and Qwest provides a large and appropriate value to the Arizona ratepayers. Arizona ratepayers benefit from the relationship between DEX and Qwest in the same way that ratepayers of other Local Exchange Carriers benefit from Publishing

Agreements between their LEC and the official publisher, whether that official publisher is DEX or some other publisher.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

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 REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN	)	DOCKET NO. T-1051B-99-105 AFFIDAVIT OF ANN KOEHLER-CHRISTENSEN
STATE OF WASHINGTON	)	
COUNTY OF KING	)	
	)	SS

Ann Koehler-Christensen, of lawful age being first duly sworn, deposes and states:

1 My name is Ann Koehler-Christensen. I am a Finance Analyst in the Regulatory Finance Department of Qwest Corporation in Seattle, Washington.

2 Attached hereto and made a part hereof for all purposes is my testimony.

3 I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct tot the best of my knowledge and belief

Ann Koehler-Christensen

SUBSCRIBED AND SWORN to before me this 18th day of September, 2000.

Elizabeth M. Weber
Notary Public

My Commission Expires:

09/15/02

EXHIBIT
Q-37
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 RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES	)	DOCKET NO. T-01051B-99-0105

REJOINDER TESTIMONY OF

SCOTT A. MCINTYRE

QWEST CORPORATION

SEPTEMBER 19, 2000

REJOINDER TESTIMONY OF SCOTT A MCINTYRE

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IDENTIFICATION OF WITNESS

Q. PLEASE STATE YOUR NAME, OCCUPATION, AND PLACE OF EMPLOYMENT.

A. My name is Scott A. McIntyre. I work for Qwest Corporation ("Qwest", or "Company") (formerly known as U S WEST Communications, Inc. My title is Director – Product and Market Issues. My responsibilities include developing markets and prices strategies for Qwest and supporting these positions in the regulatory arena. My business address is 1600 7th Avenue, Room 3009, Seattle, Washington 98191.

Q. ARE YOU THE SAME SCOTT A. MCINTYRE WHO FILED SUPPLEMENTAL AND REBUTTAL TESTIMONY IN THIS CASE?

A. Yes, I am.

PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR REJOINDER TESTIMONY?

A. My rejoinder testimony will respond to the surrebuttal testimony of AT&T's Arleen Starr, William Dunkel for the Commission Staff, and Michael J. Ileo, Ph.D., representing the Arizona Payphone Association. These witnesses have submitted testimony in response to my rebuttal testimony on issues concerning switched access, private line, and public access line (PAL) services. While I have already stated my position in previous testimony, these witnesses have made statements I need to address.

REPLY TO ARLEEN M. STARR

Q. MS. STARR TAKES ISSUE WITH YOUR ASSERTION THAT DS1 PRIVATE LINE IS A REASONABLE ALTERNATIVE TO SWITCHED ACCESS. DOES SHE ADDRESS YOUR ASSERTION HEAD ON?

A. No. She attempts to challenge my position by redirecting the focus to residential customers instead of the business market I addressed in my rebuttal testimony. Clearly, DS1 is primarily a business alternative that effectively reduces the average switched access rates AT&T pays. By reducing the average effective rate, AT&T can offer end-user customers long distance plans that are far below the theoretical rates driven by switched access pricing.

Q. DOES MS. STARR SUPPORT YOUR POINT ON THIS BYPASS ISSUE?

A. Yes, actually she does. She states, "I think Mr. McIntyre very clearly demonstrates that if DS1 private line service for $250 per month was (sic) a realistic alternative to switched access, IXCs would not choose to pay $11,000 for switched access instead." This pretty clearly makes my point. I cannot imagine a carrier paying the $11,000 for switched access, when all they have to do (at minimum) is place an order for a DS1 from any of several providers.

Q. MS. STARR STATES THAT THE PROPOSED INTRASTATE ENTRANCE FACILITY RATES FOR DS1 AND DS3 ARE DIFFERENT THAN THOSE IN THE FCC TARIFF. CAN YOU EXPLAIN WHY THIS IS TRUE?

A. Yes. When this case was originally filed, in January 1999 Qwest did plan to make these rates consistent with FCC rates. Since that time, there have been two annual adjustments to FCC rates and it is the most current FCC annual adjustment that Ms. Starr compares with our original proposal. The rates proposed now align with FCC private line prices for DS1 and DS3, and no longer match switched access entrance facilities. Qwest attempts to keep these rates in line because they are substitutable services, but jurisdictional differences make this difficult. This is one of the key reasons Qwest proposed to deregulate high capacity services in Arizona. If these services were deregulated, it would be far easier to prevent pricing differences due only to jurisdictional constraints. While Qwest does have pricing flexibility for these services, this is a rate case and these services are still regulated. This means, to demonstrate revenue impacts, we must propose rates and changes to rates and calculate the annualized impact. In a constantly changing regulated environment, where rate changes take years to accomplish, it is not surprising that we have a pricing difference at any given moment.

Q. MS. STARR FINDS IRONY WITH THE FACT THAT QWEST IS PROPOSING TO RAISE PRICES IN A MARKET YOU CLAIM IS COMPETITIVE AND SUBSTITUTABLE FOR SWITCHED ACCESS. DO YOU FIND IT IRONIC?

A Hardly. As a substitute for switched access, private line services provide such an economic advantage that modest price changes have very little impact. Qwest offers these services across many jurisdictions and we try to keep pricing consistent. Many of our customers purchase service in many states and also through FCC tariffs. Sometimes these rates need adjustment, both up and down

to maintain consistency. The proposed pricing originally was intended to match the FCC rates, as describe above. In addition, the rates proposed are the month to month rates for these services. There are several pricing plans available at rates below the ones listed. Fluctuations, both up and down are common in competitive markets and Qwest's proposal in this case is hardly unusual. The analog private line prices need to be increased because several elements are below costs. This is by far the most significant increase proposed by Qwest and even Mr. Dunkel, supports such an increase.

REPLY TO WILLIAM DUNKEL

Q. MR. DUNKEL SEEMS TO BELIEVE THAT LOWERING SWITCHED ACCESS RATES DISCOURAGES COMPETITION. WOULD YOU LIKE TO COMMENT?

A. Yes. Mr. Dunkel seems to think lowering the margin on switched access discourages competition by making this service less profitable.[1] AT&T claims lowering switched access rates encourages competition. In theory at least, Mr. Dunkel is closer to correct than is AT&T, but both are mainly using this as an argument to support their respective positions. Much of the competition in the switched access market has to do with bypass. As I have discussed in my rebuttal testimony, the price differences between switched access and private line bypass are huge. A DS1 private line for $250 per month is an easy choice over $11,000 worth of switched access. While lowering switched access rates by converting the carrier common line (CCL) charge to an explicit subsidy may

[1] Dunkel surrebuttal, page 32, lines 18-21

change this picture a little, but it has no significant impact on those competitors building bypass networks.

Q. WHAT IS THE COROLLARY TO MR. DUNKEL'S POSITION ON COMPETITION?

A. The corollary is that if, (and this is a big if) lowering margins in switched access discourages competition in the access market, then raising margins (by raising prices) for local exchange services must encourage competition in that market. Keeping local exchange rates low discourages competition in that area. This is one of the key benefits to eliminating implicit subsidies. Implicit subsidies hide the true economics of providing service and stifle competition in markets where it would normally develop.

Q. MR. DUNKEL STATES THAT YOU HAVE OBJECTED TO THE "FORM" OF BILLING FOR THE CCL. HE SUGGESTS THAT CHANGING THE FORM OF THE CHARGE RATHER THAN WHO PAYS THE CHARGE, MIGHT BE ACCEPTABLE. IS THIS REASONABLE?

A. By itself, a change in the form of the charge wouldn't accomplish anything. Mr. Dunkel is referring to my concern over two facets of the CCL charge. One is that the CCL is charged on a per minute basis (form) and the second is that carriers pay it. The CCL has traditionally been considered as revenue support that helps keep local exchange rates low. Charging for CCL on a per minute basis hides the true nature of the revenue support for local exchange service which is charged on a per line basis. This creates an implicit subsidy, supported by toll customers. This also encourages uneconomic bypass of switched access. This

is my concern over the "form" of the charge. My concerns over the fact that carriers pay this charge are basically the same. Making carriers pay, and then pass along to customers, rates intended to support local exchange service hides the true nature of the revenue support and this too, is why it is an implicit subsidy. In addition, it also encourages uneconomic bypass. If you want to rebalance rates to reduce or eliminate the revenue support provided by the CCL charge, you must address where this revenue will be recovered. After you decide where it will be recovered, you can determine what form is appropriate. There are many services that may be affected by this type of rate re-balancing.

Q. MR. DUNKEL CLAIMS YOU HAVE MIS-STATED HIS TESTIMONY CONCERNING THE SUSTAINABILITY OF THE PRIVATE LINE REVENUE REQUIREMENT HE HAS SUGGESTED. DO YOU BELIEVE THE LEVEL HE HAS SUGGESTED IS SUSTAINABLE?

A. No. If we were to price at the $70 million revenue level, as he suggests, we would surely lose significant market share.

Q. HAS MR. DUNKEL STATED THAT ANY SHORTFALL OF THIS REVENUE REQUIREMENT SHOULD NOT BE MADE UP BY ANY OTHER PRODUCT?

A. Yes. Mr. Dunkel stated in his direct and in his rebuttal testimony, "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."

Q. IN YOUR OPINION, HAS MR. DUNKEL RECOMMENDED THAT QWEST BE ASSIGNED A REVENUE REQUIREMENT THAT IS NOT ATTAINABLE?

A. Yes.

Q. MR. DUNKEL TAKES ISSUE WITH YOUR EXAMPLE OF HOW CUSTOMERS GENERATING MORE THAN $250 PER MONTH IN TOLL ARE TARGETS FOR BYPASS USING PRIVATE LINES. WOULD YOU COMMENT ON HIS ASSERTIONS?

A. In my rebuttal testimony, I stated that an average DS1 is priced at about $250 per month and suggested this, as a means of bypassing switched access. There are certainly such circuits priced much less than this, depending on the specific circuit configuration. I also stated that customers generating **more** than $250 in toll are target customers for such bypass. I agree that this private line charge is only one element of the total cost of toll services. However, from a marketing perspective, this is a good place to start looking at specific customers for bypass opportunities. Customers that generate this level of toll revenue receive toll calls as well. Once such a private line circuit is established the carrier also bypasses terminating switched access charges. This means that while the originating toll may establish a revenue threshold, carriers save switched access costs for both originating and terminating traffic. Compared to the possible $11,000 in switched access rates that might be bypassed by using such private lines, this seems to be a pretty reasonable marketing approach.

REPLY TO MICHAEL J. ILEO, PH.D.

Q. MICHAEL J. ILEO, PH.D. FILED SURREBUTTAL TESTIMONY ON BEHALF OF THE ARIZONA PAYPHONE ASSOCIATION. DO YOU WISH TO REPLY TO HIS TESTIMONY?

A. Yes. I will try to boil Dr. Ileo's testimony down to a few key issues. Dr. William E. Taylor and Jerrold H. Thompson will also make reply remarks in their rejoinder testimony.

Q. ARE THERE ISSUES IN DR. ILEO'S TESTIMONY THAT YOU WOULD LIKE TO ADDRESS?

A. Yes. I will focus on three key points of Dr. Ileo's testimony.

Q. WHAT IS THE FIRST POINT OF DISCUSSION?

A. The first issue is the new services test. Despite Dr. Ileo's protestations, there are two key factors in this discussion. The first is that this Commission has found in the past, that both the current and proposed rates for PAL services are reasonable. The second is that the FCC has found that rates as high as 4.8 times the relevant cost were also reasonable in the context of the new services test. Qwest's rates, both existing and proposed, fall well within this range. As a result, there is no evidence at all to suggest these rates are not reasonable. The new services test requires services to be above cost (to prevent subsidization by other services) and to contain a reasonable contribution.

Q. WHAT IS THE SECOND ISSUE?

A. The second issue is the topic of subsidy as it applies to payphone services. In this case Dr. Ileo simply misrepresents section 276 of the telecommunications act. As quoted by Dr. Ileo [2], the Act states "any Bell operating company that provides payphone service – (1) shall not subsidize its payphone service directly or indirectly from it telephone exchange service operations or its exchange access operation." This refers to "payphone service" not PAL. Payphone service is defined in the Act as "the provision of public or semi-public pay telephones, the provision of inmate telephone service in correctional institutions, and any ancillary services." This is **not** Public Access Line service at all. PAL service is an access line, not a "payphone service". Payphone service is provided by the members of the APA, other payphone providers, and by a separate division of Qwest.

Even though section 276 of the Act does not apply to PAL service, Dr. Ileo has even misrepresented the subsidy issue as it relates to payphone service. The Act says a company cannot subsidize its payphone operation with other profits. It does not say its payphone service cannot subsidize other operations. This is only a one way restriction. While Dr. Ileo may claim that payphone service must be "subsidy free; i.e., contain neither subsidies from or to other telecommunications services of ILECs[3] the Act does not support this statement at all.

Q. WHAT IS THE THIRD ISSUE RAISED BY DR. ILEO THAT REQUIRES A REPLY?

[2] Dr. Ileo surrebuttal, page 21, lines 21-23
[3] Dr. Ileo surrebuttal, page 19, lines 19-22

A. Dr. Ileo brings up the issue of wholesale versus retail in distinguishing between PAL rates and business exchange rates. In the telecommunications business, the terms wholesale and retail do not fit well with many services provided. Most services must be made available, at any location desired, on the same terms and conditions, regardless of the purchaser. In this sense, business exchange services and PAL services offer very similar functionality. PAL services do offer slightly higher functionality than do business exchange services, but the differences are relatively small, considering that the largest portion of the cost for these services is the network facility. Qwest offers many services where the "wholesale" prices and the "retail" prices are exactly the same. Take the example of private line service. Interexchange carriers are large purchasers of these services and they resell these services to their customers. "Retail" business customers also purchase these services under the same terms and conditions, for the exact same prices. For Qwest to offer these same services, providing the same functionality, at different prices to different classes of customers, would be considered discriminatory.

There are circumstances where regulatory commissions have ordered certain services to be offered at discounted prices to resellers. This is a way of offering a "wholesale" price to resellers of a "retail" service. In Arizona, this discounting process applies to PAL services, which are considered to be "retail" offerings. Competitive Local Exchange Providers (CLEC's) can purchase PAL services at a discount, for resale in providing payphone service. If PAL services were redefined as wholesale, this discount would no longer be required, even if the prices were the same.

Q. HAS THE ARIZONA PAYPHONE ASSOCIATION (APA) MADE PREVIOUS CLAIMS AS TO THE WHOLESALE OR RETAIL NATURE OF PAL SERVICE?

A. Yes. On March 18, 1998, the APA filed with the Commission a Motion for Clarification of Decision No.60635, dated January 30, 1998. In its motion, the APA requested that the Commission clarify that PALs are in fact business lines and subject to resale discounts.

Q. DID THE COMMISSION CONCUR WITH THE APA ON THIS ISSUE?

A. Yes. The Commission's order states; "We concur with the APA and Staff. Pursuant to Section 251 (c)(4), U S West must "offer for resale at wholesale rates any telecommunication service that the carrier provides at retail rates to subscribers who are not telecommunications carriers"."

Q. WHAT THEN IS THE RETAIL RATE AND WHAT IS THE WHOLESALE RATE?

A. The retail rate is the current tariffed rate and is available to subscribers that are not telecommunications carriers (CLECs). The wholesale rate is this same rate discounted by the resale business discount, established by the Commission. This discounted wholesale rate is available to CLECs.

Q. ARE MEMBERS OF THE APA AS REPRESENTED BY DR. ILEO CLECS?

A. I don't know, but those that are, are eligible to purchase PAL circuits at discounted "wholesale" prices and those that are not must purchase at "retail" rates.

Q. DR. ILEO PLACES SOME EMPHASIS ON THE RECENT DECISION BY THE ARIZONA COURT OF APPEALS IN CONFIRMING COMMISSION DECISION NO. 61304. WOULD YOU CARE TO COMMENT ON THIS?

A. Yes. Qwest has filed for reconsideration of this decision by the appeals court. There appear to be portions of the decision that are inconsistent with what I understand about the telecommunications act and the new services test. I will refrain from further comments pending resolution of Qwest's appeal.

Q. DR. ILEO CLAIMS YOU DISAGREE WITH THE COMMISSION, THE COURT AND HIMSELF WITH THE STATEMENT THAT PAL PRICING SHOULD INCLUDE DIRECT COST AND A REASONABLE PORTION OF COMMON COST. DO YOU IN FACT, DISAGREE WITH THIS STATEMENT?

A. Absolutely not. It appears that our disagreement focuses on the definition of "reasonable". I would like to add, however, that in determining what is reasonable; there are other constraints that are constantly dealt with in a regulated environment. These issues involve the public policy concerns of discrimination, network efficiency, and support for universal service. In an industry shifting from monopoly to competition, these factors affect the pricing of many services and there is still a need to balance these concerns.

Q. DOES THIS CONCLUDE YOUR REJOINDER TESTIMONY?

A. Yes, it does.

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF QWEST CORPORATION (FORMERLY KNOWN AS 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 APPPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN.	)	**DOCKET NO. T-1051B-99-105** **AFFIDAVIT OF SCOTT A. MCINTYRE**
STATE OF WASHINGTON	)	**ss**
COUNTY OF KING	)	

Scott A. McIntyre, of lawful age being first duly sworn, deposes and states:

1. My name is Scott A. McIntyre. I am Director – Product and Market Issues, of Qwest Corporation (formerly known as U S WEST Communications, Inc.) in Seattle, Washington. I have caused to be filed written testimony in support of USWC in Docket No. T-01051B-99-0105

2. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct to the best of my knowledge and belief.

Further affiant sayeth not.

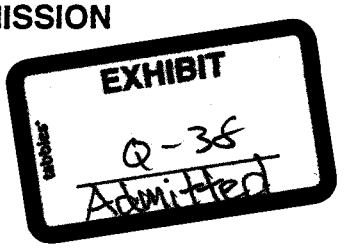
Scott A. McIntyre

SUBSCRIBED AND SWORN to before me this 12 th day of September, 2000.

Notary Public residing at
Seattle, Washington.

My Commission Expires: 09/15/02

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-01051B-99-105

REJOINDER TESTIMONY OF

WILLIAM E. TAYLOR, Ph.D.

SENIOR VICE PRESIDENT
NATIONAL ECONOMIC RESEARCH ASSOCIATES, INC.

ON BEHALF OF

QWEST CORPORATION

September 19, 2000

n/e/r/a
Consulting Economists

REJOINDER TESTIMONY OF WILLIAM E. TAYLOR, Ph.D.

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INTRODUCTION AND PURPOSE

Q. PLEASE STATE YOUR NAME, OCCUPATION, AND BUSINESS ADDRESS.

A. My name is William E. Taylor. I am Senior Vice President of National Economic Research Associates, Inc. ("NERA"), head of its Communications Practice, and head of its Cambridge office located at One Main Street, Cambridge, Massachusetts 02142.

Q. HAVE YOU FILED TESTIMONY PREVIOUSLY IN THIS PROCEEDING?

A. Yes, I filed rebuttal testimony on behalf of Qwest Corporation on August 21, 2000.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I have been asked by Qwest Corporation ("Qwest") to respond to the economic surrebuttal testimony filed by other parties on September 8, 2000 regarding the five issues I had addressed in rebuttal testimony, filed on August 21, 2000. These five issues were:

1. A price cap regulation plan for Qwest proposed by the Staff of the Arizona Corporation Commission ("Staff").
2. Treatment of loop costs as joint costs of telecommunications services in testimonies sponsored by the Staff and the State of Arizona Residential Utilities Consumer Office ("RUCO").
3. Whether pricing carrier access service above incremental cost is anti-competitive as alleged by AT&T.
4. Whether Qwest's proposed competitive zone pricing flexibility plan inadequately protects customers as claimed by Staff, RUCO, AT&T Communications of the Mountain States ("AT&T") and Cox Arizona Telcom ("Cox").
5. Whether prices for payphone access lines should be set at forward-looking economic cost as asserted by the Arizona Payphone Association ("APA").

My rejoinder testimony responds specifically to Mr. Harry M. Shooshan III (representing Staff on the price cap regulation plan), Dr. Ben Johnson and Mr. William Dunkel (representing RUCO and Staff, respectively, on the treatment of loop costs and Qwest's competitive zone proposal), Dr. Lee Selwyn (representing AT&T on Qwest's competitive zone proposal), Dr. Francis R. Collins (representing Cox on Qwest's competitive zone proposal), Ms. Arleen M. Starr (representing AT&T on the pricing of carrier access service), and Dr. Michael J. Ileo (representing APA on payphone issues).

STAFF'S PRICE CAP PLAN FOR QWEST

Q. TO WHAT ISSUES REGARDING THE PRICE CAP PROPOSALS OF THE STAFF AND QWEST ARE YOU RESPONDING?

A. I am responding to some of the issues raised in Mr. Shooshan's surrebuttal testimony, particularly (1) the degree to which Staff's proposed price cap plan permits rate rebalancing, (2) the use of a "full-blown" total factor productivity ("TFP") study to determine the productivity factor in the plan, (3) Mr. Shooshan's analysis of the Qwest productivity data, (4) the use of company-specific rather than industry-wide data, (5) the use of intrastate (separated) data, (6) the need for a service quality adjustment in the price cap formula, and (7) Mr. Shooshan's mischaracterization of the Qwest price cap proposal for its Basket 1 as a revenue cap with no mechanism for flowing through productivity gains.

Staff's Plan Permits No Additional Pricing Flexibility for Qwest

Q. MR. SHOOSHAN CLAIMS [AT 5] THAT, CONTRARY TO THE CLAIM IN YOUR REBUTTAL TESTIMONY [AT 9], STAFF'S PLAN PERMITS QWEST TO RECOVER ITS FIXED LOOP COSTS OVER A WIDER RANGE OF SERVICE AND OFFERINGS. IS THIS AN ACCURATE CHARACTERIZATION OF YOUR TESTIMONY?

A. No. My Rebuttal Testimony [at 9] addresses Staff's *price cap plan* and criticizes the structure of that plan because "(b)y isolating carrier access services in Basket Two, Mr. Shooshan's current plan specifically *prevents* recovery of fixed loop costs over a wider range of services." That is, Staff's proposed plan prevents rate rebalancing through the price cap mechanism because the pricing flexibility that price cap regulation provides—raise or lower prices within a basket without any constraint as long as the average price for the basket meets the price cap—cannot be used to reduce carrier access charges or increase residential basic exchange rates. That is, there is no mechanism in Staff's proposed plan to reduce the implicit subsidy to residential basic exchange service by reducing the contribution contained in carrier access charges.

Q. SPECIFICALLY, WHAT "WIDER RANGE OF SERVICES AND OFFERINGS" FOR RECOVERING FIXED LOOP COSTS DOES MR. SHOOSHAN CONTEND IS PROVIDED BY THE STAFF'S PLAN?

A. Mr. Shooshan loosely refers [at 5] to rate rebalancing by offering new services and packaged services. However, Staff's Plan contains no *additional* ability (even of the type cited by Mr. Shooshan) to recover loop costs. Specifically, he states

> Under the Staff Plan, Qwest has the ability to rebalance by taking advantage of (1) retail pricing flexibility for services in Basket 3 (including new services and service packages); and (2) the same service packaging freedom as is afforded their competitors.

However, services in Basket 3 have already been classified as competitive and are currently subject to pricing flexibility. The only *additional* pricing flexibility potentially offered in Staff's Plan is that provided by the structure of price caps, i.e., the ability to raise and lower prices within a basket. But the basket structure and pricing rules proposed by Staff rule out that source of additional flexibility.

Indeed, applying Staff's proposed price cap adjustment formula would only make things worse. With a productivity factor of 4.2 percent and an expected inflation rate between 2 and 3 percent, the price cap formula would require that prices in Basket 1 fall, on average, by 1 or 2 percent each year. Because residential basic exchange service is such a large component of that basket (measured by revenue), it would be difficult to meet the required average price reduction without reducing residential basic exchange rates even further below cost. Requiring price reductions for services already priced below cost is the opposite of "providing a wider range of services and options" to recover fixed loop costs.

Q. MR. SHOOSHAN CLAIMS [AT 5] THAT YOU ASSERT THAT "UNDER THE STAFF PLAN, NO RATES IN BASKET 1 COULD BE INCREASED....[TAYLOR AT 6,7]." DO YOU MAKE THAT ASSERTION?

A. No. The only reference to rates in Basket 1 on pages 6-7 of my testimony says:

> The Staff's plan explicitly prevents increases in residential basic exchange prices through its "hard cap" on all basic exchange service prices in Basket One.

which I believe to be a correct statement about Staff's Plan. I can find no other reference in my testimony to pricing rules for Basket 1.

Q. MR. SHOOSHAN CLAIMS [AT 6] THAT "PRICES FOR SOME SERVICES IN BASKET 1 (E.G., EXISTING SERVICE PACKAGES) COULD BE INCREASED...." DO YOU AGREE?

A. I agree in theory, but not in practice. In practice, under Staff's Plan, rates in Basket 1 will have to fall, on average, by 1 or 2 percent per year. Because revenue from residential basic exchange services is a large fraction of the revenue in that basket—and because reducing prices of services already priced below cost is unprofitable for the firm and bad policy for customers and competitors—it would be difficult for Qwest to meet its average price reduction for Basket 1. For example, if revenue from basic residential exchange services were 50 percent of the revenues in Basket 1, prices of the remaining services in Basket 1 would have to fall by 2 to 4 percent per year to prevent further reductions in residential basic rates. If prices of some other services or service packages were actually increased, even greater price reductions would be required for the remaining services in Basket 1.

Q. MR. SHOOSHAN STATES [AT 6] THAT "WHILE REASONABLE PEOPLE MIGHT DISAGREE ABOUT HOW MANY DEGREES OF FREEDOM TO GIVE QWEST UNDER THE CIRCUMSTANCES, I BELIEVE IT UNREASONABLE FOR DR. TAYLOR TO SUGGEST THAT THE STAFF PLAN 'RULES OUT ANY KIND OF RATE REBALANCING AS PART OF ITS PROPOSED REDUCTION IN CARRIER ACCESS CHARGES.'" IS YOUR SUGGESTION UNREASONABLE?

A. No, the suggestion cited by Mr. Shooshan is precisely correct. Staff's Plan requires 20 percent annual reductions in intrastate carrier access charges. Nowhere in Staff's Plan is that rate reduction offset by an ability to increase a rate, i.e., to rate rebalance. Prices of other services in Basket 2 are frozen, and carrier access charge reductions do not trigger offsetting price increases in Basket 2. Prices of services in Basket 1 must be reduced under Staff's Plan (in real terms by 4.2 percent annually), and the reduction in carrier access charges in Basket 2 in no way affects this requirement on prices in Basket 1. Pricing rules for services in Basket 3 are unchanged under Staff's Plan, and no *additional* ability to raise rates or package services to offset carrier access reductions is proposed in Basket 3 as part of Staff's Plan. Thus, my comment is correct that, *as part of its proposed reduction in carrier access charges*, Staff's Plan rules out any kind of rate rebalancing.

Staff's Proposed Productivity Offset is Calculated Incorrectly

Q. MR. SHOOSHAN ASSERTS [AT 7-9] THAT IT IS "APPROPRIATE" TO USE HISTORICAL DATA FROM 1995-1998 TO ESTABLISH A PRODUCTIVITY TARGET FOR THE PRICE CAP PLAN. ARE HIS REASONS VALID?

A. Not in my opinion. Mr. Shooshan gives two reasons [at 7] for the period he selects: (1) data should follow Qwest's most recent rate case so revenue changes would better track output changes and (2) data before the 1993 rate case reflects a different industry structure. The first reason is irrelevant because the revenue data used by Mr. Shooshan is adjusted for price changes. The second is specious: obviously any historical period differs in many ways from the future. The important question is: differs in what respect? Mr. Shooshan claims that more recent data "are best able to predict the future growth in Qwest's output," but that is not what we are asking the data to do. Rather, at any point in time, a productivity study measures the difference in rates of change in outputs and inputs, and there is no reason to suppose that including or excluding any particular year of data would result in a more accurate estimate. Indeed, historical estimates of U.S. productivity growth and productivity growth for the telecommunications industry show generally that productivity growth measured over long periods of time (e.g. 10 year intervals) is reasonably stable.

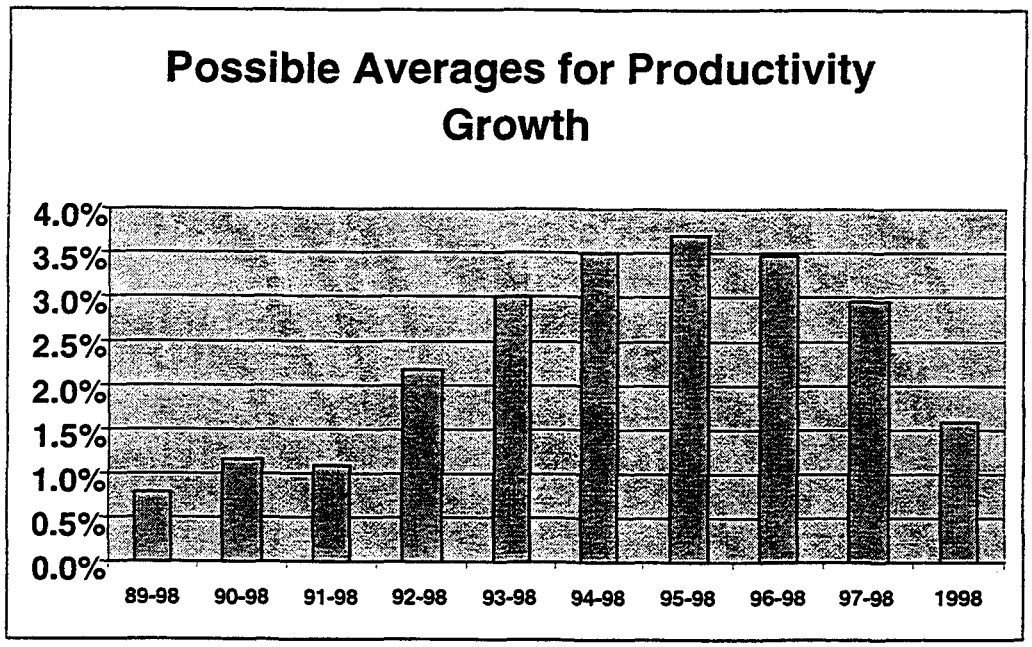
Q. IF MR. SHOOSHAN'S REASONS ARE INVALID, HOW SHOULD THE COMMISSION DECIDE OVER WHICH TIME PERIOD TO CALCULATE AN HISTORICAL PRODUCTIVITY TARGET?

A. Generally speaking, when historical data have been used to establish a productivity target for a price cap plan, analysts have examined the largest relevant set of data possible because productivity and price data are quite volatile from year to year. Most analysts would agree that an important feature of their analysis would be robustness or stability. It makes no sense to set a productivity target using data for some short period if a small change in the period used (adding or dropping a year) gives rise to a large change in the target. A target set in that manner would certainly be arbitrary, since there is no hard and fast rule that tells the Commission precisely which historical period is or is not relevant to future productivity growth.

Q. GIVEN THE DATA HE USED, IS MR. SHOOSHAN'S CALCULATION OF A PRODUCTIVITY FACTOR OF 3.7 PERCENT ROBUST?

A. Not at all. His calculation of the productivity offset is extremely sensitive to the time period he selects. If, as Mr. Shooshan claims [at 7], "the most recent data" are best, then the answer would be 1.6 percent (the value for 1998), not 3.7 percent. If all available data were used, i.e., the average for 1989 through 1998, the answer would be 0.8 percent. The range of possible choices of a productivity factor implied by the data used by Mr. Shooshan is shown below. Each bar corresponds to an average of the productivity data over different periods of time, starting with the most recent 1998 observation. The bar for 1998 is the average for 1998, the

bar for 1997-1998 is the average productivity change between 1997 and 1998, and the bar for 1989-1998 is the average productivity change over the 1989- 1998 period. It should be clear from the chart below that the average selected by Mr. Shooshan is by no means representative of the data; instead, it represents an average over the period which gives the largest possible average productivity growth.



Q. MR. SHOOSHAN JUSTIFIES [AT 9] HIS USE OF DEFLATED REVENUES AND COSTS TO MEASURE TFP BECAUSE A TFP STUDY IS EXPENSIVE, COMPLEX, AND UNNECESSARY. DO YOU AGREE?

A. No. I agree that it is *not* necessary to use a TFP study to set a productivity factor in a price cap plan. However, basing the productivity factor on a rough approximation to TFP growth makes no sense: there are better alternatives that make fewer

demands on the data. For example, the most direct and relevant measure of the historical performance of a firm or industry is its real rate of change of output prices. After all, the measurement is being used to determine a reasonable target for the *future* real rate of growth of output prices (inflation less X); a very reasonable way to determine a reasonable target is to look at the historical real rate of growth of output prices.

Q. MR. SHOOSHAN STATES [AT 8] THAT NO SINGLE METHOD (INDUSTRY-WIDE OR COMPANY-SPECIFIC) IS USED UNIFORMLY ACROSS THE U.S. TO SET THE PRODUCTIVITY TARGET. DO YOU AGREE?

A. I agree that state and federal regulatory authorities use different methods to set the productivity target in telecommunications price cap plans. I disagree with the implication his statement carries because, to my knowledge, very few state or federal price cap plans base their productivity offsets on measures of *company-specific* productivity growth. That is because any plan of that nature would likely distort the regulated company's incentive to increase productivity growth. In theory, a five-year price cap plan based on company-specific productivity growth amounts to cost-of-service regulation with a five-year lag. For that reason, California and the FCC, for example, explicitly acknowledge the distortion in

1 incentives when company-specific productivity measures are used and base their
2 productivity factors on industry-wide data.[1]

3 **Q. DO YOU AGREE WITH MR. SHOOSHAN'S ASSESSMENT [AT 9] THAT HIS**
4 **"METHODS AND DATA WERE REASONABLY APPLIED IN THIS**
5 **PROCEEDING?"**

6 A. No. Even if Mr. Shooshan had analyzed his data correctly, his application of the
7 data would remain incorrect. First, the data purport to apply to Qwest's intrastate
8 services, and, if Mr. Shooshan were correct, would suggest that Qwest
9 experienced an annual reduction in unit costs of 3.7 percent for those services,
10 hence justifying a 4.2 percent annual reduction in prices for those services as a
11 reasonable target. But, that isn't the target in Staff's Plan. The Staff Plan requires
12 a 4.2 percent annual reduction in prices for Basket 1 services *and* a 20 percent
13 annual reduction in carrier access prices in Basket 2. In total, the productivity
14 target actually used in Staff's Plan is not consistent with the data used to set the
15 target.

[1] California Public Utilities Commission, *Decision 89-10-031*, October 12, 1989, Finding of Fact 47: "A productivity adjustment based on information outside the company's control would provide strong incentives for efficient operations...." FCC, CC Docket No. 94-1, *First Report and Order,* April 7, 1995, at ¶146: "The current X-factor embodies our original assessment of the extent to which the productivity of the LEC industry as a whole has, in the past, exceeded the productivity of the general economy. This use of an industry-wide average productivity factor is consistent with our goal of creating a price regulation plan that replicates the incentives provided by competition. The LECs are, in effect, made to compete against the industry average. As in competitive markets, those that are more efficient and more innovative than average can achieve above average profits, while those that lag the industry in performance will also lag in earnings..."

1 Second, Mr. Shooshan applies the wrong formula in using productivity
2 growth to set an X—the productivity offset—in a price cap plan. As I showed in my
3 Rebuttal Testimony [at 11], by ignoring U.S. productivity growth, his method
4 *overstates* the value of X that should be used in a price cap plan, even assuming
5 that his measure of historical productivity growth is correct. Unlike some issues
6 under discussion, this point is not controversial,[2] and no one in this proceeding
7 (including Mr. Shooshan) has disagreed with it.

8 Third, the use of unseparated intrastate data to measure firm productivity
9 growth is incorrect. Unless the production process is separable, there is no well-
10 defined measure of productivity growth for subsets of services of the firm. And
11 since common facilities are used pervasively to supply intrastate and interstate
12 services, the production process in telecommunications is manifestly *not*
13 separable. Practically speaking, it is easy to see that the concept of intrastate TFP
14 growth in Mr. Shooshan's Surrebuttal Testimony [at 9] makes no sense. Take a
15 simple example in which productivity growth is generated by technical progress
16 and new technology is introduced into the network when switches are replaced.
17 Switches will be replaced more rapidly when usage volumes increase, but it
18 doesn't matter for replacing the switch whether the usage in question is intrastate
19 or interstate. So an increase in intrastate usage will cause switches to be replaced
20 more rapidly which will cause unit costs for interstate services (as well as intrastate

[2] See fn. 1 above, where the FCC acknowledges that the X-factor measures the difference between LEC productivity growth and the productivity growth of the general economy.

services) to fall. In this example, there is no increase in interstate output but there is an increase in interstate inputs (as switches are replaced and separations sends some costs to the interstate jurisdiction). Hence, interstate TFP—as measured by Mr. Shooshan—will appear to fall, so that interstate unit costs (and interstate unit prices) should rise. But, in fact, productivity growth has increased and unit costs for both interstate and intrastate services have fallen, so that prices for both interstate and intrastate services will fall.

Service Quality

Q. MR. SHOOSHAN DEFENDS [AT 10] HIS INCLUSION OF A SERVICE QUALITY ELEMENT IN THE ANNUAL PRICE CAP ADJUSTMENT BECAUSE REGULATORS MUST CONTROL SERVICE QUALITY AS WELL AS PRICE. DO YOU AGREE?

A. Yes. However, the point of my Rebuttal Testimony [at 13] to which Mr. Shooshan refers is *not* that service quality regulation isn't required. Indeed, Qwest already has service quality standards with self-effectuating refunds and penalties in place which were set to provide proper incentives for Qwest to supply an efficient level of service quality. There is nothing about the introduction of price cap regulation which necessitates either (1) more stringent service quality rules or (2) a different structure of penalties.

Q. MR. SHOOSHAN JUSTIFIES [AT 11] THE ADDITIONAL PENALTY IN HIS PRICE CAP PROPOSAL BECAUSE IF HIS "SWORD OF DAMOCLES" HAS TO

BE USED, "CONSUMERS WILL AT LEAST BE ASSURED THAT THE PRICES THEY PAY WILL MORE CLOSELY MATCH THE QUALITY OF SERVICE THEY ARE RECEIVING." IS THIS REASONING CORRECT?

A. No. Under the existing system of refunds and penalties, customers who receive poor service pay only for poor service. Under Mr. Shooshan's proposal, if carrier access or interconnection customers receive poor service, his Sword of Damocles will fall, and customers in Basket 1 will receive larger price reductions than otherwise. There is absolutely *no* connection between the customers who receive poor service and the customers who receive the penalty. That is why I criticized—in my Rebuttal Testimony [at 14]—the inclusion of service quality factors in the price cap annual adjustment formula as "far too blunt an instrument."

Q. HOW SHOULD THE COMMISSION REGULATE SERVICE QUALITY FOR A FIRM UNDER PRICE CAP REGULATION?

A. In general, service quality rewards and penalties should be set so that the regulated firm would find it in its self-interest to meet each service quality standard. Given that such rewards and penalties are in place, an overall adjustment to the price cap formula based on service quality amounts to double counting and results in distorted incentives. If such rewards and penalties are not in place or are inadequate, the Commission should institute a proceeding to determine them; they are too important to set as a part of a price cap proceeding.

Service-specific and sometimes customer-specific rewards and penalties are generally a more accurate mechanism for service quality incentives than

1 changes in the price cap formula, which does not affect the actual price charged for
2 any particular service to any particular customer.

3 **Qwest's Proposed Price Cap Plan**

4 **Q. MR. SHOOSHAN SUGGESTS [AT FN. 15] THAT QWEST'S PROPOSED**
5 **TREATMENT OF BASKET 1 "CHOOSES NOT TO SPECIFY A PRODUCTIVITY**
6 **OFFSET AT ALL." IS THIS A CORRECT INTERPRETATION OF QWEST'S**
7 **PROPOSAL?**

8 A. No. Qwest's proposal has exactly the same *structure* as the one proposed by Mr.
9 Shooshan. The productivity offset specified in the Qwest plan is the rate of U.S.
10 inflation: a number expected to fall between 2 and 3 percent. To see this, note that
11 capping average prices in Basket 1 at the going-in rate for the duration of the Plan
12 is mathematically identical to requiring that average prices in that Basket meet a
13 price cap index set, in effect, at U.S. inflation rate minus U.S. inflation rate, i.e.,
14 zero. Thus, the Staff Plan and the Qwest proposal have exactly the same structure
15 and incentive properties: the difference is the Staff plan proposes a productivity
16 factor of 4.2 percent (which corresponds to a price cap annual adjustment of U.S.
17 inflation minus 4.2 percent) while the Qwest plan proposes a productivity factor
18 equal to inflation (which corresponds to a price cap annual adjustment of U.S.
19 inflation minus U.S. inflation, i.e., zero).

20 **Q. MR. SHOOSHAN CRITICIZES [AT 16] QWEST'S BASKET 1 PROPOSAL**
21 **BECAUSE "THE LACK OF AN 'INFLATION LESS PRODUCTIVITY" INDEX**

MECHANISM DENIES ARIZONA COMSUMERS THE DIRECT BENEFITS OF INCREASED EFFICIENCIES QWEST CAN BE EXPECTED TO ACHIEVE UNDER PRICE REGULATION." IS THIS CRITICISM VALID?

A. No. The Staff's proposal passes through increased efficiencies through its productivity offset of 4.2 percent. As I showed above, Qwest's proposal passes through increased efficiencies through its productivity offset equal to the future value of U.S. annual inflation. We can disagree on the appropriate amount of productivity growth the plan should pass through to consumers, but there should be no confusion that both plans pass through their respective productivity targets to Arizona consumers in exactly the same way.

TREATMENT OF QWEST'S LOOP COST

Cost Causation is Different from Cost Recovery

Q. MR. DUNKEL [AT 22] FAULTS YOUR APPARENT "MISUNDERSTANDING OF THE WAY THE TELECOMMUNICATIONS NETWORK IS ENGINEERED" FOR HAVING CONCLUDED THAT THE LOCAL LOOP IS NOT A SHARED FACILITY. DO YOU ACCEPT THAT THIS MAY HAVE HAPPENED?

A. No. How a network is engineered may be interesting, but it is irrelevant for determining who causes the cost of the local loop and how. Yes, the network is designed to facilitate the delivery of a number of telecommunications services (including those provided by other carriers) to the customer. But, that fact is irrelevant in determining the causal responsibility for the loop. If the customer does

not demand the loop to gain access to the network, and subsequently to various network services, then the network is placing its facilities in vain. Put another way, the carrier places its network facilities—including the multi-functional local loop—precisely because it believes that a customer may want to access the network and network services. The design issue is one of engineering efficiency, but no matter what design is eventually chosen and facilities placed, the bottom line aspiration of the carrier is to earn revenue (and a return to its entrepreneurship) by selling network access and network services to the customer. Therefore, it always comes back to the customer: the customer's decision to purchases access and services drives the carrier to place facilities and, in so doing, to incur cost. Cost causation runs from the customer to the carrier—the customer makes the economic decision that causes a cost to arise and the carrier fulfills the customer's need and incurs the cost on the customer's behalf. Therefore, regardless of whether the carrier places facilities *in anticipation of* or *in response to actual* demand, the cost arises because there is that demand (on the consumer side) and the cost is incurred initially by the carrier (on the supply side). The idea of setting a price for the local loop is for the consumer to compensate the supplier, regardless of how the loop, or the rest of the network, may have been designed.

Dr. Johnson [at 6] faults my understanding of cost causation for allegedly failing to realize that

> ... the cost of a local loop is incurred because someone—perhaps an aspiring subscriber in years past, perhaps a real estate developer or home builder, perhaps a phone company executive—made a decision to install loop plant along a particular route ... The decisions that lead to the act of installing these

> facilities can be seen as the proximate cause of the cost. Subsequently, if consumers don't decide to purchase telephone service, the plant will often sit idle; if they do decide to purchase service, it will be utilized. ... Thus, [Dr. Taylor's] assumption that the loop costs set forth in Qwest's studies can be directly traced to customer decisions to join the network is simply not valid. Most of these costs would continue, regardless of whether or not particular customers purchase telephone service.

Economics teaches us to connect the dots between the supplier (the carrier with the network) and the cost-causing customer. Where the carrier installs a loop in anticipation of demand, the carrier temporarily absorbs the cost but expects to recover it nonetheless from a customer. Whether the supplier temporarily holds the cost on the customer's behalf and the customer eventually assumes it, or the cost is recovered from the customer at the point of installation, is a distinction without a difference. The fact is that to supply adequate service to customers who demand it, carriers with networks to build must plan ahead and often install facilities they eventually hope to sell well before demand actually manifests itself. Cows are born and raised long before I demand my glass of milk. After all, if there were no customers, no network would be built. That, however, does not alter the manner that cost is ultimately caused—by a customer's decision, whether actual or anticipated. And, as Dr. Johnson seemingly accepts [at 6], that cost is pretty much the same in either situation.

Q. ARE YOU SAYING THEN THAT IT DOES NOT ULTIMATELY MATTER HOW, OR EVEN WHETHER, THE LOCAL LOOP IS USED BY THE CUSTOMER?

A. Yes, but only for determining who pays whom and how much for the loop (or network access service). The cost of an item cannot be partitioned or doled out to

1 different service providers irrespective of cost, depending on how many, or the type
2 of, uses to which that item is put. For example, suppose Tom decides to take the
3 loop only for the privilege of *receiving* calls, Dick takes it to both make and receive
4 local and toll calls, but Harry takes it to use a wide range of services. Under Mr.
5 Dunkel's logic, the cost of the loop would look very different for the three
6 customers; therefore, by that logic, different amounts should be recovered from
7 each customer. As absurd as that is, it gets even worse when one considers the
8 possibility that in some months Dick could use directory assistance or Harry could
9 make no calls at all. In other words, as customers vary their use of different
10 network services, the cost of the loop—as calculated by Mr. Dunkel—would vary as
11 well. Imagine Qwest, or any local exchange carrier that provisions the local loop as
12 part of residential basic exchange service trying to recover cost in accordance with
13 this customer-to-customer and month-to-month variation in the use of the loop. It is
14 pointless trying to recover the cost, not from customers but, instead, from the
15 carriers that provide services, because all that does is shift the source of recovery
16 but solves none of the accounting problems.

17 The difficulty of cost recovery is not, however, the central issue here. The
18 more important issue is what it would imply for economic efficiency to effect such
19 cost recovery by applying rates that reflect *average* usage of different customers.
20 A customer with above-average use relative to the rate being charged will over-
21 consume, while a customer with below-average use will pay too much for the

actual consumption. This, in fact, would amount to a subsidy of one class of customers by another, where none is needed.

None of these complications can arise when the cost of the loop is recognized as being what it is—the value of resources expended to provide a single physical facility. Since that cost can be determined fully and unambiguously, it can also be recovered directly from all customers, regardless of their actual usage of network services over time or their choice of service providers. Happily, the loop's cost is invariant to how it is used. The value of resources used to provide the loop does not change with the patterns of use associated with either of Tom, Dick, or Harry in the example above. As a result, a single and unique charge directly to the customer should be used to recover the cost of the loop while providing correct incentives for Tom, Dick and Harry.

Finally, whether the loop is eventually used by a customer (the point Dr. Johnson raises) may present a cost recovery issue, but it is fundamentally not a cost causation issue. That is, if the customer does not actually materialize—despite there being at least the promise of one which led to the carrier installing the loop in the first place—then the supplier does not get to recover that cost from the customer. That cost would be considered stranded if the loop proved to be non-fungible, i.e., could not be sold to some other customer instead. That fact, however, should have little bearing (if any) on the way the loop cost arises and is recovered when customers are actually served.

Q. DR. JOHNSON CONTENDS [AT 7] THAT QWEST'S OWN RATE PROPOSALS IGNORE COST PATTERNS BECAUSE PROPOSED RATES FOR CERTAIN SERVICES EXCEED THE COSTS THAT ARE ACTUALLY CAUSED FOR THEM. DO YOU AGREE WITH DR. JOHNSON'S DISCUSSION OF COST CAUSATION IN THIS CONTEXT?

A. No. All that cost causation does in this case is to identify a cost with a cost-causer, i.e., draw a connection between the economic decision that gives rise to a cost and the cost itself. The principle does *not*, however, say anything about how that cost should be recovered, i.e., what the level of price ought to be. Dr. Johnson's contention is irrelevant to the proper application of the cost causation principle.

Q. MR. DUNKEL ARGUES [AT 22] THAT LOOP FACILITIES WOULD CONTINUE TO BE REQUIRED EVEN IF ANY PARTICULAR SERVICE THAT USES IT WERE ELIMINATED. DOESN'T THAT PROVE THE LOOP IS A SHARED FACILITY?

A. No. There is no denying the fact that the local loop is required within a wireline network to deliver *any* wireline service. However, it is important—and should be obligatory in any serious analysis of this issue—to keep in view just *how* and *in what context* the local loop is provisioned. There is a long tradition in this country and elsewhere for the local loop or network access to be provided as a bundled element of basic exchange service. In order to gain access to the network, even if I were to make no subsequent *use* of it, I must first contact the local exchange carrier serving my area. Even then, I cannot sometimes order network access

1 service just by itself although I may wish (for whatever reasons) to only seek
2 access for the purpose of receiving, not making, calls. Instead, more than likely,
3 my local exchange carrier will offer me a choice of plans, all of which combine
4 network access with certain local usage services in some measure. Where local
5 measured service is available, customers can purchase pure network access,
6 unaccompanied by additional local exchange services. I could choose to subscribe
7 to additional optional services through the same carrier at that time, though I would
8 retain the option to sign up for those services at a later time. The essential fact
9 remains, however, that the only way I could avoid the cost of the loop is by
10 discontinuing residential basic exchange service from that local exchange carrier
11 altogether. I could not selectively drop the loop but continue to consume the other
12 services.

13 **Q. BUT, SUPPOSE (AS MR. DUNKEL ASKS US TO [AT 22]) THAT QWEST WERE**
14 **TO WITHDRAW ITS RESIDENTIAL BASIC EXCHANGE SERVICE, BUT NOT**
15 **THE LOOP OR ITS OTHER SERVICES. WOULDN'T THE LOOP STILL BE**
16 **NEEDED AND DOESN'T THAT MAKE THE LOOP A SHARED FACILITY?**

17 A. Absolutely not. Recognizing that the scenario is hypothetical, it is likely that Qwest
18 would sell the loop as part of a bundle with some other service, e.g., toll. If it were
19 to do so, Qwest's economically rational price for the *bundle* of the loop and toll
20 service would reflect the cost of that bundle. Thus, if AT&T or WorldCom—or any
21 carrier that only sells long distance service—were to also provide the loop facility

1 for delivering their service, each would have to devise a price that reflected the full
2 cost of the loop as well as of toll usage.
3 If the loop were really a shared facility, it would have to be considered
4 shared by both Qwest (its original provider) and all other carriers that provide
5 services over it. The pertinent *economic* point, however, is that the loop's cost
6 would still exist *even if* the other carriers did not provide any service over it.
7 Therefore, the loop cost should not be recovered from other carriers because it is a
8 cost specific to the provider of the loop even though other carriers may use it to
9 deliver their services.[3]

10 **Q. HOW SHOULD THE COMMISSION VIEW THIS DISAGREEMENT?**

11 A. There are really two facts that the Commission must consider. First, if Qwest were
12 to withdraw residential basic exchange *usage* service but not the loop, then the
13 loop would have to be provisioned with some other service.[4] The long tradition of
14 the loop being provided as part of basic exchange service probably comes from the

[3] See, e.g., Alfred E. Kahn and William B. Shew, "Current Issues in Telecommunications: Pricing," *Yale Journal on Regulation*, 4, 1987, at 191-256, and Steve G. Parsons, "Seven Years After Kahn and Shew: Lingering Myths on Costs and Pricing Telephone Service," *Yale Journal on Regulation*, 11, 1994, at 149-170.

[4] Dr. Johnson argues [at 16] that the loop cost would continue to be incurred even if "local service" were withdrawn. I do not disagree with this argument, provided that by "local service" he means what I have identified in my testimony as only the *usage* component of residential basic exchange service. If, as is unlikely in the real world, Qwest were to withdraw its residential basic exchange service *in total*, then the cost of every component of that service—including the local loop—would be avoided. However, that does not mean that the customer could not continue to receive network services from non-Qwest sources over loops provided by those sources. My argument is not that a loop is not needed to receive services other than residential basic exchange service, only that it would have to be someone else's loop to carry other services if Qwest were to withdraw its residential basic exchange service.

1 fact that telephone customers have, by and large, wished to have the ability at least
2 to make and receive *local* calls. Had that been true of some other service, say,
3 custom calling features, then the loop would likely have been provisioned along
4 with those features. In fact, now that loops can be unbundled, it has become
5 possible to get network access on a stand-alone basis. Regardless of how the
6 loop is provisioned—by itself or bundled with some usage service, the price of the
7 loop would not be parceled out.

8 Second, if the loop were provisioned not by Qwest, but some other carrier,
9 then the loop cost would most definitely be avoided by *Qwest*, although not by the
10 other carrier that actually provisions it. So, if Qwest discontinued basic exchange
11 service, and customers chose to obtain their loops from some other carrier, then
12 the cost of the loop would not disappear but it wouldn't be Qwest's to recover,
13 regardless of whether Qwest continued to provide other network services.

14 These two facts are sufficient for the Commission to conclude that the cost
15 of the loop is not a shared cost among the services that use the loop. If it were, the
16 Commission would have to require that Qwest recover its unbundled loops from
17 several different sources, not just the carrier that leases those loops from Qwest on
18 behalf of its customers. Mr. Dunkel's hypothetical scenario (and protestations
19 about "engineering facts") may obscure the issue, but it doesn't alter the implication
20 of the cost causation principle—that the loop cost is caused by the customer's
21 decision to gain access to the network. For this reason also, much of Mr. Dunkel's
22 testimony on this issue [especially at 24-30] has little support from economics.

The Shared Loop Cost View is Not Universally Held

Q. MR. DUNKEL CONTESTS [AT 23] YOUR CLAIM THAT THE VIEW THAT THE LOOP'S COST IS SHARED HAS BEEN DISCREDITED IN THE ECONOMICS LITERATURE. DO YOU ACCEPT HIS ALLEGATION THAT ECONOMISTS WHO HAVE REJECTED THE "SHARED COST" VIEW ARE NOT DISINTERESTED PARTIES?

A. No. The economics literature that explains why the cost of the loop is not a shared cost is not confined to the two articles cited by Mr. Dunkel, one by Alfred Kahn and William Shew, and the other by myself. This issue has been addressed mainly in litigation and regulatory proceedings (such as the present one), and it is, therefore, no surprise that economists who have pronounced on it have done so as expert witnesses for parties involved in those proceedings. However, not all economists who have rejected the "shared cost" view have been witnesses for local exchange carriers. For example, Professor John Mayo, testifying on behalf of AT&T, has rejected that view of the loop. Specifically, in a 1996 case, he disagreed with the notion of recouping the loop cost through an allocation mechanism, stating instead:

> It is well known in the economic analysis of the telecommunications industry that there is a well-defined demand for, and supply of, access to the telecommunications network. The costs of providing that access can, and should be borne by the consumers that cause these costs to be incurred." [5]

[5] Rebuttal Testimony of John W. Mayo, on behalf of AT&T, Maryland Public Service Commission Case No. 8715, March 14, 1996, at 9. See also Rebuttal Testimony of John W. Mayo, on behalf of AT&T, *In re: Investigation into NTS Cost Recovery, Phase I*, Florida Public Service Commission Docket No. 860984-TP, June 1, 1987.

1 Other economists sharing Mayo's view include several academic
2 economists like John T. Wenders of the University of Idaho, Lester D. Taylor of the
3 University of Arizona, Jean-Jacques Laffont of the Université des Sciences
4 Sociales de Toulouse and the Institut Universitaire de France, and Jean Tirole of
5 the Massachusetts Institute of Technology.[6] Apart from the articles referred to by
6 Mr. Dunkel, other papers of note on the issue of the loop cost are those by
7 Professor Alfred Kahn and Steve Parsons.[7]

8 Moreover, Mr. Dunkel is wrong to dismiss Professor Kahn's work as being
9 that of just another witness for local exchange carriers. As a non-economist, Mr.
10 Dunkel can be excused for failing to recognize that Professor Kahn has been for
11 many years one of the most eminent and respected scholars and experts on the
12 economics of regulated industries. His textbook, *The Economics of Regulation*,

[6] Professor Wenders has long been known in telecommunications circles as an expert on the economics of the industry, particularly after the publication of his book, *The Economics of Telecommunications: Theory and Policy*, Cambridge, MA: Ballinger, 1987. Professor Lester Taylor's book, Lester D. Taylor, *Telecommunications Demand in Theory and Practice*, Boston: Kluwer Academic Publishers, 1994, is widely acknowledged as being the foremost source of information about the demand for telecommunications services. His article, "Pricing of Telecommunications Services: Comment on Gabel and Kennet," *Review of Industrial Organization*, 8, 1993, at 15-19, is of particular note in the present context. Professors Laffont and Tirole have individually and together authored a large number of books and scholarly articles on industrial organization, the branch of economics that studies firm structure and market conduct, and the antitrust laws. Their most recent book, *Competition in Telecommunications*, Cambridge, MA: MIT Press, 2000, addresses several pertinent and current issues in telecommunications. See especially Ch. 5 for the view that the fixed cost of the loop should be recovered from the customer. Laffont and Tirole's book has drawn high praise from economists like Carl Shapiro, Richard Schmalensee, and William Baumol who have themselves written and testified extensively on telecommunications matters on behalf of a variety of telecommunications companies.

[7] Alfred E. Kahn, "Pricing of Telecommunications Services: A Comment," *Review of Industrial Organization*, 8, 1993, at 39-41; William E. Taylor, "Efficient Pricing of Telecommunications Services: The State of the Debate," *Review of Industrial Organization*, 8, 1993, at 21-37; and Steve G. Parsons, "Seven Years After Kahn and Shew: Lingering Myths on Costs and Pricing Telephone Service," *Yale Journal on Regulation*, 11, 1994, at 149-170.

has become a modern classic and is widely considered essential reading for all students of regulatory economics.[8] On the other hand, as a frequent participant in regulatory proceedings, Mr. Dunkel might be expected to have recognized Professor Kahn as the former Chairman of the New York Public Service Commission, the former Chairman and deregulator of the Civil Aeronautics Board, and former President Carter's point man for fighting the high inflation of the late 1970s.

Q. HOW DO YOU RESPOND TO THE CLAIMS BY MR. DUNKEL [AT 24] OR DR. JOHNSON [AT 4] THAT VARIOUS REGULATORS AND COURTS TAKE THE OPPOSITE VIEW OF THE COST OF THE LOOP?

A. I don't deny the fact that several observers of the industry hold the opposite view—after all this *is* a contested issue, and we wouldn't be discussing it if it weren't. There are also economists in this proceeding like Dr. Johnson who subscribe to that opposite view. However, as well-intentioned and strongly held the opposite view of these parties may be, they are not firmly anchored in structured economic reasoning. The classic example, of course, is the tendency—also displayed by Mr. Dunkel and Dr. Johnson—to equate "shared use" with "shared cost" or to regard the loop's cost as shared because the loop creates value for other services. It is also possible for the treatment of the loop cost as a shared cost to arise for public policy, rather than economic efficiency, reasons. The desire to hold residential

[8] Alfred E. Kahn, *The Economics of Regulation*, Volumes I and II, Cambridge, MA: MIT Press, 1988.

1 basic exchange service prices at an acceptably low level can easily justify the
2 "shared cost" fallacy in the minds of policymakers. That fact, however, does not
3 mean that such a view is justified by economic theory.

4 Indeed, contrary to the assertion by Mr. Dunkel and Dr. Johnson, the FCC
5 treats loop costs as a fixed cost to be recovered entirely from the customer.
6 Moreover, not all state Commissions have ruled the way of Mr. Dunkel or Dr.
7 Johnson on the loop cost issue. A notable exception to the rule is California which
8 explicitly considered the issue of economic efficiency and determined that "it would
9 not be appropriate to treat the loop as a shared cost."[9]

10 **Q. PLEASE INDICATE THE FCC'S CURRENT THINKING ON THIS ISSUE.**

11 A. In a recent decision,[10] the FCC accepted many of the salient features of an
12 integrated proposal by the Coalition for Affordable Local and Long Distance
13 Service ("CALLS")—a group of prominent local exchange and long distance
14 carriers including AT&T and Sprint—for universal service and access charge
15 reform. In that decision, the FCC determined to replace implicit subsidies
16 historically embedded in the interstate access rate structure with explicit (interstate
17 portion of) support needed for universal service. To this end, the FCC increased
18 the subscriber line charge on residential and business customers with the aim

[9] Public Utilities Commission of the State of California, Decision, Docket No. 96-08-021, August 2, 1996.

[10] FCC, *In the Matter of Access Charge Reform* (CC Docket No. 96-262), *Price Cap Performance Review for Local Exchange Carriers* (CC Docket No. 94-1), *Low Volume Long Distance Users* (CC Docket No. 99-249), and *Federal-State Joint Board on Universal Service* CC Docket No. 96-45, Sixth
(continued...)

eventually to recover all of the interstate portion of the non-traffic-sensitive local loop in fixed flat-rated charges. The following excerpts from the *CALLS Order* demonstrate the FCC's commitment to the view that the cost of the local loop is not—and should not— be shared with usage services.

> Whether a LEC allocates all of its interstate loop costs to the end user or to the IXC, the LEC's competitive position as compared to other suppliers of local exchange facilities remains the same. Section 254(k) [of the Federal Act] was not designed to regulate the apportionment of loop costs between end users and IXCs because this allocation does not involve improperly shifting costs from a competitive to non-competitive service.[11]
>
> The Eighth Circuit upheld the Commission's increases to various LEC SLC caps, however, and found that "Texas Counsel's contention that increasing the SLC price ceiling violates the prohibition against using non-competitive services to subsidize competitive services [wa]s unpersuasive." In doing so, the court reaffirmed the *Commission's long standing view that the subscriber "causes" local loop costs, whether the subscriber uses the service for intrastate or interstate calls.* These costs are, in any event, recovered from the end user, either through direct end-user charges or indirectly through higher rates or additional charges paid to IXCs. The court further affirmed the Commission's conclusion *that it was appropriate and rational for the Commission to impose these costs on the end user.* The court concluded as a result that increasing SLC caps on certain lines did not result in a windfall for IXCs.[12]
>
> Similarly, the court in *Southwestern Bell* rejected the argument that increasing the SLC cap violates the second sentence of section 254(k) by causing services included in the definition of universal service to bear more than a reasonable share of the joint and common costs of facilities used to provide those services. ... [Section 254(k)] places a continuing obligation on the Commission to ensure that the treatment of joint and common costs, *such as corporate overheads,* prescribed by our accounting, cost allocation, separations, and access charge rules will safeguard the availability of universal service. Opponents argue that by eliminating the PICC and increasing the SLC cap, the Commission violates section 254(k) by allocating 100 percent of the joint and common costs to the common line elements paid by the end user.

(...continued)

Report and Order in CC Docket Nos. 96-262 and 94-1, Report and Order in CC Docket No. 99-249, and Eleventh Report and Order in CC Docket No. 96-45 ("*CALLS Order*"), May 31, 2000.

[11] *CALLS Order,* ¶92 (footnotes omitted).

[12] *Id.*, ¶95 (footnotes omitted, emphasis added).

> The Commission, however, has complied with the requirements of Section 254(k) by allocating joint and common costs to various interstate services, including ... common line and switching ... and ... special access services. ... Because the SLC is a method of recovering properly allocated loop costs, not an allocation of those costs between supported and unsupported services, section 254(k) is not implicated.[13]

Q. MR. DUNKEL [AT 30-31] FAULTS YOUR ARGUMENT THAT INTER-EXCHANGE CARRIERS ("IXCs") CAN USE QWEST'S LOCAL LOOPS FOR FREE, ASSERTING INSTEAD THAT THE IXCs PAY A CARRIER COMMON LINE CHARGE ("CCLC") FOR THE PRIVILEGE OF USING THOSE LOOPS. DO YOU AGREE?

A. No, Mr. Dunkel is mistaken in characterizing the CCLC as a cost-based charge paid by IXCs to use Qwest's local loops.[14] Rather, the CCLC is a pure subsidy element that shifts part of the burden of recovering the cost of the loop from the cost-causer—the end-user customer that orders the loop—to IXCs. Nowhere is this fact clearer than in the interstate domain where the FCC has recently undertaken a fundamental change in the structure of access charges. Specifically, the FCC has moved to eliminate all pure subsidy elements and to migrate to higher flat-rated subscriber line charges which are appropriate for recovering the fixed, non-traffic-sensitive costs of the loop. From an economic efficiency standpoint, that is precisely the kind of change that needs to happen in the intrastate domain as

[13] *Id.*, ¶96 (footnotes omitted, emphasis added).

[14] Dr. Johnson makes the same error when he asserts [at 12] that "Qwest routinely charges toll carriers like AT&T and MCI [sic] for "access" to its customers. The fees it collects help recover the cost of the loops which are used in providing that access."

well with pure subsidy elements eliminated and residential basic exchange rates raised.

In light of Mr. Dunkel's claim, it is important to examine what costs the IXC *does* cause for Qwest. Any time Qwest has to switch a long distance call (either from the calling customer to the IXC or from the latter to the called party), it incurs traffic-sensitive switching costs and other costs related to inter-office transport. These costs are legitimately recovered in switched access rates.[15] However, the CCLC has no role in this; it is included in the switched access rate solely for paying for part of Qwest's cost to provide the loop and to keep residential basic exchange rates low.

Moreover, the argument that the CCLC recovers part of an interstate assignment of non-traffic sensitive loop costs, though historically correct, no longer has economic significance. Carriers pay CCL charges based on the number of minutes they originate and terminate: from an economic perspective, the CCLC is part of the price of a switched minute and has nothing to do with loops which are supplied by other parties. There is also no longer any indirect effect: that is, if loop costs were to increase, there would be no effect on the CCLC which is regulated under the FCC's price cap rules.

[15] True cost-based compensation of Qwest by the IXC only occurs for network elements such as switching and transport between Qwest's end office and the IXC's point of presence. It should *not* include any compensation for the loop connection to the consumer instead. Hence, the CCLC that is currently applied to recover part of the loop's cost is not justified by cost causation and is not cost-based.

Q. WHAT MOTIVE DOES MR. DUNKEL ATTRIBUTE TO QWEST FOR WANTING TO GRANT IXCs "FREE ACCESS" TO ITS LOCAL LOOPS, AND DO YOU AGREE?

A. Mr. Dunkel remarks [at 32]:

> [S]witched access service is one of the services that Qwest believes is a potentially competitive service.... Therefore, by supporting reduced switched access rates with monopoly services (i.e., basic exchange service) rate increases, Qwest can discourage competition for the access service (by making the service less profitable), and still "remain relatively neutral" with respect to the total revenues it receives.

Of course, this suspicion is unfounded. First, all Qwest is seeking is the ability to raise its below-TSLRIC rates for residential basic exchange service *nearer* to actual cost. This is hardly a move to "support" or subsidize another service like switched access. Predictably, Mr. Dunkel would claim that Qwest's residential basic exchange rates are already well above TSLRIC, so any increase in those rates would make available more contribution with which to support switched access. That claim, would, of course, be false.

Second, there is some irony in Mr. Dunkel's claim that, by increasing its residential basic exchange rates, Qwest will attempt to *reduce* competition for its switched access service. The truth, of course, is quite the opposite. A very powerful reason for the slow emergence of residential basic exchange service competition in Arizona is that the rates Qwest is permitted to charge for that service are *too low* to make entry by equally and, perhaps, more efficient competitors worthwhile. Naturally, with less entry by competitive local exchange carriers ("CLECs"), the fewer sources there can be of a competing switched access

service. So, if Qwest truly wants to avoid competition for its switched access service, it would be better off seeking the status quo of below-cost rates for residential basic exchange service, rather than getting those rates to rise.

Mr. Dunkel is fundamentally wrong to claim—as he has so liberally—that Qwest intends to give the IXCs a free ride on the use of local loops. There is simply no benefit to Qwest from doing that. If anything, Qwest would be better off assessing higher, rather than lower, switched access charges and, as long as the CCLC is a usage-sensitive charge, increase its switched access contribution by encouraging IXCs to make greater use of those loops. That outcome, however, is hardly likely. If Qwest and the IXCs have a mutual interest in seeing the CCLC eliminated and access charges reduced, it is because such a move would enhance economic efficiency (by shifting the burden of cost recovery to true cost-causers) and improve the prospects for, and the quality of, local exchange competition. Mr. Dunkel's suggestion [at 34] to have Qwest assess flat-rated, rather than per-minute, charges on IXCs misses that point completely. Where there should be *no* subsidy, merely replacing a per-minute subsidy by a flat-rated subsidy is not the answer, as the FCC has clearly realized.

Local and Toll Services are Not Joint Products and the Loop Cost is Not a Joint Cost

Q. DR. JOHNSON [AT 8] OFFERS A PARALLEL BETWEEN THE JOINT PRODUCTS NATURE OF HAMBURGER AND LEATHER SHOES AND THAT

ALLEGEDLY BETWEEN "LOCAL" AND TOLL SERVICES. WHAT IS THE POINT OF THIS PARALLEL AND DO YOU ACCEPT IT?

A. No, I do not accept the point that Dr. Johnson attempts to make. Economic theory attributes two special properties to "joint products:"

1. The products must be produced in (or approximately in) fixed proportions to each other out of the same production process and employing the same production inputs.
2. If cost (in production inputs) is incurred to produce any one of those products, then all other products that get produced jointly are available, in effect, at zero marginal (incremental) cost.

The first property is key because it narrows considerably the types of production that qualify for this classification. Celebrated examples of production in more or less fixed proportions are mostly agricultural: wool and mutton, beef and hides (or, in Dr. Johnson's case, hamburger and leather shoes), or egg yolks and egg whites. From the perspective of the second property, the entire quantity of the "other" product is available without any additional cost whatsoever. So, in Dr. Johnson's example, if cattle feed were the input for producing hamburgers, and a certain quantity of leather shoes (actually hides would be a better example) were produced, then there would be no additional cost to supply the leather shoes. Stated differently, the cost of cattle feed—the production input—should be regarded as a joint cost to produce the two joint products.

Dr. Johnson's parallel between the hamburger-leather shoes case and the case of "local" and toll services is flawed for several reasons. First, I disagree with Dr. Johnson that the local loop plays the same role as cattle feed, namely, as a production input. As I explained in my Rebuttal Testimony [at 23-26], the local loop

(network access service) is an output that can be demanded in its own right and not, strictly speaking, an input, although, because it is used as a common delivery vehicle for network services, it has the appearance of an input.

Second, unlike beef and hides, Dr. Johnson's "local" service (which I assume to be local *usage* service) and toll service are *not* produced or consumed in fixed proportions. For example, for every minute of toll usage, I do not make six minutes of local calls (or *vice versa*). Every additional minute of toll service that the network has to provide costs it some incremental amount, regardless of whether I make six minutes of local calls or sixty. There is also the possibility that I take my local usage service from my local exchange carrier but my toll service *over the same loop* from another carrier. Products cannot be considered joint if they are produced by different firms.

Finally, Dr. Johnson appears to place the focus on *total* cost when the proper focus should be on *incremental* or marginal cost. For example, he states [at 8]:

> If demand for hamburger increases, the cattle feed used in fulfilling this demand will costlessly be available for use in producing more leather shoes. Similarly, if the demand for basic local service increases, the loops which are used in fulfilling this demand will costlessly be available for use in producing more toll service.

Obviously, as the number of loops installed increases, it would become possible to increase the consumption of both toll and local usage services. However, the real question is whether when the quantity of one product increases, does the quantity of the other increase as well, without any *additional* cost associated with the second product? Consider the beef cow in Dr. Johnson's

example. If demand for hamburgers increases, one way to meet increased demand is to fatten cattle further, i.e., put more beef on an existing cow. In the process of gaining weight, that cow may arguably also gain size and, hence, make available more hide to produce leather shoes. In that case, the additional weight of the cow comes at the additional cost of the cattle feed, but the additional hide comes at *no* additional cost at all.

Now, suppose Dr. Johnson is right and the loop is an input with the same economic function as cattle feed. If the customer decides to make additional local calls, will that either require more of a loop, incur more loop cost, or automatically lead to the making of additional toll calls (in some proportion)? The answer to all three questions is an obvious "no." The additional local calls *will* incur a cost (such as usage-sensitive network costs) but not on the loop. Also, more calls of either kind can be made without requiring any increment of the loop. Clearly, when the focus is properly placed on incremental cost (which, for the loop, has a central role in this proceeding), the parallel drawn by Dr. Johnson self-destructs.

Economically Efficient Pricing in the Presence of Distortions

Q. MR. DUNKEL DEVOTES A CONSIDERABLE AMOUNT OF HIS TESTIMONY [AT 37-40] DECRYING THE USE OF RAMSEY PRICING PRINCIPLES FOR THE RECOVERY OF QWEST'S SHARED AND COMMON COSTS. DO YOU ACCEPT HIS ARGUMENTS IN THIS REGARD?

1 A. No. Ramsey pricing owes its name to its progenitor, Frank Ramsey, who, over 70
2 years ago, solved the problem of setting optimal taxes so as to minimize the
3 distortion and loss of efficiency that every tax engenders.[16] This was among the
4 first contributions to the welfare economics literature on the "Theory of the Second
5 Best," i.e., the branch of economics devoted to studying how markets can be made
6 to function with the least amount of efficiency loss in the presence of real-world
7 distortions. While taxes are well-known distortions because they drive a wedge
8 between price and marginal cost and, therefore, disrupt a fundamental condition for
9 a form of economic efficiency known as *allocative* efficiency, in
10 telecommunications, the best-known source of disruption of allocative efficiency
11 are economies of scale and scope.[17] In the presence of those economies, the
12 shared and other fixed costs of the firm represent a far larger proportion of the
13 firm's total cost than its variable or incremental costs. In these conditions,
14 enforcing the allocative efficiency condition of setting prices equal to underlying
15 incremental or marginal costs fails to produce enough revenue for the firm to break
16 even. Because of this failure, economists have long espoused the ideal regulatory

[16] Frank Ramsey, "A Contribution to the Theory of Taxation," *Economic Journal*, 37, 1927, at 47-61. In this connection, also see William J. Baumol and David F. Bradford, "Optimal Departures from Marginal Cost Pricing," *American Economic Review*, 60, 1970, at 265-283.

[17] Economies of scale arise as the unit cost of production falls with increasing scale or volume of production. Thus, a firm with a larger scale can produce at a lower unit cost than two or more firms that between them have the same total scale as the larger firm. Economies of scope arise when it is cheaper (and more efficient) to produce several different products out of a common plant or facility than to have to each product produced out of a separate plant or facility. These arise whenever the different products have significant shared fixed costs so that the firm that produces them out of a common facility incurs those fixed costs only once. In contrast, when each such product is produced
(continued...)

1 solution: allow the firm to recover its shared and other fixed costs by including
2 contribution markups in its product prices, but impose an overall earnings
3 constraint to prevent any monopoly exploitation. As for the markups themselves,
4 several generations of economists have supported a mechanism for marking prices
5 above marginal cost that minimizes the loss of efficiency as a consequence of such
6 pricing. In other words, the economic prescription is a mechanism that introduces
7 and, at the same time, controls a distortion, while allowing the firm to recover all its
8 costs. The Ramsey pricing approach—which ensures that services are consumed
9 in the same proportions that they would be consumed if all services were priced at
10 marginal cost—is one such mechanism.

11 Ironically, what Mr. Dunkel fails to say is that, contrary to his
12 characterization, Ramsey pricing minimizes social welfare loss in the presence of
13 distortions and, at least from the standpoint of economic efficiency, is the most
14 desirable course of action. In addition, Mr. Dunkel ignores the fact that an earnings
15 constraint—that the firm earn its authorized cost of capital—accompanies such
16 pricing. Moreover, Mr. Dunkel misses the fact that it is precisely by preventing
17 consumers from substituting away from less price-elastic products toward more
18 price-elastic products that Ramsey pricing minimizes the effects of price-cost

(...continued)

by a different stand-alone firm, then each firm has to incur the same fixed cost that would otherwise be shared in a multi-product firm.

1 distortions.[18] Another way to think of it is that Ramsey pricing comes closest to
2 ensuring that consumers would consume different products in the same relative
3 proportions in the presence of those distortions as they would without the
4 distortions (and with prices set at marginal cost).

5 **Q. WHAT WAS YOUR PURPOSE IN SUGGESTING RAMSEY PRICING FOR THE**
6 **RECOVERY OF QWEST'S SHARED AND OTHER FIXED COSTS?**

7 A. My purpose in bringing up Ramsey pricing was to highlight the availability of
8 second-best pricing techniques that can minimize the inefficiency that arises from
9 distortions in real-world markets. In fact, the very Professor Baumol whom Mr.
10 Dunkel cites so selectively [at 38] has long advocated Ramsey pricing for regulated
11 telecommunications firms that have large shared and other fixed costs (i.e., scale
12 and scope economies).[19]

[18] In this connection, Mr. Dunkel [at 39] portrays customers with "inelastic demand," with low price elasticities as somehow susceptible to monopoly exploitation. He should know that no monopoly *with the freedom to set its own prices*, i.e., an unregulated monopoly, would ever operate on the inelastic portion of its demand curve. In other words, no profit-maximizing monopoly would, of its own volition, set prices that were so low as to have very low price elasticity. It is well known that as price rises, so does the price elasticity. A profit-maximizing monopoly would only set prices where the price elasticity is in the elastic, rather than the inelastic, range. The problem Mr. Dunkel alludes to—customers with very low price elasticities—only arises in the context of a *regulated* firm (and erstwhile monopoly) like Qwest which is *prevented* from setting compensatory prices or prices within the profit-maximizing and price-elastic range. This is hardly the result of exploitative behavior by Qwest.

[19] See William J. Baumol and J. Gregory Sidak, *Toward Competition in Local Telephony*, Cambridge, MA: MIT Press and Washington DC: American Enterprise Institute, 1994, especially Ch. 3. See also Alfred E. Kahn, *The Economics of Regulation*, Volumes I and II, Cambridge, MA: MIT Press, 1988, and Sanford V. Berg and John Tschirhart, *Natural Monopoly Regulation*, New York: Cambridge University Press, 1988.

Q. ISN'T IT TRUE, HOWEVER, THAT RAMSEY PRICING RAISES SOME PROBLEMS EVEN AS IT ENHANCES ECONOMIC EFFICIENCY?

A. Yes. While seeing the economic efficiency virtues of Ramsey pricing, economists also recognize the distributional equity problems with such pricing. The strength of Ramsey pricing—that higher percent markups in price can be incorporated for customers with the lowest price elasticities without causing a distortion in consumption—is also its most problematic feature because it appears to put the greatest burden of higher prices on those who can least escape them. Economists like Baumol and others have long recognized this fact. Another practical problem with applying Ramsey pricing in a multi-product world is that for selecting the markups in service prices with precision, it is necessary to have reliable estimates of both own-price and cross-price elasticities of demand for those services. As Baumol and Sidak note, this data requirement has often been a practical problem that regulators have been unable to overcome.[20] Nevertheless, Baumol and Sidak believe that

> [R]egulators have accepted the usefulness of Ramsey theory as a source of general qualitative guidance rather than as a generator of precise and definitive prescriptions for pricing. Ramsey theory has, for example, been used to defend the legitimacy in terms of the general welfare of what in the regulatory arena is called "differential pricing"—that is, the use of discriminatory prices, in the economic rather than the legal sense. ... Ramsey theory has also been used to reject high markups on costs in the prices of goods whose demands are highly elastic, and to note that the self-interest of firms will normally lead them to avoid that sort of pricing behavior, in the understanding that charging prices for goods whose demands are elastic is a sure way to lose one's customers. In sum, Ramsey-pricing analysis continues to play a significant role in regulation, and

[20] Baumol and Sidak, *op cit.*, at 38.

> one that may become more substantial in the future. But that role is nevertheless circumscribed, and Ramsey analysis is unlikely to determine the actual magnitudes of regulated prices.[21]

In trying to cast Ramsey Pricing in a very negative light, Mr. Dunkel does not either address the full context in which regulators and policymakers consider the use of Ramsey pricing or provide the balanced and reasoned analysis of the virtues and possible qualified uses of Ramsey pricing that Baumol and Sidak offer.

In response to the onerous data requirements of Ramsey pricing, economists have proposed several optimal pricing mechanisms—such as nonlinear pricing or multi-part tariffs—with the larger goal of reconciling the apparent conflict between economic efficiency and distributive equity.[22] Moreover, by relying on customers to self-select into different pricing plans, such pricing actually avoids having to observe price elasticities directly and, therefore, overcomes the most significant data hurdle faced by Ramsey pricing. With the increasing popularity of such pricing among *un*regulated firms with scale and scope economies (e.g., airlines, long distance telephone companies, and wireless companies), the Commission could find significant value in extending them to regulated carriers like Qwest as well.

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[21] *Id.*, at 39. Footnotes omitted, but see footnotes for examples of regulatory cases in which Ramsey pricing has been used.

[22] See, e.g., Stephen J. Brown and David S. Sibley, *The Theory of Public Utility Pricing*, New York: Cambridge University Press, 1986, Robert B. Wilson, *Nonlinear Pricing*, New York: Oxford University Press, 1993, or Mitchell and Vogelsang, *op cit.*, Chs. 4 and 5. Also see Baumol's own efforts at that reconciliation in his book, *Superfairness*, Cambridge, MA: MIT Press, 1986, Ch. 6.

PRICING CARRIER SWITCHED ACCESS ABOVE INCREMENTAL COST

Q. MS. STARR ACKNOWLEDGES [AT 13] THE SEPARATE AFFILIATE PROVISION OF SECTION 272 OF THE TELECOMMUNICATIONS ACT OF 1996. HOWEVER, SHE CLAIMS THAT REQUIRING SEPARATE AFFILIATES STILL DOES NOT PREVENT QWEST FROM PRICING ITS SWITCHED ACCESS SERVICE TO FAVOR ITS OWN AFFILIATE FOR TOLL SERVICE OVER AT&T AND OTHER IXCs. DO YOU AGREE?

A. No. The separate affiliates provision is not an empty requirement because it requires that access impose the same cost on Qwest's long distance affiliate as it does on competing IXCs. Ms. Starr is incorrect to say that "the Qwest affiliate is paying the "price" of access, but the corporation is really only incurring the "cost" of access." That is only true if accounting, rather than economic, costs are used. As I explained in my Rebuttal Testimony [at 33-36], the price paid by the affiliate for switched access is really a cost at the corporate level because, when the affiliate—not the IXC—carries the long distance call, Qwest forgoes the contribution that it could have earned from selling switched access to the IXC instead. The error in Ms. Starr's analysis stems from missing this subtle, but important, economic point.

QWEST'S COMPETITIVE ZONE PROPOSAL AND MARKET SHARE ISSUES

Excessive Reliance on Market Shares Obscures Whether Qwest is Capable of Anti-Competitive Behavior

Q. DR. SELWYN ASSERTS [AT 5] THAT YOUR DISCUSSION OF THE RELEVANCE OF MARKET SHARE AS AN INDICATOR OF A FIRM'S MARKET POWER IS "ENTIRELY THEORETICAL AND IGNORES ENTIRELY THE CONTEXT OF ACTUAL LOCAL EXCHANGE MARKET CONDITIONS EXTANT IN ARIZONA." DO YOU AGREE?

A. Not at all. I base my assessment of the role of market share on the U.S. Department of Justice *Merger Guidelines*. The *Merger Guidelines* (1) outline the enforcement policy and (2) describe the analytical framework and specific standards used by both the Federal Trade Commission ("FTC") and the Department of Justice ("DOJ") to enforce the antitrust laws. Inasmuch as these enforcement agencies rely routinely on the *Merger Guidelines* to inform their analysis of markets, assess market concentration, and evaluate the likely effects of market power in real markets, I hardly think my analysis is "entirely theoretical" when I do the same.

Q. HAVING CALCULATED THAT QWEST SUPPOSEDLY CONTROLS 95.78% OF THE MARKET FOR RESIDENTIAL BASIC EXCHANGE SERVICE IN ARIZONA, DR. SELWYN ARGUES [AT 6] THAT QWEST "HAS THE *ABILITY* TO EXERCISE SUBSTANTIAL MARKET POWER TO CONTROL PRICE LEVELS AND LIMIT COMPETITIVE ENTRY." MORE GENERALLY, DR. JOHNSON [AT

23] QUESTIONS YOUR UNWILLINGNESS TO USE MARKET SHARE AS ANYTHING MORE THAN A SUPPORTING STATISTIC FOR JUDGING THE STATE OF MARKET COMPETITION. DO YOU AGREE?

A. No. First, the *Merger Guidelines* do not make an immutable *a priori* distinction between the effects of a high or low market share on a firm's ability to exercise market power. Rather, they set out "general standards" and specifically allow any presumption following from the general standards to "be overcome" with a showing that other factors, e.g., entry analysis, may warrant a different conclusion.

Second, the *Merger Guidelines* specifically recognize other factors that may determine the course of future competition:

> The post-merger level of market concentration and the change in concentration resulting from a merger affect the degree to which a merger raises competitive concerns. However, in some situations, market share and market concentration data may either understate or over state the likely future competitive significance of a firm or firms in the market of the impact of a merger. (*Merger Guidelines*, ¶1.52)

Accordingly, the *Merger Guidelines* direct the enforcement agencies to:

> consider reasonably predictable effects of recent and ongoing changes in the market conditions in interpreting market concentration and market share data. (*Id.*, ¶1.521)

There is no question that telecommunications markets, particularly those for basic exchange services, are in transition from monopoly to competition. The Telecommunications Act of 1996 ("1996 Act"), state laws, and follow-on federal and state policies have created the structural conditions for that transition. There have been, and will continue to be, *ongoing changes* in the relevant market conditions. The effects of those changes are also *predictable* in some essential respects: incumbent carriers like Qwest have, and will continue to, lose market share to

1 competitive entrants. However, no matter the actual speed with which that market
2 share will erode,[23] there is no question that Qwest cannot re-create the entry
3 barriers that have been removed or re-monopolize a market in which safeguards
4 against monopoly control have been, and are being, deployed.

5 Third, contrary to Dr. Selwyn's claim, Qwest has *no* ability to exercise
6 market power and/or control price levels. The term "market power" specifically
7 refers to a firm's ability to profitably raise and maintain price(s) above the
8 competitive level.[24] Qwest cannot exercise such power. With its service prices
9 and earnings subject to regulatory control, Qwest simply has not had, and does not
10 presently have, the ability to set prices unilaterally. If granted pricing flexibility for
11 the competitive zones, Qwest's ability to set prices in the future will be constrained
12 by the market.[25] In those competitive zones, Qwest's competitors already have
13 facilities in place to serve both business and residential customers, and can extend

[23] Just as Dr. Selwyn calculates a nearly 96% market share for Qwest in Arizona, Dr. Johnson reports [at 33] that ILECs received about 94% of local service revenues in 1999. The intent again is to make it seem that a market share at that level necessarily signifies substantial market power. Yet, ILECs including Qwest were—and are—by and large unable to charge residential basic exchange rates at or above incremental cost. In the same vein, Dr. Collins argues [at 10] that market power can be manifested in ways other than pure price control. For example, he says that one such way would be "removal of a high enough percentage of total potential market revenue to chill the *pro-forma* business cases run by competitors to decide if market entry is warranted." How exactly is that supposed to happen? More to the point, given that Qwest's residential basic exchange rates are below cost, what must Qwest do to remove a "high enough percentage of total potential market revenue?" Dr. Collins provides no insight into this question.

[24] Note that the *competitive level* does *not* necessarily refer to strict equality of price and incremental cost. Even in competitive markets, firms may settle on prices above incremental cost, given their need to recover shared and other fixed costs.

[25] Qwest is already at a competitive disadvantage in parts of Arizona where Cox is able to sell residential basic exchange service at a lower price than Qwest, particularly when bundled with cable television service. See Dunkel Surrebuttal Testimony [at 46].

capacity sufficiently to thwart any attempt by Qwest to restrict output and raise prices above competitive levels.

Finally, contrary to Dr. Selwyn's claim, Qwest has *no* ability to limit competitive entry. The 1996 Act removed legal barriers to entry and imposed duties on incumbent local exchange carriers that, in effect, mitigated economic and technical barriers to entry. Qwest is required to interconnect with CLECs, make available unbundled network elements ("UNEs"), and offer its retail services for resale at a discount. Qwest has no ability to prevent CLECs from pursuing customers using any of these options. As Professor Kahn pointed out recently, the provisions of Sections 251 and 252 of the 1996 Act have made the local exchange market more contestable than at any other time in the history of telecommunications.[26]

Q. HOW DO YOU RESPOND TO DR. JOHNSON'S USE [AT 23-25] OF THE LERNER INDEX (MODIFIED FOR THE DOMINANT FIRM-COMPETITIVE FRINGE MARKET) TO ASSERT THAT THE LARGER THE DOMINANT FIRM'S MARKET SHARE, THE GREATER WILL BE ITS MARKET POWER?

A. Dr. Johnson's advocacy of the Lerner Index for a market with a dominant firm with a competitive fringe is fine so far as it goes, but its use is not justified in the context of residential basic exchange service in Arizona. That is because the form of the

[26] Alfred E. Kahn, *Letting Go: Deregulating the Process of Deregulation*, Michigan State University Utilities Papers, East Lansing, MI: Michigan State University, 1998, at 54-60.

1 Lerner Index that Dr. Johnson uses pre-supposes *profit-maximizing behavior* on
2 the part of the dominant firm for the service or market in question.[27] In no sense,
3 can it be argued that Qwest is able to price its residential basic exchange service
4 (or the underlying residential access line) in a profit-maximizing manner. As has
5 been testified to, residential basic exchange rates are, in fact, *below* incremental
6 cost in many parts of Arizona. And even those who might disagree that residential
7 basic exchange services are priced below cost cannot claim that residential basic
8 exchange service is price-elastic at current prices—which it would be if a monopoly
9 supplier were maximizing profit. Therefore, the Lerner Index is not applicable when
10 market share is measured in terms of residential access lines or revenues from
11 residential basic exchange service.

12 **Q. DR. SELWYN ASSERTS [AT 8] THAT YOUR SELECTION OF REVENUES OR**
13 **PROFITS AS THE APPROPRIATE BASIS FOR MEASURING MARKET SHARE**
14 **AMOUNTS TO "BLOWING SMOKE" BECAUSE YOU DIDN'T BACK UP THAT**
15 **SELECTION WITH ANY QUANTITATIVE DATA. IS THIS A FAIR**
16 **CHARACTERIZATION?**

17 A. No, and Dr. Selwyn is, or should be, aware that detailed quantitative data on the
18 revenues and/or profits of individual CLECs on a statewide basis are not publicly

[27] See William M. Landes and Richard A. Posner, "Market Power in Antitrust Cases," *Harvard Law Review*, 94, 1981, or Richard A. Posner and Frank H. Easterbrook, *Antitrust Cases, Economic Notes, and Other Materials*, Second Edition, St. Paul, MN: West Publishing Co., 1981, Appendix: Introduction to the Economics of Antitrust.

available. I note that he has not presented any data of his own to refute my conclusion.

More importantly, it is a generally accepted fact that entrants first target high revenue or profit-yielding business customers located in mainly densely-populated urban areas. In contrast, residential customers located in less densely-populated areas that present a low revenue/profit potential are a far lower priority for those entrants.[28] This would suggest that the average per line revenue/profit from the typical CLEC customer is higher than the average per line revenue/profit from the average Qwest customer. Thus, a market share analysis based on revenue/profit per residential access line in Arizona would produce a lower market share for Qwest than an analysis based on access lines alone. Using revenue/profit rather than access lines amounts to assigning a higher weight to each CLEC-served access line and a lower weight to each Qwest-served access line in any weighted average calculation of revenue or profit per line across all carriers. This, again, is likely to produce a lower market share for Qwest than a simple access line-based analysis.

Q. DR. SELWYN REPORTS THAT THE FCC REACHED AN OPPOSITE CONCLUSION REGARDING THE MEASUREMENT OF MARKET SHARE USING LINES INSTEAD OF REVENUES. HE CITES AN FCC ANALYSIS OF DS1 AND DS3 MARKET SHARE USING LINES RATHER THAN REVENUES,

[28] The FCC has, in fact, confirmed this trend. See FCC, *Local Competition: August 1999.*

AND REMINDS THE COMMISSION THAT "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." SHOULD THE COMMISSION DISMISS YOUR CONCLUSION AS INCORRECT?

A. No. My testimony was not that any market share analysis based on revenue/profit would result in a lower market share. Instead, it was that ILECs and CLECs do not compete for lines *per se*, but rather for that which lines make possible, namely, revenues and profits. On this basis, I testified that an appropriate market share analysis—if one were to be deemed relevant at all—would be better based on revenues or profits, not lines. The FCC's conclusions regarding alternative measures of market share using lines and revenues for DS1 and DS3 circuits are in no way indicative of the likely outcome when market share using both access lines and revenues is analyzed for residential basic exchange service in Arizona. If every access line sold in Arizona generated exactly the same amount of revenue or profit, the distinction would not matter. But, as I stated earlier, that is not likely to be the case. Unlike the case of market share for DS1 or DS3, a market share analysis of Arizona's residential access lines will more likely reveal a lower market share for Qwest when revenue/profit is used than when the lines themselves are used.

Q. DR. SELWYN ALSO ASSERTS [AT 8-9] THAT QWEST'S CURRENT "GROSSLY ABOVE-COST PRICES FOR MANY OF ITS SERVICES" IS

EVIDENCE THAT YOUR PROPOSAL TO USE POTENTIAL CAPACITY TO MEASURE MARKET SHARE "FAILS ON ITS VERY FACE." DO YOU AGREE?

A. No. First, the services Dr. Selwyn refers to (namely, vertical features and DSL) are considered optional and discretionary. Thus, it is very likely for incumbent and entrant carriers alike to price those services above incremental cost, i.e., to make them contribute to the recovery of their shared and other fixed costs. That is hardly a surprising finding: he has simply discovered the obvious fact that firms recover their shared fixed and common costs by marking up prices for their various services as market conditions permit.

Second, this issue has only arisen because I stated in my Rebuttal Testimony [at 40] that a capacity-related measure of market share is a more meaningful indicator of potential barriers to entry or strategic behavior by a firm and, hence, a predictor of potential market power more worthy of attention. It is unclear whether Dr. Selwyn disagrees with that notion. That notwithstanding, my observation is supported by the *Merger Guidelines* which, as I explained earlier, represent the *practical* basis for the pertinent enforcement policy and analytical framework used by both the FTC and the DOJ.

> Market shares will be calculated using the best indicator of firms' *future* competitive significance. Dollar sales or shipments generally will be used if firms are distinguished primarily by differentiation of their products. Unit sales generally will be used if firms are distinguished primarily on the basis of their relative advantages in serving different buyers or groups of buyers. Physical capacity or reserves generally will be used if it is these measures that most effectively distinguish firms. (*Merger Guidelines*, ¶1.41; emphasis added)

1 Many telecommunications services are not differentiated in that a minute of
2 local or toll service from one carrier appears to the consumer exactly like a minute
3 of that service from another carrier. For the services that are nearly homogeneous,
4 competing telecommunications carriers have limited ability to pursue the custom of
5 any particular buyer or group of buyers. For these reasons, I believe it is
6 appropriate to follow the *Merger Guidelines'* suggestion to market share in terms of
7 physical capacity, rather than revenue or access lines.

8 Finally, Dr. Selwyn mischaracterizes my testimony by taking it out of context.
9 This could prove confusing to the Commission. In his discussion of the supply
10 elasticity as an indicator of entrants' ability to counter any strategic attempt by the
11 incumbent to restrict output and raise prices, Dr. Selwyn claims that I have
12 conceded that the supply elasticity is low and thus agree with him that CLECs in
13 Arizona have little or no ability to rapidly serve additional demand for residential
14 access lines. That is simply not true. The relevant passages from page 10 of Dr.
15 Selwyn's testimony are reproduced below.

16 Q. Does Dr. Taylor appear to agree with you that the supply elasticity reflecting
17 competitor's ability to rapidly satisfy market demand is, in fact, quite low?

18 A. Yes. At page 43 of his rebuttal testimony, Dr. Taylor explicitly concedes that
19 "[n]aturally, it takes considerable time and effort on the part of those entrants to
20 bring about significant erosion in the market share of the incumbent firm."

21 **Q. DO YOU AGREE WITH DR. SELWYN THAT THE SUPPLY ELASTICITY FOR**
22 **THE PROVISION OF RESIDENTIAL ACCESS LINES IN ARIZONA IS LOW?**

23 A. No. In addition to the ready capacity of the facilities-based CLECs already in
24 operation, competitors have every opportunity to use resale or UNEs to serve

demand. In practical terms, there is probably little or no capacity constraint in the markets for which Qwest is seeking a competitive zone declaration.

The statement that Dr. Selwyn has taken out of context appeared in my Rebuttal Testimony [at 43] in my discussion of the reliability of the Herfindahl-Hirschman Index ("HHI") as an indicator of market concentration when concentration is *decreasing*. The relevant passage from my Rebuttal Testimony is reproduced below, including the sentence (shown with emphasis) that Dr. Selwyn cites in his testimony.

> There is an important asymmetry between increasing and decreasing concentration in a market and, for this reason, the HHI is typically of no practical value when concentration is decreasing. When a market with a single firm is opened to competition, the HHI—measured on the basis of whatever outcome or driver—necessarily starts out at its ceiling value of 10,000 (100 percent squared) and then declines as that firm loses market share to new entrants. *Naturally, 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.* Does that mean that the HHI in that market would have to fall from 10,000 to near 1,800 before the market could be declared competitive? Absolutely not. The 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 that ability to exercise market power, a high HHI says nothing about the actual and potential state of competition in the market. This fact is particularly true for regulated telephone companies whose initial market share of 100 percent was due to regulation rather than to any inherent characteristic of the firm or the technology.

Q. HOW DO YOU RESPOND TO DR. JOHNSON'S ARGUMENT [AT 25] THAT GRANTING QWEST'S COMPETITIVE PROPOSAL COULD DISCOURAGE COMPETITIVE ENTRY IN ARIZONA?

A. This rationalization for not granting Qwest a legitimate request for a competitive zone declaration where competition has taken hold amounts to nothing less than

"infant industry" protection. In the long run, such protection almost always proves to be counter-productive because it (1) encourages too much entry by relatively less efficient competitors, (2) suppresses or shifts consumer demand inappropriately, so that lower quality or higher-priced service from less efficient competitors is not eliminated from the market, and (3) encourages the incumbent firm to seek other markets. In any event, Dr. Johnson's rationalization is counter to both the spirit and the letter of the 1996 Act which made no distinctions or preferences about which class of carriers should be trusted to lead the charge toward competition. Ironically, Dr. Johnson *is* correct when he remarks rather tellingly [at 25] that:

> Given a choice between competing in a state where the incumbent has been largely deregulated and one where the incumbent is subject to traditional prohibitions against discriminatory pricing practices, new carriers would logically find the latter market more attractive.

Q. BUT, ISN'T DR. JOHNSON ONLY SAYING THAT COMPETITORS WOULD FAVOR ENTERING ONLY THE MARKETS WHERE DISCRIMINATORY PRICING PRACTICES BY THE INCUMBENT ARE PREVENTED BY REGULATION?

A. If that is what he is saying, then a closer look is warranted at the overall context of his statement. First, in states where the incumbent has been deregulated, it is very likely that regulators and public policymakers have first determined that such deregulation is safe, pro-competitive, and in the public interest. Therefore, the lack of competitive entry in those states can only signify either an unwillingness to compete or less efficiency on the part of potential competitors.

1 Second, it is a myth that service prices would be the same everywhere
2 within a carrier's service area even under competition. Competition may move
3 prices towards cost, but incremental costs of services are not the same
4 everywhere. For example, the cost of wireline basic exchange service is sensitive
5 to cable lengths and relative densities of customer locations. Also, price
6 discrimination—in the economic, not the legal, sense—is not necessarily a bad
7 thing and often occurs under competition for differentiated products. Price
8 discrimination, e.g., multi-part prices (to which I referred earlier) can actually be
9 economic efficiency-enhancing and give customers more freedom to choose the
10 pricing plans that best suits them. In competitive long distance and wireless
11 markets, such price discrimination—across customers and by service area—is
12 already practiced. If Dr. Johnson's objection to "discriminatory pricing" only
13 pertains to anti-competitive pricing (not justified by cost differences or economic
14 efficiency criteria), then I am perfectly willing to join in that objection.

15 **Q. DR. SELWYN [AT 13-14] DISPUTES YOUR CRITICISM OF THE HHI IN THE**
16 **PRESENT CONTEXT. PLEASE RESPOND.**

17 A. The disagreement between us concerns what useful purpose can be served by
18 using HHIs in the present context. Dr. Selwyn examines the absolute measure of
19 the HHI to draw conclusions about market power. I disagree with the
20 indiscriminate use of the HHI (to examine market power) outside of merger
21 analysis and, as I stated in my Rebuttal Testimony [at 41-43], market events that
22 trigger *increasing* concentration. I consider the approach embraced by the DOJ

1 and the FTC in the *Merger Guidelines* to be consistent with this thinking. When
2 challenging a merger on the grounds that the combined company would have
3 market power, the *Merger Guidelines* ask to examine two factors: (1) the absolute
4 level of the HHI itself and (2) the change in that HHI as a result of specific market
5 events. Contrary to what Dr. Selwyn's believes, an HHI by itself cannot provide
6 sufficient information to conclude whether a firm possesses market power. The
7 *Merger Guidelines* state that, by itself, an HHI above 1800 is insufficient to
8 conclude that the combined firm will possess market power.[29] A more meaningful
9 test of market power when market share is *decreasing*, as in Arizona's local
10 exchange markets, is one that examines directly whether the incumbent or
11 dominant firm has both the incentive and the ability to directly restrict output, deter
12 entry, and raise prices above competitive levels. The mere fact that the firm's
13 market share is still in the 90+% range—which is natural so soon after competition
14 was introduced and the structural conditions for it were created—is not evidence of
15 any of those three anti-competitive practices. Nor does the fact that prices have to
16 exceed incremental cost in order to help recover shared and fixed costs (and, in

[29] Mr. Dunkel responds [at 53-54] to my computation of an HHI of 3,197 for the interstate long distance market at the time the FCC granted AT&T non-dominant carrier status by pointing out that the HHI in the parts of Arizona where Qwest is seeking a competitive zone declaration is considerably higher. As I stated above, a revenue-based HHI is not appropriate for making determinations about the potential for anti-competitive behavior, particularly in those parts of Arizona. In my Rebuttal Testimony [at 44], I had asked how even an HHI of 3,197 in the long distance market could pass muster unless the FCC had implicitly decided to not lay so much stock in the HHI for determining whether AT&T was deserving of non-dominant carrier status.

1 some cases, to contribute to the implicit subsidy for universal service) sufficient to
2 conclude that the incumbent's prices reveal anti-competitive behavior.

3 **Q. DR. SELWYN ALSO DISPUTES [AT 15] YOUR EXAMPLE IN WHICH YOU**
4 **CALCULATE AN HHI OF 1,720 FOR A HYPOTHETICAL MARKET SERVED BY**
5 **A FACILITIES-BASED CARRIER SERVING 40% OF THE MARKET AND 30**
6 **RESELLERS EACH WITH A 2% MARKET SHARE. IS THERE ANY TRUTH TO**
7 **THAT CRITICISM?**

8 A. No. Dr. Selwyn's states his criticism of my example [at 15] as follows:

9 There are, in fact, two separate "markets" here, one for the provision of the
10 underlying services by the sole facilities-based carrier, and the second for the
11 provision of retail services by the facilities-based carrier and its 30 resellers.

12 Dr. Selwyn faults me for failing to take account of the wholesale market served by
13 the single facilities-based carrier. Specifically, he states that my example fails
14 because I fail to report the actual HHI for the market for the underlying facilities-
15 based service which, by virtue of having only one participant, must have an HHI of
16 10,000.

17 This criticism is completely off the point. The concern in the present
18 proceeding is with the strength and quality of competition in Arizona's *retail*
19 telecommunications markets, most particularly for residential basic exchange
20 service. It is most decidedly not with the degree of competition in wholesale
21 markets. From that standpoint, the relevant product market for the computation of
22 the HHI must include not merely the facilities-based carrier but also all of the 30
23 resellers from whom the retail service is available. If Qwest were to increase retail

1 service prices, customers would be free to shift to any of 31 carriers, not merely the
2 one facilities-based carrier. For that market, my computation of an HHI of 1,720 is
3 beyond dispute.

4 **Q. DR SELWYN ACCUSES YOU [AT 18] OF BEING "DELIBERATELY**
5 **MISLEADING." HOW DO YOU RESPOND?**

6 A. I disagree. Consider first Dr. Selwyn's observation that I failed to provide a specific
7 paragraph citation to support the statement in my Rebuttal testimony [at 51] that "in
8 first undertaking reform of interstate *switched access* charges, the FCC adopted a
9 market-based, rather than an overtly-regulatory approach." While it is true that I
10 did not provide a specific citation, I refrained from doing so because my
11 characterization of the FCC's approach is a readily apparent and important theme
12 throughout the *Access Reform First Report and Order*.[30] If a specific reference is
13 necessary, I direct Dr. Selwyn's attention to ¶263 of that Order.

14 Dr. Selwyn goes on to say that "nothing in the First Report and Order
15 expressly confers any pricing flexibility authority upon any ILEC; at best the
16 Commission expressed an intention to pursue this course in the future." The
17 problem with this criticism is that I never said or implied that the FCC expressly
18 conferred any such authority on Qwest or any other ILEC! In the *First Report and*
19 *Order*, the FCC relied on market forces as the basis for *reforming* switched access

[30] FCC, *In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, End User Common Line Charges*, First Report and (continued...)

1 charges. Apparently, Dr. Selwyn ignores the fact that, faced with a choice between
2 relying on market forces to reform the access charge regime or using a prescriptive
3 approach, i.e., setting access charges at total *element* long run incremental cost
4 ("TELRIC"), the FCC chose the former. The point that I was making with apparent
5 support from the FCC was that, where possible, market forces should be preferred
6 to an overtly regulatory and prescriptive approach for the purpose of setting prices.
7 In this proceeding, the Commission can choose to either rely on market forces for
8 setting prices or continue to use a regulatory approach. While Dr. Selwyn and I
9 disagree on the right approach, when I compared the choice facing the
10 Commission with the FCC's choice in the *Access Charge First Report and Order*, I
11 was not "deliberately misleading" as Dr. Selwyn suggests.

12 The same comment applies to Dr. Selwyn's further charge that, by
13 dovetailing passages from the FCC's 1999 *Access Reform Fifth Report and Order*
14 and a passage from the 1997 *Access Reform First Report and Order*, I had meant
15 to give the impression that the passages all pertained to the same case or even to
16 the same service (switched access). Regardless of impressions, I never concealed
17 the fact that the sources were different (footnotes 35-38 in my Rebuttal Testimony),
18 Moreover, on page 52 of that testimony, I also acknowledged that the FCC's
19 principles were "adopted in a different context (i.e., forbearance from regulation of

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(...continued)

Order ("*Access Reform First Report and Order*"), CC Dockets 96-262, 94-1, 91-213, and 95-72, released May 16, 1997.

1 exchange access services)." The point of that exercise was to inform the
2 Commission about the FCC's new orientation regarding regulated service prices in
3 the new competitive era ushered in by the 1996 Act and other laws and policies.
4 Clearly, the FCC has shown a keen appreciation of the damage to social welfare
5 and economic efficiency that can occur from persisting with outmoded pricing
6 restrictions as market conditions change in the direction of increasing competition.
7 The purpose of all economic regulation should be to simulate conditions that would
8 prevail in competitive markets. Thus, as actual competition starts to take hold,
9 regulators can help the process along by gradually liberalizing the conditions under
10 which regulated firms operate.

11 **Fears of Anti-Competitive Pricing by Qwest are Not Justified**

12 **Q. IF THE COMMISSION GRANTS QWEST'S COMPETITIVE ZONE PROPOSAL,**
13 **DR. SELWYN BELIEVES [AT 16] THAT QWEST WILL BE ABLE TO**
14 **"EFFECTIVELY CROSS-SUBSIDIZE THE SERVICES IN [SIC] FURNISHES**
15 **UNDER "COMPETITIVE" CONDITIONS WITH HIGHER RATES AND**
16 **REVENUES FROM MONOPOLY AREAS." HE ALSO APPEARS TO DISAGREE**
17 **[AT 27] WITH THE NOTION THAT, SINCE WHOLESALE RATES WILL**
18 **CONTINUE TO BE REGULATED, QWEST CANNOT EXERCISE MARKET**
19 **POWER OVER ITS RETAIL SERVICES. HOW DO YOU RESPOND?**

20 A. First, let me clear up an apparent misstatement in Dr. Selwyn's testimony [at 27].
21 Dr. Selwyn asks the question:

> But what about the argument that since wholesale rates will continue to be regulated, Qwest cannot exercise market power over its wholesale services?

I believe he meant to say "...Qwest cannot exercise market power over its retail services." The sole basis for Dr. Selwyn's disagreement with this position is the erroneous belief that

> 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.

Dr. Selwyn incorrectly implies that Qwest will be able to engage in anti-competitive pricing and cross-subsidization.

Q. WHY DO YOU BELIEVE THAT DR. SELWYN IS WRONG?

A. There are several reasons why Dr. Selwyn's concerns are unfounded and make little economic sense. First, Dr. Selwyn seems to be arguing that Qwest will use its control over an alleged bottleneck (wholesale services) in order to subsidize and price retail service in an anti-competitive manner, e.g., below economic costs. The problem with this argument is that Qwest cannot, even if it had the incentive—which as I describe below it does not—easily shift costs between retail and wholesale services. The Commission has rules, regulations and procedures in place that are intended to prevent the misassignment of costs that Dr. Selwyn is concerned with. Certainly, the adoption of a price cap plan (as proposed by Staff and Qwest in this proceeding) would be a step in that direction.

More importantly, Qwest has no ability to use its alleged control over wholesale services in order to price retail services anti-competitively because there

1 are two fundamentally different pricing standards for Qwest's wholesale and retail
2 operations.

3 **Q. PLEASE EXPLAIN THAT POINT.**

4 A. Qwest's wholesale operations include UNEs and interconnection services that it
5 makes available to its competitors. The pricing methodology for wholesale services
6 is based on the FCC's Interconnection Order which prescribed the use of forward-
7 looking economic costs.[31] On the other hand, the prices of retail services in
8 Arizona are currently determined by rate-of-return and revenue requirement
9 considerations and could, in the future under price cap regulation, be more market-
10 responsive or subject to caps (as conditions warrant). Thus, there can be no
11 practical way for Qwest to "misassign" or shift costs because the manner in which
12 service prices are determined will remain unaffected by any attempt to shift costs.

13 **Q. ARE THERE OTHER REASONS WHY DR. SELWYN'S CONCERNS ARE**
14 **UNFOUNDED?**

15 A. Yes. First, Dr. Selwyn appears to fear that Qwest will engage in predatory pricing
16 in order to drive competitors from the market and then recoup losses by pricing
17 above the competitive level.[32] But, that is hardly a viable strategy for the context in

[31] The 8th Circuit Court recently ruled that the FCC can mandate prices for UNEs and interconnection that are based on forward-looking costs as long as they are based on the ILEC's actual network, not a hypothetical network. See *Iowa Utilities Board v. FCC and the United States*, U.S. Court of Appeals for the 8th Circuit, No. 96-3321, July 18, 2000.

[32] In alleging the possibility of "*anticompetitive pricing* and cross-subsidization," I assume Dr. Selwyn is referring to predatory pricing and, in the context of the supply of a retail service (e.g., intraLATA toll) with support from a wholesale service (switched access), to price squeeze as well.

which Qwest operates. Competitors have entered Qwest's markets because of the profitable opportunities that exist and because entry barriers are low. Despite the current imbalance in market shares, the structural conditions exist to make the telecommunications markets in Arizona contestable. A predatory pricing strategy could only work if Qwest could not only sustain the initial losses associated with such a strategy but also raise and defend permanent entry barriers in order to keep competitors from re-entering and to maintain prices above competitive levels.[33] That scenario is simply unthinkable: complete deregulation of Qwest is not imminent, nor is there a possibility that the substantial capacity investments now being made by several competitors in Arizona will vaporize overnight under predatory pricing pressure from Qwest.

Second, Dr. Selwyn appears to believe that Qwest has, or is seeking, the flexibility to price its wholesale services (in particular, switched access) not only above costs but at even higher than current levels. That suspicion is misplaced, however, because it is very much in Qwest's interest to bring certain wholesale service prices (particularly, switched access) down from current levels, as competitive supply of those services develops. For example, Qwest has asked regulators to initially reduce and eventually remove implicit subsidy contributions

[33] Predatory pricing has been defined as "pricing at a level calculated to exclude from the market and equally or more efficient competitor." See W. Kip Viscusi, John M. Vernon, and Joseph E. Harrington, Jr., *Economics of Regulation and Antitrust*, Second Edition, Cambridge, MA: MIT Press, 1996, at 272. This source also explains why predatory pricing is an unwise *strategy* and has never been shown to succeed.

1 from its wholesale service rates in conjunction with either rate rebalancing or
2 universal service reform.

3 The whole specter of price squeeze raised by Dr. Selwyn is, in my opinion,
4 totally misplaced. Apart from the fact that imputation practices *are* effective
5 safeguards against price squeeze, there is also a fundamental finding from
6 economic theory that a profit-maximizing monopoly in an upstream wholesale
7 market gains *absolutely no advantage* by trying to monopolize a competitive
8 downstream retail market (using price squeeze or other tactics) *if* the retail product
9 uses the wholesale input *in fixed proportions.*[34] Even if Qwest truly monopolized
10 the carrier access market (which it does not as substitutes for Qwest's switched
11 access service are available), it cannot leverage its monopoly power in the
12 wholesale market to become a profit-maximizing monopoly in the retail market.
13 That is because the retail service—most likely, intraLATA toll—uses the wholesale
14 service—most likely, switched access—in fixed proportions. The point is: *even if*
15 Qwest wanted to monopolize the retail markets in which it operates, it would *not*
16 gain anything more from its troubles than if it were to just compete in those
17 markets. There is, thus, no incentive—let alone ability—for Qwest to attempt to
18 monopolize the retail markets that are presently competitive.

19 **Q. DR. SELWYN ALSO CLAIMS [AT 28] THAT IMPUTATION WILL NOT WORK AS**
20 **AN ADEQUATE SAFEGUARD. IS THERE ANY TRUTH TO THIS CLAIM?**

[34] *Id.*, at 235-236.

A. None whatsoever. Dr. Selwyn states that "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 cost of wholesale services to prevent an anticompetitive price squeeze from being perpetrated upon competitors." But as I have just explained, Qwest has neither the incentive nor the ability to attempt to monopolize retail markets that are presently competitive. On the point of imputation itself, Dr. Selwyn's worry about its safeguarding ability is similar to that expressed by Ms. Starr [at 12-13]. As I demonstrated in my Rebuttal Testimony [at33-36], their worries are unfounded. Imputation, properly viewed (i.e., when the ILEC's opportunity costs are taken account of), completely eliminates any possibility of price squeeze. Moreover, imputation is needed as a safeguard only as long as competitive alternatives to the wholesale services in question do not exist. That situation is rapidly changing.

PRICING PAYPHONE ACCESS LINES ABOVE INCREMENTAL COST

Q. PLEASE SUMMARIZE DR. ILEO'S REBUTTAL ARGUMENTS.

A. Dr. Ileo criticizes my Rebuttal Testimony on the issue of Public Access Line ("PAL") services. He argues [at 21, 25, and 29] that:

1. I am mistaken in my view of Section 276 of the 1996 Act as it pertains to subsidies *from* payphone services *to* other telecommunications services. He argues that Section 276 of the 1996 Act requires the removal of subsidies *from* payphone services as well as *to* payphone service.

2. I have mischaracterized his direct testimony as equating the Commission's task in this proceeding to setting UNE rates. He argues that he has not equated the two tasks.

3. Nothing in my Rebuttal Testimony supports a finding that Qwest's PAL rates are reasonable. Dr. Ileo reaches this conclusion based on the argument that I have neither conducted a PAL cost study nor performed a Ramsey Pricing study, and my testimony contradicts Qwest's own reasons for including a TELRIC-based UNE rate in the costs of PAL.

Q. HOW DO YOU RESPOND TO DR. ILEO'S CRITICISMS?

A. Dr. Ileo's arguments are unfounded. First, my understanding of Section 276 of the 1996 Act and its implications for removing subsidies is correct, and comports with the conclusions from most other regulatory proceedings I am aware of that have implemented that section of the 1996 Act. Second, although Dr. Ileo may not explicitly equate the Commission's task in this proceeding to setting UNE rates, his Direct Testimony nevertheless makes numerous references to Commission Decision No. 60635, arguing how the results from that proceeding should be used in the current proceeding. In fact, Dr. Ileo's Direct Testimony makes more references to the Commission's UNE proceeding than there are pages in his Direct Testimony. Third, I do not need to perform either a PAL cost study or a Ramsey Pricing study to conclude that Qwest's rates are reasonable. Qwest's PAL rates are in accordance with the principles I discussed in my Rebuttal Testimony [at 58-60 and 64-71]. Qwest's incorporation of cost elements based on TELRIC is not inconsistent with my testimony, nor is it inappropriate.

Q. HOW DO YOU RESPOND TO DR. ILEO'S ASSERTION [AT 22] THAT YOU ARE MISTAKEN IN YOUR VIEW OF SECTION 276 OF THE 1996 ACT? PLEASE EXPLAIN HOW YOUR INTERPRETATION DIFFERS FROM DR. ILEO'S.

A. It is apparent that Dr. Ileo and I disagree about the following paragraph in the Act, namely, Section 276(a):

> any Bell operating company that provides payphone service – (1) shall not subsidize its payphone service directly or indirectly from its telephone exchange service operations or its exchange access operations

As I understand Dr. Ileo's position, he argues [at 22] that this paragraph prohibits subsidies *from* payphone services *to* other services. I disagree and, although I am not a lawyer, find no support for that conclusion in this paragraph of the 1996 Act. According to the plain language of the paragraph above, the 1996 Act prohibits subsidies *to* Qwest's payphone services "*from* its telephone exchange service operations or its exchange access operations."[35] That prohibition was intended (at a minimum) to remove the explicit payphone element in the interstate non-traffic sensitive costs recovered in the interstate carrier common line and subscriber line charges.

Q. ON THE SUBJECT OF SUBSIDIES, DR. ILEO ARGUES [AT 7] THAT QWEST WITNESS MR. THOMPSON'S TESTIMONY INAPPROPRIATELY DISCUSSES STAND-ALONE COSTS WITH RESPECT TO PAL COSTING AND PRICING. IS DR. ILEO CORRECT?

[35] Emphasis added.

A. No. It is entirely appropriate for Mr. Thompson to raise the issue of SAC when discussing subsidy calculations. Dr. Ileo states [at 9-10] that he does not disagree with the definition of a subsidy inherent in the theory of SAC, only that the differences between SAC and "TELRIC plus a reasonable allocation of common costs" are invariably small. Whether or not that assessment is correct, it is beside the point: the test of subsidy he offers [at 7], namely, a service provides a subsidy *whenever* its price exceeds TELRIC and a reasonable share of common costs, is wrong. As I explained in an earlier section, for a service to provide a subsidy, its price must exceed its SAC. So Dr. Ileo would have to demonstrate that his preferred standard (TELRIC plus a reasonable share of common costs) is indeed the same as SAC. Simply asserting that it is so is a far cry from proving that result with hard data or evidence.

Q. DR. ILEO ARGUES [AT 24] THAT HIS TESTIMONY DOES NOT DRAW A COMPARISON BETWEEN THE COMMISSION'S TASK IN THIS PROCEEDING AND ITS DECISION NO. 60635. PLEASE RESPOND.

A. Dr. Ileo may not explicitly draw that comparison, but his testimony certainly links the current proceeding with a UNE rate-setting proceeding. For example, he recommends [at 48] that the Commission clarify its Decision No. 60635, and require PAL-specific cost studies using the very cost methodology that was used to set UNE prices. To that end, he even recommends using the same allocation of common costs that the Commission prescribed for setting UNE rates.

1 The Commission's task in this proceeding is *not* to set PAL rates based on
2 UNE rates, rather it is to ensure that Qwest (1) does not subsidize its payphone
3 service from telephone exchange services or exchange access operations and (2)
4 does not prefer, or discriminate in favor of, its payphone services. Qwest has
5 satisfied both requirements by setting its PAL rate at TSLRIC plus a reasonable
6 contribution to common costs, and by making PAL service available to its own
7 payphone affiliate and competing independent payphone service providers on
8 exactly the same charges, terms, and conditions. The critical requirement, of
9 course, is that Qwest's tariffed rates for BPAL and SPAL pass the FCC's "new
10 services test." The new services test does not set a rate in the same sense that a
11 UNE proceeding does, but rather it considers whether proposed rates for BPAL
12 and SPAL services are (1) cost based, (2) consistent with the requirements of
13 Section 276 of the 1996 Act, and (3) non-discriminatory. As I discussed in my
14 Rebuttal Testimony [at 71-78], Qwest's proposed rates in this proceeding pass the
15 new services test.

16 **Q. BECAUSE YOUR REBUTTAL TESTIMONY CRITICIZES THE USE OF TELRIC**
17 **FOR SETTING PAL RATES, DR. ILEO [AT 27] DOUBTS YOUR**
18 **ENDORSEMENT OF QWEST'S COST STANDARD IN THIS CASE. PLEASE**
19 **RESPOND.**

20 A. Dr. Ileo's doubts stem from my opposition to the use of a TELRIC methodology in
21 the current proceeding and Qwest's basing a portion of its PAL cost standard on
22 results from a TELRIC study used to set UNE rates. However, Qwest's cost

support in this proceeding is not entirely TELRIC-based, which would be incorrect for the reasons I reviewed in my Rebuttal Testimony. Dr. Ileo appears to be creating an issue where there is none. Simply put, Qwest has used a proper cost standard for PAL services in this proceeding.

Q. DOES THAT CONCLUDE YOUR REJOINDER TESTIMONY?

A. Yes.

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 APPPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN.	)	**DOCKET NO. T-1051B-99-105**
	)	**AFFIDAVIT OF WILLIAM E. TAYLOR**
	) :	**ss**
COMMONWEALTH OF MASSACHUSETTS	)	
COUNTY OF MIDDLESEX	)	

William E. Taylor, of lawful age being first duly sworn, depose and states:

1. My name is William E. Taylor. I am Senior Vice President, National Economic Research Associates, Inc., of Cambridge, Massachusetts. I have caused to be filed written rejoinder testimony in support of Qwest in Docket No. T-1051B-99-105.

2. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct to the best of my knowledge and belief.

Further affiant sayeth not.

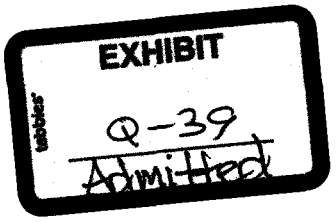
William E. Taylor

SUBSCRIBED AND SWORN to before me this 15th day of September, 2000.

Notary Public
Cambridge, MA

My Commission Expires: 9-24-04

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-01051B-99-0105

REJOINDER TESTIMONY OF

DAVID L. TEITZEL

QWEST CORPORATION

SEPTEMBER 19, 2000

REJOINDER TESTIMONY OF DAVID L. TEITZEL

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INTRODUCTION AND PURPOSE

Q. PLEASE STATE YOUR NAME, OCCUPATION, AND BUSINESS ADDRESS.

A. My name is David L. Teitzel. I am employed by Qwest Corporation (Qwest), formerly known as U S WEST Communications, Inc., as Director-Product and Market Issues. My business address is 1600 7th Avenue, Room 2904, Seattle, WA, 98191.

Q. DID YOU FILE DIRECT TESTIMONY IN THIS DOCKET ON JANUARY 8, 1999, SUPPLEMENTAL DIRECT TESTIMONY ON MAY 19, 2000 AND REBUTTAL TESTIMONY ON AUGUST 21, 2000?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR REJOINDER TESTIMONY?

A. The purpose of my testimony is to address and respond to various issues raised by intervening parties in this Docket through surrebuttal testimony, including Dr. Francis Collins, Mr. William Dunkel, Dr. Lee Selwyn, Dr. Ben Johnson and Ms. Arleen Starr.

RESPONSE TO DR. FRANCIS COLLINS

Q. AT PAGE 3, DR. COLLINS CLAIMS THAT QWEST HAS FAILED TO PROVIDE A COMPREHENSIVE ASSESSMENT OF COMPETITIVE LOSSES IN ARIZONA IN THIS DOCKET AND THAT THE CURRENT LEVEL OF COMPETITION DOES NOT WARRANT PRICING FLEXIBILITY FOR QWEST. WHAT IS YOUR RESPONSE?

A. Dr. Collins assertions are simply wrong. The competitive losses identified in my previous testimony in this docket represent only a subset of the Qwest competitive losses in Arizona. For example, customers moving into Arizona and establishing service with a Qwest competitor are not identifiable as competitive losses and are not included in any "share" estimates. Customers who choose to leave Qwest for a facilities-based competitor, such as Cox, who do not self report as leaving Qwest for a competitor are not tracked as competitive losses (as acknowledged by Dr. Collins at Page 4, lines 15-17 of his surrebuttal testimony). Customers who choose to replace a Qwest additional line with a competitor's service are not tracked as competitive losses so long as the primary service remains with Qwest.

Dr. Collins asserts that the argument that identifiable Qwest competitive loss do not represent total losses is "...neither logical nor convincing"[1] Again, Dr. Collins is wrong. The competitive losses Qwest has the ability to identify are a subset of overall losses to competition in Arizona.

Finally, Dr. Collins attributes a belief to Qwest that "...100% of the existing market, as well as the future market, belongs to Qwest..."[2] Dr. Collins' logic in arriving at this conclusion is mysterious at best. Nowhere in any Qwest testimony or data request response has any Qwest witness suggested anything of the sort. Qwest fully recognizes that competition is here to stay, and will comply with all federal and state requirements designed to foster the growth of fair competition. The demonstration of the presence of open competition and consequent request for Competitive Zone classification for wire centers in which full competition exists as set forth in previous testimony is intended only to establish an environment of competitive parity in which either Qwest or its competitors will win customers' business based on value-added packaging, creative marketing and service quality instead of uneven regulatory constraints.

Q. AT PAGE 4, DR. COLLINS ASSERTS THAT QWEST COMPETITIVE LOSSES TO RESALE OR UNE-BASED COMPETITION ARE NOT TRUE LOSSES, BUT SIMPLY REVENUE TRANSFERS BETWEEN QWEST'S RETAIL AND WHOLESALE ORGANIZATIONS. IS THIS VIEW ACCURATE?

[1] Collins surrebuttal, Page 4, Lines 21-23.
[2] Collins Surrebuttal, Page 4, Lines 1 and 2.

A. Absolutely not. In fact, Dr. Collins extends his argument to say "...Qwest considers the transfer of net revenue, **which may be the same number of dollars as net revenue**, to wholesale services as a loss to competition."[3] (emphasis added). Dr. Collins' argument makes no sense. Currently, Qwest's residential resale discount in Arizona is approximately 12%, and UNEs are fully available to competitors at prices even lower than the discounted resale rate levels, with the exception of unbundled loops for residence customers. The net revenue impact of Qwest losses to these forms of competition is certainly greater than zero. Additionally, a customer lost to resale or UNE-based competition represents a customer with whom Qwest has lost a direct marketing relationship, which diminishes the opportunity for Qwest to offer service packages and other new value propositions to that customer. Contrary to Dr. Collins' assertions, competitive losses to resale and UNE forms of competition are true customer losses to Qwest.

Q. DR. COLLINS SUGGESTS THAT COMPETITIVE LOCAL EXCHANGE CARRIERS (CLECS) AND QWEST ARE ON EQUAL REGULATORY FOOTING, SINCE CLECS TYPICALLY PROVIDE SERVICE TO ANY CUSTOMER REQUESTING SUCH SERVICE IN THE LOCALITIES IN WHICH THE CLECS HAVE CHOSEN TO SERVE.[4] IS HE CORRECT?

A. No. Qwest's competitors have chosen to deploy service in Phoenix and Tucson in a very targeted way. For example, residential customers in Chandler have the option to subscribe to telephone service offered by

[3] Collins surrebuttal,Page 4, Lines 23-25.
[4] Collins surrebuttal, Page 7, Lines 1-9

Cox, while customers in Bisbee and other less urban areas of the state do not. In this example, if Qwest chooses to deploy a package of services designed to counter Cox's offer, it must make the package available to all residential customers in Arizona. Qwest currently does not have the flexibility to respond to competitors with the same granularity with which Qwest's competitors enter the market. Regulatory parity between Qwest and its competitors does not yet exist.

Q. AT PAGE 9, DR. COLLINS ARGUES THAT QWEST'S DATA REGARDING THE PRESENCE OF COMPETITION IS INCOMPLETE.[5] IS HE CORRECT?

A. Perhaps, but on this point, it is not clear what he means. Qwest's data is incomplete in the sense that Qwest does not have data that measures the full extent of competitive losses. While Dr. Collins implies that the competitive intelligence sources cited in footnote 6 of my rebuttal testimony can be used to accurately quantify overall competitive losses, he neglects to mention what footnote 6 said, which is as follows:

> However, Qwest has obtained competitive intelligence regarding Cox's plans to deploy telephone service in Tucson in 2001.

This reference is only to a publicly-available document Qwest located which refers to Cox's intent to deploy residential service in Tucson. In no way does this footnote suggest that Qwest has the ability to accurately quantify all competitive losses in Arizona. In fact, only Qwest's

[5] Collins surrebuttal, P. 9, Lines 1-19

competitors have accurate data regarding the number of customers they now serve.

Qwest has provided extensive data in this docket demonstrating the presence of competition in each of the wire centers for which Qwest has requested Competitive Zone classification. Each of these wire centers is served by at least one facilities-based provider in addition to resale and wireless providers. The competitive data available to the Commission in this Docket is more than sufficient to support a finding that effective competition exists in these wire centers.

RESPONSE TO MR. WILLIAM DUNKEL

Q. AT PAGE 41 OF HIS SURREBUTTAL TESTIMONY, MR. DUNKEL CLAIMS THAT QWEST IS ASKING THIS COMMISSION TO CLASSIFY ANY WIRE CENTER AS A COMPETITIVE ZONE IF A COMPETITOR IS SERVING ONLY ONE CUSTOMER IN THAT WIRE CENTER. IS THIS AN ACCURATE REPRESENTATION OF QWEST'S PROPOSAL?

A. No. In fact, Qwest has provided extensive documentation demonstrating the presence of a variety of competitors, each serving a significant number of customers, in each wire center for which Competitive Zone classification is being requested. Further, any future Competitive Zone requests will be subject to Commission scrutiny and approval..

Q. ALSO AT PAGE 41, MR. DUNKEL COMPLAINS THAT QWEST HAS NOT PROVIDED SUFFICIENT COMPETITIVE INFORMATION TO SATISFY THE REQUIREMENT OF ARTICLE 11, SECTION R.14-2-1108(B) OF THE COMMISSION'S RULES. DO YOU AGREE?

A. No. Qwest has supplied extensive evidence of the presence of competition in each of the wire centers for which it seeks Competitive Zone status. Included in this evidence is customer loss tracking data (to both facilities-based and non-facilities based competition), identification of specific competitors, known affiliations/mergers between competitors, summaries of competitors' pricing in the subject wire centers, route maps displaying the location of competitors' fiber optic facilities in each of these wire centers and marketing materials demonstrating the active promotion by Qwest's competitors of substitute services. For the reasons outlined in my responses to Dr. Collins' testimony, Qwest cannot accurately determine its market share nor that of its competitors in each wire center for which Competitive Zone status is requested without first obtaining information from competitors that they will not produce. In-service data specific to individual carriers is available only to those carriers, and the competitive carriers protect such information as extremely confidential. However, Qwest's estimates of market share is no less accurate than that which has been relied on by the numerous other CLECs who have petitioned for competitive classification under these same rules. In those instances, the carriers have made no attempt to quantify market share with any degree of accuracy. Instead, they have relied on broad statements and estimates that are much less detailed and accurate than

the information Qwest has provided in this docket. And in most instances, the Commission has chosen to accept those broad estimates. The rules specify neither a standard of review, nor a threshold for determining what constitutes a competitive market. However, the Commission possesses the authority to compel each provider of telecommunications services in the greater Phoenix and Tucson areas to confidentially provide reports to the Commission of the number of access lines now served in each geographic area in which Qwest has requested Competitive Zones be established. This data, coupled with previously supplied Qwest counts of access lines by wire center, would enable the Commission to gain an accurate view of relative market shares for each provider. Interestingly, the Utah Commission has taken this approach, and subsequently found that sufficient competition now exists to classify wire centers along the Wasatch Front as Competitive Zones.

Q. AT PAGES 41 AND 42, MR. DUNKEL COMPLAINS THAT, UNDER QWEST'S PROPOSAL, QWEST COULD "...INCREASE RATES WHERE EFFECTIVE COMPETITION DOES NOT EXIST." IS HE CORRECT?

A. No. If the Commission determines that Competitive Zone classification of a particular wire center is warranted, it will do so on the basis of the presence of a broad array of competitive alternatives to Qwest's services in that wire center. In reality, there is no competitor in any Qwest wire center in the greater Phoenix and Tucson areas that is offering only one residential or business service, as documented in my direct testimony in

this Docket. Competition exists in each wire center for which Qwest seeks Competitive Zone classification.

Q. AT PAGE 45, MR. DUNKEL TAKES ISSUE WITH YOUR CONTENTION THAT THE PRESENCE OF RESALE-BASED COMPETITION IS MUCH MORE PREVALENT IN PHOENIX AND TUCSON EXCHANGES THAN IN THE REMAINDER OF THE STATE. WOULD YOU COMMENT?

A. Yes. In his surrebuttal, Mr. Dunkel references Confidential Exhibit DLT-4 to my rebuttal testimony, which provides a comparison of the number of access lines served by resale-based competitors in the Bisbee and Chandler Main wire centers. The numbers shown on this exhibit are incorrect, and have been corrected in Confidential Exhibit DLT-1 to this testimony. The source for this information is Qwest's data request response to WDA 02-39, and the data was not compiled correctly in Confidential Exhibit DLT-4 to my rebuttal. As revised Confidential Exhibit DLT-1 shows, resale-based competition is much more prevalent in Chandler than it is in Bisbee.

Q. AT PAGE 46, MR. DUNKEL STATES "IN ORDER TO LURE CUSTOMERS AWAY FROM QWEST, COMPETITORS HAVE TO CHARGE LOWER PRICES OR OFFER SOME OTHER ADVANTAGE OVER QWEST." IS THIS AN ACCURATE REPRESENTATION OF THE COMPETITIVE DYNAMICS IN WIRE CENTERS IN THE GREATER PHOENIX AND TUCSON AREAS?

A. It certainly is. In fact, this is the model for competitive entry I have seen in each of the 14 traditional Qwest states. Competitors choose to enter markets on a selective geographic basis and offer attractive pricing and packaging to encourage customers to shift to their services. The problem with this model, of course, is that Qwest must offer the same services, at the same basic prices, to all customers in its Arizona service territory. Qwest is currently precluded from differentiating between geographic markets to respond to competition occurring on that basis. To the extent that Qwest is compelled by competitive dynamics to offer a certain bundle of services to respond to a specific competitor's offer in a particular wire center, that same bundle must be offered statewide.

Q. AT PAGE 46, MR. DUNKEL STATES THAT COX COMMUNICATIONS OFFERS RESIDENTIAL BASIC EXCHANGE SERVICE TO ITS CABLE TELEVISION CUSTOMERS AT $11.75 PER MONTH. IS THIS CORRECT?

A. Only in part. Cox actively promotes residential basic exchange service for additional lines at $6.50 per month for its customers who also subscribe to cable television from Cox. Under current regulatory guidelines, Qwest cannot offer prices competitive with Cox's additional line offer. Additionally, since this offer is only available to customers who also subscribe to Cox cable television service, I can only conclude that Cox is subsidizing this low price with margins available from its cable television operations.

Q. MR. DUNKEL, AT PAGE 47, ARGUES THAT QWEST COULD RAISE RATES IN PARTS OF ARIZONA NOT SUBJECT TO EFFECTIVE COMPETITION TO OFFSET A PRICE RESPONSE TO A COMPETITIVE OFFER SUCH AS THE ONE AVAILABLE FROM COX. IS THIS REASONABLE?

A. No. If Qwest's services are found by the Commission to not be subject to competition, the Commission will not grant Competitive Zone status for that wire center. At this point, services in wire centers outside greater Phoenix and Tucson are generally fully regulated, and the Commission will have continued full regulatory control of Qwest's prices in those areas. Finally, if Qwest hypothetically increased a price in a Competitive Zone which the Commission found to be inappropriate or anticompetitive, the Commission has full authority under Commission Rule R14-2-1108(H) to reclassify Qwest's services in that wire center as noncompetitive. Clearly, both competitive and regulatory checks and balances are in place to ensure appropriate pricing in the competitive Phoenix and Tucson markets.

Q. AT PAGE 48, MR. DUNKEL COMPLAINS THAT, UNDER QWEST'S COMPETITIVE ZONES PROPOSAL "...THE MINIMUM PRICES FOR SERVICES COULD BE BELOW THE TOTAL SERVICE LONG RUN INCREMENTAL COST..." WOULD YOU COMMENT?

A. As stated in the previous response, the Commission will continue to have the authority to monitor Qwest's pricing practices and to take appropriate action if necessary. Nothing in previous Qwest testimony suggests that

Qwest's pricing in a Competitive Zone will violate any Commission rule or Arizona statute. Commission Rule R-14-2-1109(A) states:

> A telecommunications company governed by this Article may price a competitive telecommunications service at any level at or below the maximum rate stated in the company's tariff on file with the Commission, provided that the price for the service is not less than the company's total service long run incremental cost of providing the service.

Qwest will continue to comply with this requirement in any wire center the Commission determines to warrant Competitive Zones classification. Although Qwest believes that, so long as average prices for services within Competitive Zones exceed TSLRIC for the service, subsets of customers could receive prices slightly below TSLRIC within existing Commission rules. However, Qwest will not contest this issue in this Docket, and will commit to maintaining prices above TSLRIC in all competitive zones.

Q. AT PAGE 50, MR. DUNKEL IMPLIES THAT THE COMMISSION HAS NO AUTHORITY TO TAKE ACTION IF QWEST WERE TO "DOUBLE" ITS RATES WITHIN COMPETITIVE ZONES. IS THIS IMPLICATION ACCURATE?

A. No. Commission rules provide the Commission the authority to rescind Competitive Zone status in any wire center in which it finds that Qwest has priced its services in an inappropriate manner. In addition, competitive forces present in the wire centers for which Qwest has requested

Competitive Zones status will drive prices for all providers serving those markets to market-based levels.

Q. AT PAGES 51 AND 52, MR. DUNKEL DISMISSES RESALE AND UNE-BASED COMPETITION AS BEING UNABLE TO PROVIDE "...ANY SIGNIFICANT PROTECTION FROM IMPROPER PRICES INCREASES BY THE LEC." IS HE CORRECT?

A. No. Mr. Dunkel bases his entire conclusion on the dynamics of resale, which provides resellers of Qwest services in Arizona a discount of approximately 12% from standard residential retail rates. Certainly, resale of Qwest services is a means of competitive entry with minimal capital investment. Additionally, resellers of services such as Centrex are able to create additional margins by contracting with alternative long distance providers to gain volume discounts on toll services which can be passed on, at least in part, to the reseller's customers. Mr. Dunkel is incorrect if he believes the 12% resale discount defines the entirety of resale competitive dynamics. Mr. Dunkel completely ignores UNE-based competition as a viable alternative through which competitors can enter the Arizona market. In fact, UNE wholesale prices are completely unrelated to retail pricing, and represent prices to competitors even lower than resale prices, except for residence unbundled loops. Both resale and UNE-based competition create market based pricing constraints on Qwest's pricing in Arizona.

Q. MR. DUNKEL REITERATES HIS CONTENTION AT PAGE 54 THAT "...LOOP FACILITIES ARE USED BY AND ARE REQUIRED TO PROVIDE A WHOLE FAMILY OF SERVICES"[6] AND COSTS OF PROVIDING THE LOOP SHOULD THEREFORE BE TREATED AS SHARED COSTS. DO YOU AGREE?

A. No. This issue is addressed in detail in the rebuttal testimonies of Dr. Taylor and Mr. Thompson on behalf of Qwest. Mr. Dunkel relies on this flawed assumption to support his contention that Qwest's proposed Zone Increment price structure is excessive. He goes on to state that Toll and Switched Access revenues generated by rural Arizona customers should be factored into Zone Increment pricing decisions. As stated in my rebuttal testimony, it is very important that Qwest's wholesale and retail pricing structures for loop-based services remain consistent to prevent rate arbitrage and economically inefficient competitive growth in Arizona. Under Mr. Dunkel's proposal, loop costs could be allocated to a wide range of services and Toll and Switched Access revenues could be used to offset the higher costs of providing Qwest service to rural Arizona customers. This proposal is inappropriate. As discussed by Dr. Taylor and Mr. Thompson, service costs must follow the cost-causer. In addition, Mr. Dunkel's suggestion that implicit subsidies should be maintained from Toll and Switched Access services to basic exchange services is clearly contrary to the guidelines of the Telecommunications Act of 1996, which requires that implicit subsidies must be made explicit.

[6] Dunkel surrebuttal, P. 54, Lines 23-24

Q. AT PAGE 56, MR. DUNKEL STATES THAT, WHEN A COMPETITOR IS ASSESSING WHETHER TO ENTER A PARTICULAR MARKET, "...THE RATIONAL COMPETITOR WILL CONSIDER THE TOTAL REVENUES FROM THE WHOLE PACKAGE OR FAMILY OF SERVICES THAT THE COMPETITOR WOULD RECEIVE FROM A CUSTOMER (INCLUDING TOLL/SWITCHED ACCESS REVENUES", NOT JUST THE REVENUE IT WILL RECEIVE FROM BASIC EXCHANGE SERVICE. WHAT DOES THIS STATEMENT MEAN TO YOU?

A. Mr. Dunkel seems to be saying that competitors should proceed with entering rural markets, even if UNE loop rates are significantly higher than the prices the competitor may be able to charge its customers, since competitors can expect to enjoy the margin windfall associated with Toll and Switched Access service.

Q. WHAT IS THE PROBLEM WITH THIS POSITION?

A. In the Arizona market, competitors are not following Mr. Dunkel's suggestion. Rather, the preponderance of competitive activity is in the greater Phoenix and Tucson areas of the state. I can only conclude that competitors have examined the financial opportunities associated with rural versus urban markets, and have found that the cross-subsidy concept advanced by Mr. Dunkel doesn't work.

Q. AT PAGE 57, MR. DUNKEL TAKES ISSUE WITH QWEST'S POSITION THAT REDUCTIONS IN INTRALATA LONG DISTANCE RATES DO NOT RESULT IN INCREASED CALL VOLUMES, AND THAT QWEST

SHOULD NOT INCORPORATE TOLL RATE CHANGES INTO THIS DOCKET IN ANY EVENT. DO YOU AGREE?

A. No, for two reasons. First, Qwest is also proposing substantial Switched Access rate reductions in this Docket. If intraLATA long distance prices are not also reduced, Qwest will lose an even greater number of long distance minutes to its competitors than the significant number it has lost to date. Since Switched Access and intraLATA long distance revenues remain in Qwest's rate base in Arizona, the net effect of Switched Access reductions without corresponding intraLATA long distance rate reductions would be an increase in Qwest's revenue requirement in this Docket, which would ultimately be borne by the Arizona ratepayer.

Next, in the "monopoly" environment in which Qwest's predecessors operated in an earlier era, a substantial change in intraLATA long distance prices could be expected to generate a measurable demand response. However, in the current, highly competitive long distance market, customers are not swayed by price points until they approach the level of $0.05. In states such as Washington, Nebraska and Wyoming, where intraLATA long distance prices reductions have been implemented, Qwest has not experienced an increase in call volume. There is no fact-based reason to expect that intraLATA long distance call volumes in Arizona will be stimulated in response to Qwest's price proposal in this docket. The intraLATA long distance pricing proposal in this Docket can be expected, however, to enable Qwest to continue to reasonably compete in the

market, which would not be possible if Switched Access rates are reduced absent long distance price adjustments.

Q. REGARDING THE DIRECTORY ASSISTANCE (D.A.) PRICING PROPOSAL IN THIS DOCKET, MR. DUNKEL ALLEGES THAT QWEST HAS INCORRECTLY CALCULATED THE REVENUE IMPACT ASSOCIATED WITH THE PROPOSED D.A. PRICE INCREASE. DO YOU AGREE?

A. No. Mr. Dunkel alleges that the temporary D.A. surcharge of $0.12 in place during 1999 was inappropriately included in the calculation of "present" D.A. revenues in Qwest's revenue impact calculations, causing the net revenue impact of the D.A. price change to be understated. Mr. Dunkel also included a detailed spreadsheet as Confidential Exhibit 31 to his surrebuttal testimony to demonstrate how he arrived at his conclusion. While Mr. Dunkel relies upon portions of Qwest's response to data request WDA 35-6, he chose to ignore other portions of the response which directly address his contention. In Confidential Exhibit DLT-2, I recreate the full content of Qwest's response to Mr. Dunkel in WDA 35-6, Attachment B. This analysis clearly shows that the "present" revenue calculations are based on a price per D.A. call of $0.47 and provides a line item view of the components of the revenue impact calculations that result in the annual D.A. revenue impact displayed in my Supplemental Direct testimony in this Docket.

Q. AT PAGE 61, MR. DUNKEL CLAIMS THAT QWEST PRICES PRIVACY LISTINGS AS IF THEY WERE NON-DISCRETIONARY SERVICES. IS HIS INTERPRETATION CORRECT?

A. No. Mr. Dunkel bases his position on an emotional appeal that some customers utilize Privacy Listings because they have been "...targets of harassment or worse," and that Privacy Listings should therefore not be considered to be discretionary. Like Mr. Dunkel, I am sensitive to the utility of Privacy Listings to the subset of customers that use them to limit harassing calls. However, this service remains indisputably an optional service, and Qwest's proposed price levels remain reasonable.

Q. HAS MR. DUNKEL PROPERLY INTERPRETED YOUR REBUTTAL TESTIMONY REGARDING SERVICE AFFORDABILITY?

A. No. At Page 62, Lines 18, he states: "...contrary to Mr. Teitzel's claims, making universal service affordable for all not only fits in the post TA-1996 environment, but it is a specific requirement of TA96." On this point he has misinterpreted my testimony. The following is the full text of the portion of my rebuttal from which Mr. Dunkel has drawn to paraphrase my "claims":

> Mr. Dunkel seems to dismiss targeted assistance plans for customers with limited means, and instead, suggests that local exchange prices should be driven to very low levels to ensure affordability for all. This was a valid concept in the past, but no longer fits in the post-TA 1996 environment. All prices must now be moved toward cost. Implicit subsidies must be identified and made explicit. Prices must be deaveraged and cost-based. These things must be accomplished through a combination of rate rebalancing and High Cost Fund support, and Telephone

> Assistance and Link Up Plans will continue to be available to provide additional support to low income households to optimize universal service. **Qwest agrees that residential basic exchange service must continue to be available at affordable rates, but the traditional, subsidy-laden model for accomplishing that goal is no longer viable.** [7](emphasis added).

I stand by my testimony that the Telecommunications Act of 1996 requires that traditional implicit telecommunications subsidies be made explicit, that rates must become cost-based, and that High Cost Fund and other assistance plans will be available to ensure that telephone service continues to be reasonably available to all customers. These conclusions are far different from those ascribed to me by Mr. Dunkel.

RESPONSE TO DR. BEN JOHNSON

Q. AT PAGE 7, LINES 20 THROUGH 25, OF HIS SURREBUTTAL, DR. JOHNSON OPINES THAT QWEST'S RATE DESIGN IN THIS DOCKET DOES NOT CONSISTENTLY REFLECT COST CAUSATION. DO YOU AGREE?

A. No. Qwest's rate design establishes prices that are above cost (with the notable exception of residential basic exchange services) and generates revenues which support the positive revenue requirement in Arizona identified by Qwest witness George Redding. The proposed prices do not reflect a standard "mark up" above direct cost, nor should they. It is a common pricing practice in telecommunications and other industries that prices for discretionary services carry higher margins than less

[7] Rebuttal Testimony of David L. Teitzel, Pages 26 and 27.

discretionary services. For example, an optional compact disc player on a Ford typically is priced at a higher margin than the car itself. Dr. Johnson complains that Qwest's proposed prices for discretionary services such as Caller I.D. and premium listings generate increased margins for these services. These pricing proposals are not inconsistent in any way with pricing structures previously approved by the Commission, nor are they inconsistent with economic theory, as discussed in greater detail in the rejoinder testimony of Dr. Taylor.

Q. SHOULD QWEST WITHDRAW ITS PROPOSAL TO INCREASE PRICES ON DISCRETIONARY SERVICES SUCH AS CALLER I.D. OR PREMIUM LISTINGS, OR TO MOVE THEIR PRICES DOWNWARD TOWARD DIRECT COST, WHAT WOULD BE THE EFFECT ON THE REMAINDER OF QWEST'S PRICING PROPOSALS?

A. Since the discretionary services in Qwest's rate design proposal are integral to Qwest's revenue requirement in Arizona, prices for other less discretionary services, such as residential and business basic exchange services, would need to bear an additional increase to enable Qwest to fulfill the positive revenue requirement identified in this Docket if incremental revenues from discretionary services were removed from the pricing equation.

Q. AT PAGES 18 AND 19, DR. JOHNSON ARGUES THAT QWEST'S COMPETITIVE ZONES PROPOSAL WOULD ALLOW QWEST TO ENGAGE IN "ANTICOMPETITIVE PRICING."[8] DO YOU AGREE?

A. No. As discussed in my earlier rejoinder testimony regarding similar claims made by Mr. Dunkel, Qwest's Competitive Zones proposal represents a mechanism to create competitive parity between Qwest and its competitors. Currently, Qwest's competitors have the latitude to enter markets in a highly targeted manner and price services on that basis. Qwest's ability to respond to such entry is currently limited to introducing pricing or packaging plans on a statewide basis. Contrary to Dr. Johnson's claims, the Competitive Zones proposal will not create any sort of "competitive advantage" for Qwest, but will enable Qwest to compete on an equal footing with the array of competitors now present and those who will enter the market in the future.

Q. AT PAGE 19, LINES 19 THROUGH 21, DR. JOHNSON CAUTIONS THE COMMISSION THAT IT "...SHOULD NOT SIMPLY ASSUME THAT ANTICOMPETITIVE BEHAVIOR WON'T OCCUR, NOR SHOULD IT ASSUME THAT THE ANTI-TRUST LAWS ARE SUFFICIENT TO PROTECT THE PUBLIC INTEREST." DOES THE COMMISSION HAVE REMEDIES AVAILABLE TO IT IF QWEST ENGAGES IN "ANTICOMPETITIVE BEHAVIOR" IN PRICING SERVICES NOW CLASSIFIED AS FULLY COMPETITIVE OR SERVICES CONTAINED WITHIN COMPETITIVE ZONES IN THE FUTURE?

[8] Surrebuttal testimony of Dr. Ben Johnson, Page 19, Lines 15-18.

A. Yes. Dr. Johnson neglects to discuss the guidelines of Commission Rule R14-2-1108(H), which provides the Commission the continued authority to reclassify a service, or a Competitive Zone, as noncompetitive if it finds that a provider has priced in an inappropriate manner. I have no doubt that the Commission will closely follow the evolution of competition in the Arizona telecommunications market, and will be quick to take action if it finds anticompetitive behavior has occurred. I also have no doubt that it will not simply assume that the public interest has been protected.

Q. AT PAGES 20 AND 21, DR. JOHNSON COMPLAINS THAT YOU HAVE DISAGREED WITH HIM THAT A CHANGE TO COMMISSION RULE R14-2-1108(A) IS NECESSARY. WOULD YOU COMMENT?

A. As stated in my rebuttal testimony, Commission Rule R14-2-1108(A) defines the conditions for classification of a service, or group of services, as competitive. Commission Rule R14-2-1102(A) specifies that the "relevant market" may be defined on a service by service basis, a group basis and/or by geographic location. Contrary to Mr. Johnson's claim that "this term is never mentioned in the rule which allows the Company to petition for competitive classification." Subsections B and B1 of the rule he cites (R14-2-1108) state the following:

> B. The petition for competitive classification shall set forth the conditions within the **relevant market** that demonstrate that the telecommunications service is competitive, providing, at a minimum, the following information:
>
> 1. A description of the general economic conditions that exist which make the **relevant market** for the service one that is competitive;

(emphasis added).

The guidelines are already clear, and Qwest's Competitive Zone proposal follows those guidelines. The revisions to the rules proposed by Dr. Johnson are simply not necessary. However, even though we disagree with Dr. Johnson about the need for a rule change, it is clear that both RUCO and Qwest agree that the Company should be allowed to petition for competitive classification on a geographic basis.

Q. AT PAGE 25, 7 THROUGH 19, DR. JOHNSON PAINTS A PICTURE THAT QWEST'S COMPETITIVE ZONES PROPOSAL WILL LEAD DIRECTLY TO ANTICOMPETITIVE PRICING AND SLOWER COMPETITIVE ENTRY BY ALTERNATIVE CARRIERS INTO THE ARIZONA MARKET. DO YOU AGREE?

A. No. To turn Dr. Johnson's argument around 180 degrees, it appears that he is suggesting that the Commission should continue to fully regulate Qwest and require it to price on a statewide average basis, and that Qwest should not be allowed to respond to a specific competitor in a defined market. This is contrary to any reasonable interpretation of the guidelines of the Telecommunications Act of 1996 and contrary to the procompetitive policies of this Commission. The Federal and State policy objectives are geared to promote competitive growth by "leveling the playing field." It is entirely inappropriate for the incumbent provider to be constrained from competing fairly where competition is entrenched. Qwest will not price its services in an anticompetitive manner in its proposed Competitive Zones, but it will compete aggressively. The

Commission will continue to have the authority over telecommunications competition in Arizona.

Q. AT PAGE 33, DR. JOHNSON OFFERS "MARKET SHARE" DATA FOR CLECS IN ARIZONA. IS THIS DATA RELEVANT TO QWEST'S REQUEST FOR ESTABLISHENT OF COMPETITIVE ZONES?

A. No. The "share" percentages cited by Dr. Johnson are sourced from FCC data obtained at a past point in time and reflect statewide totals. Since local competition is concentrated primarily in the Phoenix and Tucson areas, Dr. Johnson's percentages do not reflect the proportionately higher level of competition in those areas. The data is also not reflective of the current level of competition in Arizona, but instead is a historical view.

Q. AT PAGE 34, LINE 21 THROUGH 24, DR. JOHNSON CLAIMS THAT YOUR REBUTTAL TESTIMONY DID NOT FULLY CRITIQUE HIS COMMENTS REGARDING QWEST'S PROPOSED RATE DESIGN. WOULD YOU COMMENT?

A. Yes. Unfortunately, the bulk of Dr. Johnson's arguments are premised on the flawed concept that loop costs can be spread across a wide variety of services and that prices therefore need not be based upon their direct cost. I will defer to Dr. Taylor to explain in his rejoinder testimony the reasons, from an economist's perspective, why cost allocation concepts are not workable in the current telecommunications market.

Many of the concerns Dr. Johnson expresses have been addressed earlier in my rejoinder testimony regarding Mr. Dunkel's rebuttal testimony. In his comments, Dr. Johnson has ignored a variety of factors that must be considered by Qwest and the Commission in determining an appropriate pricing design in this rate case. For example, prices must be driven toward appropriate cost-recovery levels to satisfy requirements of the Telecommunications Act of 1996 that implicit subsidies be made explicit and to promote the economically efficient growth of competition. Wholesale and retail price structures must be reasonably aligned to encourage competitive growth not only in densely populated urban centers, but in rural areas of Arizona. In satisfying a positive revenue requirement, margins in proposed prices for optional services and features should be higher than margins for local exchange services to mitigate pricing pressure on residential and business basic exchange customers to the extent practicable. Telephone service affordability must be a factor in designing a rate structure, and the role of Lifeline and Link Up plans in assisting low income customers to maintain service should be considered.

Q. AT PAGE 35, DR. JOHNSON CONCEDES THAT QWEST'S ZONE INCREMENT PROPOSAL FOR RETAIL SERVICES IS IN ALIGNMENT WITH QWEST'S DEAVERAGED UNE LOOP PROPOSAL, BUT ARGUES THAT THE PROPOSED ZONE INCREMENT PRICES ARE OUT OF STEP WITH THE DEAVERAGED UNE LOOP PRICES ORDERED BY THE COMMISSION. WOULD YOU COMMENT?

A. Yes. As stated in my Supplemental Direct testimony in this Docket, it is very important that price deaveraging be implemented consistently across wholesale and retail loop-based services if pricing anomalies are to be avoided and if competition is to be encouraged to expand throughout the state. This pricing alignment is the most important consideration for the parties to integrate into final decisions regarding rate design. The Zone Increment rate structure proposed in my Supplemental Direct testimony was not submitted to the Commission in response to the order in Docket T-00000A-00-0914 which established interim deaveraged UNE loop prices, and was instead based upon the proposed Qwest UNE loop prices in that Docket. In view of the Commission order in Decision No. 62753, which established interim deaveraged UNE loop rates, Qwest is willing to reconsider its Zone Increment pricing proposal to maintain appropriate wholesale and retail pricing relationships. However, any adjustment in proposed Zone Increment rates will require adjustments in other elements of Qwest's retail pricing proposal to support the revenue requirement identified by Mr. Redding.

Q. AT PAGE 37, LINES 8 AND 9, DR. JOHNSON OPINES THAT "...IT IS REASONABLE TO ASSUME THAT A TOLL PRICE REDUCTION WILL RESULT IN LARGER TOLL VOLUMES." IS THIS CONCLUSION WELL FOUNDED?

A. No. In fact, as discussed in my rejoinder testimony to Mr. Dunkel, in states such as Washington, Wyoming and Nebraska, where toll rate reductions have been recently implemented, Qwest has seen a continued

downward trend in intraLATA toll volumes. In a strictly theoretical sense, or in a market in which competition is nonexistent, one might expect to see a measurable demand response resulting from a substantial price decrease. However, elasticities are not following the theoretical model in Qwest's current intraLATA long distance markets.

Q. AT PAGE 39, DR. JOHNSON CONCLUDES THAT IT IS APPROPRIATE TO REDUCE BUSINESS BASIC EXCHANGE RATES BY $5.00 AND TO REDUCE RESIDENTIAL BASIC EXCHANGE RATES BY $2.00 IN ARIZONA. IS THIS CONCLUSION FLAWED?

A. Yes. Dr. Johnson supports this conclusion by maintaining that loop costs can be allocated across a range of services to drive down the underlying cost of providing residential and business basic exchange services. As discussed in detail by Dr. Taylor, this logic is simply wrong. In fact, Dr. Johnson's recommendation presumes that no implicit subsidies exist in Qwest's residential basic exchange prices, and if his logic is extended, would lead to the conclusion that high cost fund support, Telephone Assistance plans or Link Up programs are not necessary in Arizona or in any other state. By his reasoning, any telephone company earning a positive rate of return would simply continue to subsidize below cost basic exchange services with revenues from other above cost services.

RESPONSE TO DR. LEE SELWYN

Q. AT PAGE 24, LINES 2 THROUGH 6, DR. SELWYN ARGUES THAT QWEST'S COMPETITORS DO NOT HAVE THE SAME ABILITY TO PROVIDE SERVICE ON AN INCREMENTAL BASIS ON ITS EXISTING PLANT AND ORGANIZATIONAL RESOURCES AS DOES QWEST. DO YOU AGREE?

A. No. In fact, especially in the Phoenix and Tucson markets where CLECs are entrenched, a large number of state of the art digital central office switches are in place (either collocated in Qwest central offices or located nearby) that are capable of providing not only basic exchange services, but a whole spectrum of optional features. Qwest's competitors certainly do offer optional features on an "incremental basis" similar to the manner in which Qwest offers such features, and do so in the targeted geographic areas they choose to serve.

Q. AT PAGE 24, LINES 17 AND 18, DR. SELWYN SUGGESTS THAT BASIC RESIDENTIAL SERVICE CURRENTLY "INCLUDES" ONE FREE DIRECTORY ASSISTANCE CALL PER MONTH. IS THIS CHARACTERIZATION ACCURATE?

A. No. Qwest's current Directory Assistance tariff, which is separate and distinct from its Basic Exchange service tariff, specifies that one free Directory Assistance call per month is offered. Directory Assistance is a fully competitive service in the current Arizona market, and it is not an inherent component of Basic Exchange service.

1 **Q. AT PAGE 25, LINES 8 THROUGH 17, DR. SELWYN ARGUES THAT**
2 **DIRECTORY ASSISTANCE SERVICE IS NOT DISCRETIONARY IN**
3 **ARIZONA. IS HE CORRECT?**
4 A. No. A wide range of options are now readily available to Arizona
5 consumers to obtain directory listings, including options such as the "00"
6 and "10-10-9000" directory services of AT&T and Worldcom, dial around
7 directory assistance providers, internet directory services, wireless
8 services and standard telephone directories. The variety of available
9 directory assistance options clearly defines this service as both optional
10 and discretionary: Not only do the vast majority of Arizona customers not
11 utilize Qwest's Directory Assistance service on a regular basis, but a wide
12 range of alternatives are available to them when they do elect to use
13 directory assistance.
14
15 **Q. AT PAGE 26, LINES 21 THROUGH 27, DR. SELWYN DISMISSES**
16 **YOUR CONTENTION THAT VIABLE COMPETITION IS PRESENT FOR**
17 **QWEST'S DIRECTORY ASSISTANCE (D.A.) SERVICE. WOULD YOU**
18 **COMMENT?**
19 A. Mr. Selwyn appears to base his conclusion on the "411 dialing parity"
20 argument. It is not clear to me whether Mr. Selwyn understands that any
21 customer dialing "00", AT&T's heavily advertised dialing pattern for its
22 Directory Assistance service for local and national numbers, will be routed
23 to the customer's presubscribed interLATA carrier for handling. There can
24 be no dispute that the "00" dialing pattern is certainly equivalent to
25 Qwest's "411" dialing pattern. Additionally, other directory assistance

alternatives, such as Worldcom's 10-10-9000 service, internet directory services and wireless directory assistance services (also accessed via the 411 dialing pattern) are as convenient as Qwest's Directory Assistance service. Finally, "411" dialing parity requirements of the Telecommunications Act of 1996 specifically related to CLECs' ability to utilize this dialing pattern. On March 1, 2000, the ACC issued an order in the Section 271 proceeding certifying that Qwest has met this dialing parity requirement in Arizona.

Q. DR. SELWYN ARGUES, AT PAGE 28, THAT QWEST CAN CREATE A "PRICE SQUEEZE" ON ITS COMPETITORS WITHIN COMPETITIVE ZONES BY PRICING ITS RETAIL SERVICES LOWER THAN ESSENTIAL WHOLESALE ELEMENTS. IS THIS ACCURATE?

A. No. The key assumption behind Dr. Selwyn's contention is that Qwest's wholesale services continue to be considered "essential" to Qwest's competitors within competitive zones. However, to the extent the Commission agrees that competition is now present in the wire centers for which Qwest seeks Competitive Zone classification, the wholesale elements corresponding to those services can no longer be considered to be "essential" elements. In determining a price floor for a retail service based on nonessential elements, the TSLRIC of the service is considered to be that floor. As stated earlier in my rejoinder testimony, Qwest commits that the revenues for any service within a particular Competitive Zone will remain above the TSLRIC of that service. If the Commission finds that Qwest has violated that commitment, it will have the continued

authority to reclassify services in the Competitive Zone in question as non-competitive, which would also modify the imputation test to require that the price for essential wholesale elements and the TSLRIC for non-essential elements must be incorporated into the price floor.

RESPONSE TO MS. ARLEEN STARR

Q. AT PAGE 5, LINES 4 THROUGH 7, MS. STARR STATES "...QWEST'S PROPOSAL WOULD ESSENTIALLY ELIMINATE THE IMPUTATION REQUIREMENT FOR TOLL SERVICES IN THE AREAS CLASSIFIED AS COMPETITIVE." IS SHE CORRECT?

A. Not entirely. In wire centers found to be competitive, alternatives to Switched Access also exist by definition. In this instance, the traditional intraLATA long distance imputation test would be modified to reflect the TSLRIC of providing the wholesale Switched Access service in that wire center. An imputation requirement would remain in place, but the inputs to that calculation would be modified based on a reclassification of Switched Access as "non-essential" in that wire center.

Q. AT PAGE 6, MS. STARR CLAIMS THAT "...QWEST REMAINS A MONOPOLY PROVIDER OF SWITCHED ACCESS SERVICES AND THERE IS NO REASONABLE SUBSTITUTE FOR THESE SERVICES." WOULD YOU COMMENT?

A. Customers are now placing and receiving long distance calls via a variety of means, including dedicated access, internet protocol telephony and

wireless services. In fact, AT&T has recently taken a substantial equity stake in Net2Phone, the nation's largest internet telephony provider. In view of the alternatives to Switched Access service outlined in my direct and supplemental direct testimony, Switched Access cannot realistically be termed a "monopoly" service, especially in the wire centers for which Qwest requests Competitive Zone classification.

Q. MS. STARR, AT PAGES 7 AND 8, TAKES EXCEPTION TO YOUR CRITICISM OF AT&T'S RECENT PROPOSAL TO INCREASE INTERSTATE LONG DISTANCE RATES, AND SUGGESTS THAT THE PROPOSAL WAS REALLY A NET RATE REDUCTION FOR ITS CUSTOMERS. IS THIS CORRECT?

A. While some prices clearly were reduced by AT&T in its proposal, my understanding of the FCC's position is that it viewed AT&T's proposal as a significant net increase for interstate long distance customers. It is also my understanding that the FCC's strong expression of concern with this proposal led AT&T to subsequently discontinue these rate increase plans.

PAY PHONE USAGE CHARGE FOR 800 SERVICELINE

Q. HAS THE COMMISSION ISSUED A RECENT ORDER CONCERNING QWEST'S APPLICATION TO INITIATIVE A SEPARATE CHARGE FOR CALLS FROM PAY PHONES IN ARIZONA TO 800 SERVICELINE CUSTOMERS?

1 A. Yes. On August 29, 2000, the Commission ordered in Docket No. T-
2 01051B-00-0369 that issues concerning Qwest's establishment of a $0.26
3 charge for calls from pay phones to 800 ServiceLine customers should be
4 integrated into Qwest's pending rate case, Docket No. T-01051B-99-0105.
5
6 **Q. WHY DOES QWEST NOW FIND IT NECESSARY TO IMPLEMENT A**
7 **CHARGE OF $0.26 FOR THESE CALLS?**
8 A. On October 7, 1997, the FCC mandated compensation of Pay Phone
9 Service Providers (PSP) for completed calls originating from pay phones.
10 These compensated calls include any calls made from a pay phone where
11 the caller does not pay for the service at the time the call is completed.
12 Qwest now compensates PSPs at $0.24 per message for these calls as
13 required by the FCC. However, Qwest's billing systems have been
14 unable, until recently, to accommodate assessment of a charge to 800
15 ServiceLine customers for "non-paid" coin calls. Qwest's proposal will
16 now establish a charge of $0.26 for these calls, to be assessed to the 800
17 ServiceLine customer receiving the call to recover the expense of
18 payments to the PSPs.
19
20 **Q. IF QWEST MUST PAY PSPs AT A RATE OF $0.24 PER CALL, WHY**
21 **DOES QWEST REQUEST APPROVAL FOR A CHARGE OF $0.26 FOR**
22 **THESE CALLS?**
23 A. The differential of $0.02 will enable Qwest to recover miscellaneous costs
24 associated with recovering and remitting the charge and subsequent
25 payment to PSPs in Arizona. Cost support for this charge is being

sponsored in the rejoinder testimony of Mr. Jerrold Thompson on behalf of Qwest.

CONCLUSION

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. In this rejoinder testimony, I have discussed various contentions by Dr. Collins, Mr. Dunkel, Dr. Johnson, Dr. Selwyn and Ms. Starr regarding the propriety of Qwest's Competitive Zones and retail services pricing proposals. The contentions espoused fall into two groups: 1) Qwest should continue to be fully regulated even though its competitors operate under relaxed regulation, and 2) Qwest's retail services pricing proposals should be rejected on the basis of the concept that loop costs may be spread across a wide range of services to keep basic exchange service prices low. Both of these contentions are plainly wrong. Full competition exists in the wire centers in the greater Phoenix and Tucson areas for which Qwest requests Competitive Zone classification. In these areas, Qwest's competitors are selectively targeting lucrative markets, while Qwest is constrained from effectively competing at a sufficiently granular level. Qwest's Competitive Zones proposal will simply establish competitive parity between Qwest and its competitors in Arizona, consistent with the objectives of the Telecommunications Act of 1996 and of this Commission.

As discussed in my previous written testimony, Qwest's retail pricing proposal effectively balances a variety of objectives: appropriate cost recovery, support of Qwest's positive revenue requirement in this Docket, removal of implicit subsidies, correct alignment of retail and wholesale loop-based service pricing structures and maintenance of affordable pricing. The arguments advanced by Dr. Johnson and Mr. Dunkel seriously undermine these objectives and virtually ensure that implicit subsidies would be maintained well into the future. Their "cost sharing" concept for retail services would also undermine the economic incentives for competitors to offer service to the rural areas of Arizona, since Qwest's wholesale service prices would significantly exceed its retail service prices in those areas.

Qwest's Competitive Zones and retail services pricing proposals appropriately reflect the current Arizona telecommunications market and effectively address the policy objectives outlined above. I respectfully request the Commission to approve these proposals as filed.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF QWEST CORPORATION, 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-01051B-99-0105

EXHIBITS OF

DAVID L. TEITZEL

QWEST CORPORATION

SEPTEMBER 19, 2000

INDEX OF EXHIBITS

DESCRIPTION	EXHIBIT
Resold Lines in Service ox Bundling Strategy	DLT-1
Directory Assistance Proposal Revenue Impact	DLT-2

Redacted

Resold Lines in Service: April, 1999

Bisbee, Az.	Redacted
Chandler Main, Az.	Redacted

PROPRIETARY INFORMATION

DIRECTORY ASSISTANCE REVENUE IMPACTS

Inventory test period: Jan99-Dec99

Proposal: Increase price from $.47 to $.85, eliminate one-call allowance and include call completion.

	Current	Proposed	Change
RESIDENCE:			
Price/Call	$ 0.47	$ 0.85	$ 0.38
Allowance	1	0	-1
Total Calls	Redacted	Redacted	Redacted
Revenue	Redacted	Redacted	Redacted
Revenue/Call	Redacted	Redacted	Redacted
Free Calls	Redacted	Redacted	Redacted
BUSINESS:			
Price/Call	$ 0.47	$ 0.85	$ 0.38
Allowance	1	0	$ (1)
Total Calls	Redacted	Redacted	Redacted
Revenue	Redacted	Redacted	Redacted
Revenue/Call	Redacted	Redacted	Redacted
Free Calls	Redacted	Redacted	Redacted
TOTAL:			
Total Calls	Redacted	Redacted	Redacted
Revenue	Redacted	Redacted	Redacted
Revenue/Call	Redacted	Redacted	Redacted
Free Calls	Redacted	Redacted	Redacted

COMPLETE-A-CALL Revenue change:	Residence	**Redacted**
	Business (per call)	**Redacted**
	Business (per month)	**Redacted**
	NET ANNUAL REVENUE EFFECT	**Redacted**

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF QWEST CORPORATION, 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-1051-B-99-105 AFFIDAVIT OF DAVID L. TEITZEL
STATE OF WASHINGTON	)	
COUNTY OF KING	)	
	) :)	SS

I, David L. Teitzel, of lawful age being first duly sworn, deposes and states:

1. My name is David L. Teitzel. I am Directory, Product and Market Issues for Qwest Corporation, formerly known as U S WEST Communications, Inc., in Seattle, Washington. I have caused to be filed written rejoinder testimony in support of Qwest Corporation in Docket No. T-01051-B-99-105.

2. Attached hereto and made a part hereof for all purposes is my rejoinder testimony.

3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct to the best of my knowledge and belief.

Further affiant sayeth not.

David L. Teitzel

SUBSCRIBED AND SWORN to before me this 12th day of September, 2000.

Elizabeth M. Weber
Notary Public

My Commission Expires:

09/16/02

EXHIBIT
Q-40
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 RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES	)	DOCKET NO. T-01051B-99-0105

REJOINDER TESTIMONY OF

JERROLD L. THOMPSON

EXECUTIVE DIRECTOR- SERVICE COST INFORMATION

QWEST CORPORATION

SEPTEMBER 19, 2000

REJOINDER TESTIMONY OF JERROLD L. THOMPSON

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IDENTIFICATION OF WITNESS

Q. PLEASE STATE YOUR NAME, OCCUPATION AND BUSINESS ADDRESS.

A. My name is Jerrold L. Thompson. I am employed by Qwest Corporation (formerly U S WEST Communications, Inc.) (the Company), (Qwest) as Executive Director - Service Cost Information. My business address is Room 4400, 1801 California Street, Denver, CO.

Q. HAVE YOU PREVIOUSLY FILED TESTIMONY IN THIS PROCEEDING?

A. Yes. I provided Direct Testimony on January 8, 1999, Supplemental Direct Testimony on May 19, 2000, and Rebuttal Testimony on August 21, 2000.

PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. My testimony responds to the surrebuttal testimonies of Mr. William Dunkel representing the staff of the Arizona Corporation Commission (staff), Dr. Ben Johnson representing RUCO staff, Ms. Arlene Starr of AT&T, and Dr. Michael Ileo representing the Arizona Payphone Association (APA). In addition, I provide information on the costs of a proposed Pay Telephone Charge for 800 Serviceline calls as ordered by the Chief Administrative Law Judge on August 29, 2000.

REJOINDER OF MR. DUNKEL

Q. MR. DUNKEL STATES THAT "THERE IS NO VALID REASON TO CONSIDER 100% OF THE LOOP FACILITY COSTS WHEN ANALYZING THE COSTS OF INTRASTATE SERVICES" (P.35) ARE THERE VALID REASONS TO CONSIDER?

A. Yes. As I stated in my Rebuttal Testimony, the total cost of the loop should not be allocated, but compared to cost recovery methods when determining a price. By allocating away 25% of the loop cost, Mr. Dunkel is mixing cost and cost recovery and unnecessarily confusing the two separate processes.[1] The proper method to be used to address interstate loop cost recovery revenues involves an analysis of contribution. The interstate Subscriber Line Charge (SLC) should be considered in a comparison of costs versus cost recovery mechanisms. Proper consideration of these rates as recovery of loop costs prevents the "double recovery" addressed by Mr. Dunkel.

Q. IN HIS SUMMARY MR. DUNKEL STATES THAT YOU FAILED TO MENTION AN INDIANA ORDER THAT SPECIFICALLY FOUND THAT 100% ASSIGNMENT OF LOOP COSTS TO A SERVICE VIOLATED SECTION 254(K) OF THE TELECOM ACT. IS MR. DUNKEL'S STATEMENT ACCURATE?

A. No. Footnote 15 on page 15 of my Rebuttal Testimony states: "Another quote from the Indiana Commission, October 1998, appears to address "takings" issues related to the 5th Amendment to the Constitution, rather than rate making issues

[1] Even the FCC does not use the 25% interstate allocation of the loop in its cost model (SM) that it developed for use with Universal Service funding.

as in this proceeding." With the additional information provided by Mr. Dunkel in his Surrebuttal Testimony, I now know that the Indiana Commission also was addressing Section 254 of the Telecom Act.

In it's recent *CALLS Order* the FCC addressed this very issue. Several parties made similar arguments to those made by Mr. Dunkel in this proceeding regarding the meaning of Section 254(k) of the Telecom Act.[2] The FCC stated the following:

> 94. Indeed, these arguments have already been addressed and rejected by the United States Court of Appeals for the Eighth Circuit. In *Southwestern Bell v. FCC*, the Texas Office of Public Utility Counsel argued, among other things, that the Commission's decision in the *Access Charge Reform Order* to increase the SLC cap for certain lines resulted in a "'free ride by the IXCs on the common line facilities'" and that loop costs were being shifted from competitive services to basic services, contrary to the intent of section 254(k) of the 1996 Act. Texas Counsel argued that as a result of section 254(k), the recovery of joint and common costs, such as NTS loop costs, must be borne mutually both by end users and by IXCs. Texas Counsel asserted that it was improper for the Commission to shift additional NTS loop cost recovery from the access rates LECs charge IXCs for interstate access onto rates end users pay for certain telephone lines. Texas Counsel contended that increasing the SLC cap imposed on end users allowed IXCs to evade their fair share of the common line costs. Texas Counsel maintained that this approach violated section 254(k) "in that the existing proportion of NTS loop cost recovery by the IXCs through competitive services would be reduced through increases on end users for basic services."
>
> 95. The Eighth Circuit upheld the Commission's increases to various LEC SLC caps, however, and found that "Texas Counsel's contention that increasing the SLC price ceiling violates the prohibition against using non-competitive services to subsidize competitive services [wa]s unpersuasive." In doing so, the court

[2] Mr. Dunkel's Surrebuttal Testimony p. 37, lines 12-14.

> reaffirmed the Commission's long standing view that the subscriber "causes" local loop costs, whether the subscriber uses the service for intrastate or interstate calls. These costs are, in any event, recovered from the end user, either through direct end-user charges or indirectly through higher rates or additional charges paid to IXCs. The court further affirmed the Commission's conclusion that it was appropriate and rational for the Commission to impose these costs on the end user. The court concluded as a result that increasing SLC caps on certain lines did not result in a windfall for IXCs.[3] (Footnotes omitted, emphasis added).

Not only have the FCC and the courts rejected the notion that the loop is a joint cost which is required to be recovered from various services, but the FCC and the courts have also rejected the assertion that flat rate recovery of loop costs from the end user violates section 254(k) of the Telecom Act. The FCC also has clearly stated its "long standing view" that the subscriber ***causes*** local loop costs and should pay for those costs through flat rate charges. The issues before this Commission are directly related to this FCC dispute. There is no question that the FCC has declared that the loop is a direct cost, not a joint cost. Further, the FCC has declared that with regard to the interstate loop cost revenue requirement, the proper manner of recovery of the cost is from a flat charge assessed to the end user. The FCC has used a transition plan that has occurred over many years to accomplish this type of recovery. Qwest, through the testimonies of its witnesses are requesting the Arizona Corporation Commission to recognize and start this same type of transition.

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[3] *Sixth Report and Order in CC Docket Nos. 96-262 and 94-1, Report and Order in CC Docket No. 99-249, Eleventh Report and Order in CC Docket No. 96-45.* Released May 31, 2000 at 94-95.

REJOINDER OF DR. JOHNSON

Q. DOES DR. JOHNSON AGREE WITH YOUR VIEW THAT BASIC SERVICE IS A BUNDLE OF NETWORK ACCESS AND LOCAL USAGE?

A. Yes, Dr. Johnson states on page 11 of his Surrebuttal Testimony that this distinction can be made. However, he explains that this is not a practical perspective since customers do not view the two services as separate. The point that he misses in this comment is that the act of providing the network access for the customer causes the cost of the loop to be incurred, regardless of how the customer expects to use the loop. TSLRIC studies that look to cost causation as the primary means to identify direct costs of a service would naturally consider loop costs to be a direct cost of providing network access. The loop cost is not caused by the act of providing transport or switching services to the customer, or any other action by the Company.

Q. DR. JOHNSON MAKES AN OBSERVATION ABOUT WHERE HE AGREES AND DISAGREES WITH QWEST WITNESSES CONCERNING WHICH SERVICES PROVIDE CONTRIBUTION TOWARD THE COST OF THE LOOP. PLEASE RESPOND?

A. Dr. Johnson states that there appears to be no disagreement that certain services are providing contribution toward the cost of the loop (p. 15, of his Surrebuttal Testimony). However, he states that there is disagreement on whether a subsidy exists for basic service and whether competition requires a change in the contribution levels. There is often agreement that competition will drive prices toward economic costs. The ability to recover contributions of loop

cost will diminish as competition grows. Good examples of this are evidenced within this proceeding by representatives of two competing segments of the industry, namely a long distance carrier and a payphone provider. Each segment is spending considerable sums of money in this proceeding advancing arguments to reduce contributions from the services that Qwest provides to them, while implicitly shifting that contribution to other services.

Dr. Johnson expresses agreement that there are contributions from these other services today, but sees no reason that the Commission should agree to change that situation to any large degree.[4] Qwest, on the other hand, believes that the Commission should continue the transition toward a more competitive environment that a previous Arizona Commission established in the Company's last rate case (Docket No. E-1051-93-183) where the Commission concluded that there would be growth in competition in the future and that rate rebalancing was appropriate.[5]

REJOINDER OF MS. STARR

Q. MS. STARR CRITICIZES QWEST FOR INCLUDING COSTS OF EXCHANGES PROPOSED TO BE SOLD IN ITS COST STUDIES WHILE EXCLUDING THOSE FROM ITS REVENUE REQUIREMENT PURSUANT TO THE COMMISSION'S PROCEDURAL ORDER. DO YOU HAVE A RESPONSE?

[4] Dr. Johnson Surrebuttal Testimony, p. 15, lines 14-17.
[5] Decision No. 58927 page 72.

A. Yes. I have prepared Confidential Exhibit JLT-1, Rejoinder Testimony. This exhibit illustrates loop costs on an original deaveraged basis, on a deaveraged basis without the exchanges proposed in the sale, and on a deaveraged basis as ordered by the Commission in Docket No. T-00000A-00-0194 without the exchanges proposed in the sale. In addition, I have provided carrier access costs on a basis without the exchanges proposed in the sale.

Q. MS. STARR QUESTIONS QWEST'S USE OF A DIFFERENT COST OF MONEY IN ITS TSLRIC STUDIES THAN WHAT IT PROPOSES IN THE REVENUE REQUIREMENT PORTION OF THIS CASE. IS THERE A REASON FOR THIS?

A. Yes. As explained in the Rejoinder Testimony of Mr. Peter C. Cummings, the weighted average cost of capital used in Qwest's TSLRIC studies is appropriate and different than the Commission allowed cost of capital used in the revenue requirement portion of this proceeding.

Q. IS MS. STARR'S COMPARISON OF QWEST'S COSTS TO ITS PROPOSED SWITCHED ACCESS RATES VALID?

A. The conclusions Ms. Starr reaches are unsupported. She states: "Unless those rates are reduced substantially, both consumers and competition in the state of Arizona will suffer." (p. 12). Ms. Starr does not provide information on how consumers or competition will suffer. Moreover, Ms. Starr does not seem to acknowledge that contributions above forward looking costs (even with reasonable allocations of joint and common costs) may be appropriate in a

proceeding where the Commission needs to provide Qwest with an opportunity to earn a reasonable return on its fair value rate base.

REBUTTAL OF DR. ILEO

Q. FROM DR. ILEO'S SURREBUTTAL IT APPEARS THAT THERE IS MUCH DISAGREEMENT REGARDING THE PROPER ACTION BY THE COMMISSION FOR PAL RATES. WOULD YOU PLEASE COMMENT?

A. Yes. It appears that there is not only disagreement in views but also considerable misunderstanding that has occurred in the earlier rounds of testimony on the subject of PAL rates[6] and what the Commission should do, if anything. On this subject, there are several issues that need to be clarified.

Q. WHAT IS THE FIRST ISSUE THAT YOU WANT TO CLARIFY?

A. First, Dr. Ileo believes that Qwest has not complied with the FCC's directive to the state commissions in CC Docket No. 96-128, CC Docket No. 91-35, paragraph 163[7] which states (in part):

> We require LECs to file tariffs for the basic payphone services and unbundled functionalities in the intrastate and interstate jurisdictions as discussed below. LECs must file intrastate tariffs for these payphone services and any unbundled features they provide to their own payphone services. The tariffs for these LEC payphone services must be: (1) cost based; (2) consistent with the requirements of Section 276 with regard, for example, to the removal of subsidies from exchange and exchange access services; and (3) nondiscriminatory. States must apply these requirements and the Computer III guidelines for tariffing such

[6] When using PAL, public access line, I am referring to both the Basic PAL and the Smart PAL.
[7] Surrebuttal of Dr. Ileo, p.2 lines 16-21.

> intrastate services. (*The new services test required in the Report and Order is described at 47 C.F.R. Section 61.49(g)(2)*). (Footnotes omitted, italics at end is from footnote 492).

It is Qwest's position that it has satisfied this FCC requirement. Mr. McIntyre's Rebuttal Testimony provided an exhibit that showed the ratio of direct cost to proposed price (the FCC's New Services Test). In Mr. McIntyre's opinion, the relationship of price to direct cost is reasonable.[8] Dr. Taylor has reviewed Qwest's analysis of PAL rates and concluded that all statutory requirements have been met and that Qwest's pricing proposals are reasonable.[9]

The standard that Dr. Ileo uses is a different one. He agreed with my supposition that he views a "subsidy" to be any price that exceeds TSLRIC plus a "reasonable" (his correction) common cost.[10]

My Rebuttal Testimony expressed disagreement with this view of "subsidy". My understanding of how economists define subsidy (from the point of view of the service which is providing the subsidy) is where a price of a service is set at a level above a Stand Alone Cost, not above a TSLRIC plus reasonable common cost level. Inasmuch as Mr. Regan's Direct Testimony seemed to express a view that was similar to my understanding, my Rebuttal Testimony expressed my observation of an apparent conflict between Mr. Regan and Dr. Ileo.

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[8] Rebuttal Testimony of Scott McIntyre, pp. 20-26.
[9] Rebuttal Testimony of Dr. William E. Taylor, pp. 74-80.
[10] Surrebuttal of Dr. Ileo p.7.

Since a Stand Alone Cost study is required to identify a service whose price contains a subsidy, it was my view that Dr. Ileo had simply calculated a *contribution* not a *subsidy* in his analysis.

Even if Dr. Ileo had calculated a *subsidy* from his analysis (which he did not), it is not related to the Telecom Act. On page 21 of his surrebuttal testimony, he quotes the Act:

> any Bell operating company that provides payphone service – (1) shall not **subsidize <u>its</u> payphone service** directly or indirectly from **its** telephone exchange service operations or its exchange access operations. (emphasis added)

"**<u>Its</u>**" in the sentence clearly means that which belongs to "any Bell operating company". "**Payphone service**" is defined in Section 276 (d) which states:

> the term "payphone service" means the provision of public or semi-public pay telephones, the provision of inmate telephone service in correctional institutions, and any ancillary services."

Putting the two definitions together, it is clear that the Act was talking about a prohibition against a Bell operating company subsidizing its payphone subsidiary from its regulated telephone operations. This is not the way that Dr. Ileo is interpreting the law. Dr. Ileo has misconstrued the law and has not proven that Qwest's rate proposals have violated anything.

Q. WHAT IS YOUR SECOND ISSUE TO CLARIFY?

A. Second, Dr. Ileo believes that to have a lawful PAL rate the price should be set at a proper TSLRIC/TELRIC[11] plus reasonable common costs. Although the

[11] His terminology in this regard has caused considerable confusion. On one hand, Dr. Ileo has said that

1 FCC's New Services test is an initial screening process for a reasonable price
2 for a new interstate carrier access service (i.e., not interconnection or unbundled
3 network element- "UNE"), it is the tool that is required to test to see whether PAL
4 rates comply with the statutes. According to Dr. Ileo, compliance occurs when
5 the amount of common cost recovery, after direct costs have been recovered, is
6 reasonable. He directs the Commission to use the same common cost
7 guidelines for PAL rates as they used to determine UNEs.[12]
8
9 Qwest's position is that PAL is a rate for a business service,[13] not an UNE. UNE
10 rates cannot be set in a rate of return proceeding such as this. Section
11 252(d)(1)(A)(i) of the Telecom Act forbids it. In spite of his use of the TELRIC
12 terms, I don't believe Dr. Ileo is requesting UNE rates for PAL services. Instead,
13 he states that PAL services are "wholesale" probably suggesting that they are
14 more akin to carrier access than they are to business rates. Qwest disagrees.
15 Regardless of how Qwest may refer to payphone providers in an operational
16 sense, payphone providers are not equivalent to interexchange carriers (IXCs)
17 (i.e., "wholesale"). IXCs are common carriers certified to do common carriage in
18 Arizona. These carriers may now also be rate of return regulated.[14] Payphone
19 providers do not provide common carriage, nor are they rate of return regulated.
20 They are equivalent to business customers that use telephone lines directly in
21 their business,[15] like alarm companies.

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the "wholesale nature of PAL" is the <u>only</u> TELRIC aspect he has recommended (Surrebuttal p.25, lines 21-23). On the other hand he says that the right way to do the analysis uses a "TELRIC framework" and "TELRIC input values" from the ACC's TELRIC Decision 60635.

[12] He advises the Commission that it should look to the FCC's TELRIC pricing guidelines for determination of the reasonable portion of common costs (Direct p.22, lines 21-24).

[13] See the Rebuttal Testimony of Scott A. McIntyre, p. 19 line 7.

[14] Court of Appeals Opinion Filed 8-29-00, *U S WEST v. Arizona Corporation Commission*

[15] In fact, in Docket No. U-3021-96-448 (et al), APA requested the Commission clarify that PAL was a

The significance of whether PAL services are "wholesale" or retail lies in the distinction Dr. Ileo makes of the related allocation of marketing, advertising, and customer information costs.[16] Dr. Ileo uses the ACC's UNE Decision No. 60635 as the basis for his calculations. Qwest disagrees. Rates set in this proceeding should recover direct costs as defined in the ACC rules Sec. R14-2-1102, joint and common costs, and also provide Qwest the opportunity to earn a reasonable return on its Fair Value rate base (i.e., a type of embedded cost).[17] Because the purpose of this proceeding is 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", rates set in this proceeding need to do just that. Any exception for PAL rates would advantage those consumers over other consumers.

Probably the key issue in the determination of whether Qwest's proposed prices meet the FCC's New Services test is whether the mark up is reasonable. Mr. McIntyre believes it is a reasonable mark up. Dr. Taylor's testimony is that it is a reasonable mark up.[18] Further, as Dr. Taylor explains, the FCC has never provided guidance on what would constitute a reasonable overhead loading (mark up) in a tariffed rate subject to the New Service test.[19] Information request number 3 to the APA stated the following:

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business line that was subject to a business line resale discount. The Arbitrator, Mr. Rudibaugh, agreed.

[16] See Surrebuttal Testimony of Dr. Ileo, p.25 lines 21-22.

[17] Dr. Ileo believes that mark ups of PAL services consistent with other similar services is a violation of Section 276 of the Telecom Act (Surrebuttal p.13, lines 8-9).

[18] Rebuttal Testimony of Dr. William E. Taylor, pp. 75-80.

[19] Rebuttal of Dr. William E. Taylor, p. 74.

> Please explain in detail and with particularity the APA's understanding of what the allowable mark-up is over direct cost for a service that is subject to the FCC's "new services" pricing test found at 47 C.F.R. 61.49(g). Please provide all justification or documentation relied upon in reaching your conclusion.
>
> Response: To the best of the APA's knowledge and belief, the FCC has not specified an "allowable mark-up over direct cost" that should be employed by a state regulatory agency in applying the "new services" test as suggested at pages 21-22 of Dr. Ileo's August 9, 2000 Direct Testimony in this proceeding. Attachment 1 contains copies of documents cited by Dr. Ileo on those pages, except with respect to CC Docket No. 94-1 for which 47 CFR § 61.49 is included as a substitute.

It seems there is general agreement that the FCC has not provided information for the Commission to use in determining the proper mark up or over head loading that should be used to determine whether it believes the rate passes the New Services test.

Q. WHAT IS YOUR THIRD ITEM OF CLARIFICATION?

A. The third item is the loop cost that I proposed in my Supplemental Direct testimony. I stated "with the intent to avoid prolonged unnecessary debate as to the appropriate assumptions for loop costs, I have directed that the cost studies incorporate the Commission ordered loop rate from Docket No. U-3021-96-448 (et al), Decision No. 60635."[20] Dr. Ileo has taken issue with my recommended substitution of the UNE rate for the loop cost.[21] Dr. Ileo believes that the loop cost used in the PAL cost studies should reflect specific characteristics of PAL

[20] It is important to note that the use of the UNE loop cost was a *reduction* from the original loop cost in the TSLRIC studies in my Direct testimony.
[21] Surrebuttal of Dr. Ileo, p.25, lines 11-13. Direct at p. 10, lines 20-23, and p. 11, lines 9-11.

services. In addition, Dr. Ileo requests the Commission to explain how it made its calculations that resulted in the loop cost of $21.98.[22]

Qwest's position is that the use of the UNE loop cost has avoided significant debate of the type introduced into this proceeding by Dr. Ileo. Other than the conceptual debates regarding the direct versus joint cost, no other party has criticized the use of the UNE loop cost. This is not a new phenomenon. The approach of using the UNE loop cost in TSLRIC studies has successfully reduced unnecessary debate in other proceedings that I have participated in. For example, in a recent New Mexico rate case, the Staff witness proposed that the UNE loop cost be used in the TSLRIC studies because "it would not be a productive use of the Commission's time to rehash the issues regarding proper methods...of the USWC loop cost study into determining the appropriate costs of USWC's loop facilities."[23] Just as in this case I revised the New Mexico cost studies to accept Staff's proposal and much of the controversy around loop costs disappeared.

The loop cost is one of the primary costs for many services. The Commission spent many months evaluating the proper inputs and assumptions necessary to determine a reasonable loop cost in Arizona in its Decision No. 60635. If the Commission were to accept Dr. Ileo's request for additional clarification on details of the loop cost determination and accepted Dr. Ileo's recommendation that PAL loops be treated uniquely from all other loop costs, then equity would require that all loop costs be developed on a class of service basis reflecting individual

[22] Direct at p. 15-17.
[23] Direct Testimony of William Dunkel, Utility Case No. 3008, March 13, 2000, pp. 97-98.

characteristics for each service. This would not be productive. Basically Dr. Ileo's argument is a deaveraging argument. He wants PAL lines to be deaveraged from all other lines for the PAL cost study. This is not necessary for the New Services test, nor for the Commission to determine whether Qwest's PAL rates are reasonable.

Q. WHAT IS YOUR FOURTH POINT OF CLARIFICATION?

A. The fourth point of clarification concerns Dr. Ileo's comment that I never mentioned the recent findings of the United States Court of Appeals (Eighth Circuit). He believes that I may have not familiarized myself with that Court's conclusions.[24]

Dr. Ileo is incorrect. As I stated in my Rebuttal testimony, like Dr. Ileo,[25] I am not an attorney. However, I have read and am familiar with the Eighth Circuit decision. I am familiar with the multitude of requests for stay of the decision that were filed last week. I am familiar with the potential that the decision could be moved to the U S Supreme Court and I am familiar with comments filed by parties such as AT&T that question whether the Court's mandate will ever issue.[26] In general, my recommendation is that the Commission should carefully weigh any decision to implement the Eighth Circuit decision in Arizona at this time.

Q. WHAT IS YOUR FIFTH ITEM OF CLARIFICATION?

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[24] Surrebuttal of Dr. Ileo, p.14, lines 11-13.
[25] Direct Testimony of Dr. Ileo, p. 18 line 4, and p.19 line 14.
[26] See Docket No. T-00000A-00-0194, AT&T's Comments filed August 4, 2000.

A. Dr. Ileo strongly disagrees that I be given an opportunity in this round of testimony to comment on the cost study adjustments he made to Qwest's TSLRIC studies.[27] He also states that my concern for unjustly delaying this proceeding by the Commission granting his request for clarification in its calculation of loop costs in its Decision No. 60635 is inconsistent with my request to provide information regarding my review of his adjustments.

I will not provide new information on Dr. Ileo's adjustments that will "shift the burden of proof and impose added litigation costs on the APA."[28] I see no reason to respond to Dr. Ileo's adjustments because they are inappropriate. The effect of his adjustments is to modify Qwest's cost studies to correspond in a selective way to the Commission's UNE Decision No. 60635. With the exception of the loop substitution I have already discussed, I do not agree that Decision No. 60635 has relevance in this proceeding. That Decision was from a proceeding that was for a different purpose with different parties and rules to accomplish a different goal. His adjustments also are designed to single out PAL costs and treat them in a different manner than all other costs in this proceeding. I do not agree that adjustments of that nature are required by the Telecom Act or by the FCC's rules. Therefore, Dr. Ileo's cost adjustments should not be addressed in this proceeding.

PAY TELEPHONE SURCHARGE FOR 800 SERVICELINE CALLS

[27] Surrebuttal of Dr. Ileo, p.4-5.
[28] Surrebuttal Testimony of Dr. Ileo, p. 5 line 3.

Q. ARE YOU SPONSORING A NEW COST STUDY FOR THIS PROCEEDING?

A. Yes. The cost study is entitled "Payphone Usage Charge". The cost information is attached as Confidential Exhibit JLT-2, Rejoinder Testimony.

Q. WHY ARE YOU FILING THIS INFORMATION AT THIS TIME?

A. The Chief Administrative Law Judge issued an order requiring Qwest to file information related to its request for tariff approval in this proceeding. Arizona rules require Qwest to file cost data with this type of filing. This order was issued August 29, 2000. This is the only opportunity Qwest had to comply with the order.

Q. WHAT IS THE NATURE OF THIS NEW CHARGE?

A. This service is described in detail in the Rejoinder Testimony of Mr. David L. Teitzel. However, it is a surcharge assessed to 800 Serviceline customers of Qwest who use that service from payphones. Qwest makes payments of 24¢ to payphone providers for each call pursuant to the FCC mandate. In addition, Qwest incurs costs related to this service from the National Payphone Clearing House for lists and assistance in distributing payments to payphone providers. The proposed rate discussed by Mr. Teitzel allows Qwest to recover its direct costs and provide a modest recovery of shared and common costs including administrative overhead.

CONCLUSION AND RECOMMENDATION

Q. WHAT IS YOUR CONCLUSION AND RECOMMENDATION TO THE COMMISSION?

A. The Commission should find, as has the FCC, that the loop is a direct cost of basic service and should provide for rate rebalancing as has been proposed by Qwest witnesses in this proceeding.

The Commission should reject the arguments and requests of Dr. Ileo as they are based on flawed perceptions and incorrect conclusions.

The Commission should accept Qwest's cost filing for Pay Telephone Surcharge for 800 Serviceline Calls.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

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	)	DOCKET NO. T-01051B-99-0105

EXHIBITS OF

JERROLD L. THOMPSON

EXECUTIVE DIRECTOR- SERVICE COST INFORMATION

QWEST CORPORATION

SEPTEMBER 19, 2000

Redacted

ARIZONA

Zone	Original Proposed Loop	Original Proposed Loop Without Sale Exchanges	ACC Interim Order Without Sale Exchanges
1	$20.12	Redacted	Redacted
2	$40.65	Redacted	Redacted
3	$63.70	Redacted	Redacted

Redacted

ARIZONA

Element Description	Switched Access Original	Switched Access Without Sale Exchanges
Local Switching with shared Trunk Port – per MOU	Redacted	Redacted
Local Switching Without shared Trunk Port – per MOU	Redacted	Redacted
End Office Shared Trunk Port – per MOU	Redacted	Redacted
End Office Dedicated Trunk Port – per DSO	Redacted	Redacted

Redacted

ARIZONA

PAYPHONE USAGE CHARGE

Unit	Direct	Network Support	Direct + Network Support	Directly Attributable	Common	Fully Allocated
Per Message	Redacted	Redacted	Redacted	Redacted	Redacted	Redacted

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 APPPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN.	)	DOCKET NO. T-1051B-99-105
	)	AFFIDAVIT OF Jerrold L. Thompson
STATE OF COLORADO	) :	ss
COUNTY OF DENVER	)	

I, Jerrold L. Thompson, of lawful age being first duly sworn, depose and states:

1. My name is Jerrold L. Thompson. I am the Executive Director-Service Cost Information for Qwest Corporation ("Qwest") (formerly U S WEST Communications Inc.) in Denver, Colorado. I have caused to be filed written testimony and exhibits in support of Qwest in Docket No. T-01051B-99-0105.

2. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct to the best of my knowledge and belief.

Further affiant sayeth not.

Jerrold L. Thompson

Jerrold L. Thompson

SUBSCRIBED AND SWORN to before me this 12th day of September, 2000.

Maija Beck

Notary Public residing at
Denver, Colorado

NOTARY PUBLIC

My Commission Expires: May 8, 2004

BEFORE THE ARIZONA CORPORATION COMMISSION

EXHIBIT
Q-41
Admitted

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-01051B-99-0105

REJOINDER TESTIMONY OF

GEORGE REDDING

QWEST CORPORATION

SEPTEMBER 19, 2000

REJOINDER TESTIMONY OF GEORGE REDDING

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IDENTIFICATION OF WITNESS

Q. PLEASE STATE YOUR NAME, TITLE, EMPLOYER AND ADDRESS.

A. My name is George Redding. I am employed by Qwest Corporation as Director-Regulatory Finance. My address is 1801 California, Denver, Colorado.

Q. ARE YOU THE SAME GEORGE REDDING WHO FILED DIRECT, SUPPLEMENTAL AND REBUTTAL TESTIMONY IN THIS PROCEEDING?

A. Yes, I am.

Q. IN YOUR REBUTTAL TESTIMONY YOU STATED THAT U S WEST COMMUNICATIONS IS NOW QWEST CORPORATION. WILL YOU CONTINUE TO REFER TO THE FORMER U S WEST COMMUNICATIONS AS QWEST OR THE COMPANY IN YOUR REJOINDER?

A. Yes, I will.

PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR REJOINDER TESTIMONY?

A. I will respond to the surrebuttal of Mr. Brosch and Mr. Carver of Staff, Mr. Larkin and Mr. Smith of RUCO, Ms. Gately of AT&T and Mr. Lee of DOD/FEA. I will refute the erroneous criticisms made by these witnesses concerning my test of the revenue requirement and the end of period

adjustments against 2000 actual results. I will once again demonstrate that my test was appropriate and valid, which leads to the conclusion that the Company's test period was properly developed and produced an appropriate revenue requirement. I will also address a number of adjustments made by various parties individually.

Q. HOW IS YOUR REJOINDER TESTIMONY ORGANIZED?

A. It is organized by issue.

TEST OF THE REVENUE REQUIREMENT

Q. IN YOUR REBUTTAL, YOU STATED THAT THE PURPOSE OF THE TEST WAS TO DETERMINE THE ADEQUACY OF THE PROPOSED REVENUE REQUIREMENTS OR DEFICIENCY. HAS ANYTHING IN EITHER STAFF OR RUCO SURREBUTTAL CHANGED THE RESULTS OF YOUR TEST?

A. No. Staff, RUCO, AT&T and DOD/FEA have all tried to confuse the issue and turn attention away from the test of the revenue requirement/deficiency. They have all failed. Only Qwest's revenue requirement, when overlaid on 2000 results, produces a return close to that advocated for the historical test period of 1999.

Q. PLEASE EXPLAIN AGAIN, IN DETAIL, HOW YOU PERFORMED YOUR TEST OF THE ADEQUACY OF THE PROPOSED REVENUE REQUIREMENT.

A. Certainly. My test was based on the statements of numerous experts, with whom I concur, regarding the purpose of the test year. That purpose is to produce a revenue requirement that will allow the Company the opportunity to achieve the found rate of return in the period when rates from this proceeding will go into effect. As rates from this proceeding have obviously not yet gone into effect, I chose the closest available alternative at the time of the filing of my rebuttal testimony, namely year-to-date May 2000 actual results, which I annualized.

Q. DID YOU ADJUST THE 2000 ACTUAL RESULTS IN ANY MANNER?

A. No, I did not. I used the as booked results.

Q. MR. CARVER, ON PAGE 9 OF HIS SURREBUTTAL, STATES THAT "IT APPEARS THAT THE COMPANY INTENTIONALLY DECIDED TO <u>NOT</u> ADJUST THE YTD MAY 2000 NOI OR RATE BASE AMOUNTS FOR OUT-OF-PERIOD, ABNORMAL, NONRECURRING ITEMS OR TO OTHERWISE REFLECT CONSISTENCY WITH THE STAFF'S PROPOSED REVENUE REQUIREMENT ADJUSTMENTS. THIS LED ME TO CONCLUDE THAT THE COMPARATIVE RESULTS APPEARED TO BE INTENTIONALLY MISLEADING." HOW DO YOU RESPOND TO HIS STATEMENT?

A. Let me clearly state that my chart was not misleading. I used actual year-to-date May 2000 results for my test and I made no adjustments. It is not misleading, much less intentionally misleading, to merely state that I used actual results. Where adjustments to the year 2000 results were made in

the section relating to the test of the end of period adjustment, I clearly stated what adjustments were made. For the overall test of the revenue requirement proposals, I did not claim to have made any adjustments.

Q. MR. CARVER MAINTAINS THAT YOU SHOULD HAVE ADJUSTED ACTUAL RESULTS TO REFLECT THE EFFECT OF DISALLOWANCES AND IMPUTATIONS PROPOSED BY STAFF AND RUCO AS WELL AS HIS SOP 98-1 PROPOSAL. WHAT IS YOUR VIEW?

A. Mr. Carver is wrong. The actual results are just that, the actual results. They represent the Company's actual operating experience. Imputations and disallowances do not change the actual booked results.

Mr. Carver also alleges that I should have adjusted the actual results to reflect his adoption of SOP 98-1 relating to the capitalization of software. If the Arizona Corporation Commission (ACC) had adopted SOP 98-1 for regulatory reporting in Arizona, I would agree with Mr. Carver. However, the ACC has not adopted SOP 98-1 and the Company is requesting that they not adopt it. Therefore, it is appropriate to reflect actual results as booked for this item since regulatory treatment is unknown at this time.

Q. WOULD MAKING THE ADJUSTMENT TO ACTUAL RESULTS, AS SUGGESTED BY MR. CARVER, CAUSE THE TEST RESULTS TO BE MISLEADING?

A. Yes, it would. First, adjusting actual recorded results for disallowances or imputations proposed by any party falsely imposes the assumption that

the ACC has adopted such adjustments or positions and it should, thereafter, completely ignore the actual costs to the Company. Such assumptions are premature and, during the course of the proceeding , the ACC must be provided a complete picture of the effect of proposed adjustments, disallowances and imputations in order to arrive at a fully informed decision. Furthermore, even if the ACC adopts these positions, they will not change the actual financial results.

Second, adjusting the actual data for any party's proposed position before making the comparison to that position automatically closes any gap between the data compared. Mr. Carver even acknowedges this fact at page 9 of his rebuttal tesimony. Such a test is illogical, misleading and, by design, would diminish the impact of the test results.

Third, this diminished test result would not provide the ACC with the true picture of the very serious deficiency in Staff and RUCO proposed revenue requirements. Only the Company's test results clearly demonstrate this fact.

Q. MR. CARVER, ON PAGE 7 OF HIS SURREBUTTAL, STATES THAT "AN HISTORIC TEST YEAR WAS NEVER INTENDED TO ESTIMATE, WITH PRECISION, LEVELS OF NET OPERATING INCOME OR RATE

BASE EXPECTED TO BE EXPERIENCED IN FUTURE PERIODS". PLEASE COMMENT.

A. I never claimed that the test period was intended to estimate the future with precision. What I do maintain is that the test period, if properly adjusted, should produce a revenue requirement that allows the Company the opportunity to earn, in the future, at levels close to the found rate of return.[1] It is that condition alone for which I am testing in my comparison to 2000 actual booked results.

Q. SEVERAL OF THE OPPOSING WITNESSES SEEM TO SUGGEST THAT YOU ARE SOMEHOW ATTEMPTING TO UPDATE THE HISTORICAL TEST YEAR WITH YOUR TEST OF THE REVENUE REQUIREMENT. DO YOU AGREE?

A. Absolutely not. Mr. Carver and Mr. Smith both allude to this point, while Mr. Lee states outright that I am attempting to update the test year. I am not updating the test year. I am testing the sufficiency of the recommended revenue requirements, which were developed from the 1999 historical test year, by comparing the outcome of that development against 2000 actual, booked results.

[1] See also the quote by Dr. Alfred Kahn on page 5 of my rebuttal, which states that "the fact is . . . regulatory commissions have always been in the business of projecting, whether they knew it or not. When they used historic test year statistics . . . as the basis of future rates, they were in fact projecting. They were assuming that the future would be similar to the past. It is no more speculative, then, to make the best possible estimate of future costs when setting future rates; and honesty compels it." (emphasis added).

Q. MR. SMITH STATES THAT THE TEST HAS NO WEIGHT WHATSOEVER AS IT IS NOT A COMPLETE ANNUAL PERIOD. WHAT IS YOUR RESPONSE?

A. This is just another attempt to diminish the value of the test. What neither Mr. Smith nor Mr. Carver can say is that their proposed revenue deficiency/requirement will produce results near even their own proposed rate of return when overlaid on actual results.

END OF PERIOD ADJUSTMENT

Q. PLEASE TURN YOUR ATTENTION TO THE END OF PERIOD ADJUSTMENT. DO THE OPPOSING WITNESSES HAVE ANYTHING NEW TO ADD HERE?

A. Not really. They make the same basic argument as they did for the test of the revenue requirement. They complain that I did not adjust actual results for imputations and disallowances. My response is still the same – the actual results are not adjusted for these items. The fact still remains that Qwest's advocacy is the only one that produces both revenues and expenses that are close to the level currently being experienced.

Q. MR. CARVER AND MR. LEE BOTH STATE THAT THEY ARE REVIEWING APPROPRIATE EXPENSE TRENDS. DO YOU AGREE?

A. No. While both make assertions that their expense trends show that their expense levels are appropriate, they both suffer from a major deficiency. Neither of their trends extends past the end of the test year. Only the Company shows trends that extend into 2000. And, again, only Qwest's

proposed expenses based on end of period 1999 approximate the expenses actually occurring in 2000.

Q. MR. CARVER, ON PAGES 15 AND 16 OF HIS SURREBUTTAL, STATES THAT HIS USE OF TWELVE MONTHS FOR EACH POINT ON HIS GRAPH WILL SMOOTH OUT MONTH TO MONTH FLUCTUATIONS. IS HE CORRECT?

A. He is correct as far as he goes, but he does not discuss one obvious shortcoming of using twelve months for each data point. That shortcoming is that all of his data points portray old history. This is true since each data point consists of twelve months of historical information. While his points smooth month-to-month variances they are backward looking rather than forward looking. Again, the purpose of a properly adjusted test period is to look forward. It is not appropriate to compare adjusted test year results that are forward looking to a trend that, by its very construction, is backward looking.

Additionally, by using a backward looking 12 months for a given data point, Mr. Carver's end of test year data point at December 1999 understates the end-of-period expense level. This is the case because, on an upwardly sloping trend line where expenses are increasing, Mr. Carver's data points are weighted downward with lower prior month expense levels. To achieve an appropriate trend line representing end-of-period expense levels one must carry such a trend line forward into year 2000.

Q. MR. SMITH COMPLAINS AT PAGE 4 OF HIS TESTIMONY THAT YOU HAVE SUBSTITUTED A "TEST MONTH" FOR A TEST YEAR. PLEASE COMMENT.

A. This complaint is a smoke screen. By necessity, an end of period adjustment focuses on the latter portion of the test year. RUCO, itself, makes end of period adjustments for both revenues and wage-related expenses. While they did not employ exactly the same methodology as the Company, their adjustments were predicated, at least partly, on results at the end of the test year. Thus, Mr. Smith, is himself being inconsistent when he complains that the Company's adjustments relied on end of period data.

Q. MR. SMITH ALSO STATES THAT THE ANNUALIZATION OF NON-LABOR EXPENSE IS NOT CONSISTENT WITH PAST ACC PRACTICE. WHAT ARE YOUR REACTIONS?

A. As I have explained numerous times, I believe that a properly adjusted test period should synchronize all of the elements of the ratemaking equation, namely revenues, expenses, taxes and rate base. Since an end of period rate base is employed in Arizona, all other elements should be synchronized with it. That is what I have done in the Company's presentation of the test year. I have been careful throughout my direct, rebuttal and now rejoinder testimony to lay out a clear theoretical basis for the appropriateness of the end of period adjustment to all elements of the ratemaking equation. I have also tested the results of these adjustments

against actual, booked results in 2000 to demonstrate that the adjustments proposed by Qwest are appropriate.

Q. MR. CARVER, AT PAGE 36, IMPLIES THAT THE COMPANY WITNESSES HAVE BEEN INCONSISTENT IN THEIR TREATMENT OF LTIP. WHAT IS YOUR RESPONSE?

A. As stated in the response to data request UTI71-008, no specific LTIP adjustment was made because the end of period wage and salary adjustment produced pro forma expense levels higher than the levels that included the LTIP. The 1999 amount of LTIP involved is minor, at less than $0.2M.

POST TEST YEAR WAGES

Q. MR. CARVER RENEWS HIS ARGUMENTS REGARDING THE LEVEL OF POST TEST YEAR WAGES. DO YOU HAVE ANYTHING TO ADD TO THE POSITION YOU TOOK IN YOUR REBUTTAL?

A. Yes, I do. On page 27 of his surrebuttal, Mr. Carver states that "the ultimate objective in selecting from this menu of test year options is the establishment of rates for the future that will provide the utility with an opportunity to earn a reasonable return on investment." I concur with this statement. The test that compared fully adjusted test year expenses to actual results being incurred in 2000 established the validity of the Company's total adjustments to the test year. These adjustments included the post test year wage and salary increases of $7.8M.

Then Mr. Carver goes on to try and somehow make the Company's adjustment for post test year wages and salaries into a forecasted test year. I would agree with Mr. Carver that I was using an element of a forecasted test year except for one thing – the Company's adjustment maintained the test year volumes. In other words, the post test year wages and salary increases were stated at test year 1999 levels; that is, test year volumes times the known price level change. Changes in post test year known and measurable price levels have consistently been adopted by regulators, including the ACC, despite the fact that Mr. Carver does not agree.

Mr. Carver then claims that the Company's approach is piecemeal. I would refer Mr. Carver to page 28 of my rebuttal testimony where I stated that I would have made other post test year price level changes had there been any. The Company's approach was not piecemeal; rather the post test year wage and salary adjustments were the only price level changes uncovered in my review.

SOFTWARE CAPITALIZATION

Q. MR. CARVER AND MR. SMITH BOTH ADDRESS SOFTWARE CAPITALIZATION AGAIN IN THEIR SURREBUTTAL. DO YOU HAVE ANY COMMENTS?

A. I would only like to reiterate two points. The first is that this change will not be cash impacting if it is not adopted for regulatory purposes and that the transition is of short duration. Mr. Carver lists various accounting changes that have been adopted for regulatory purposes. Again, they all had longer lives than the five year life of the instant change.

The second point is that I would not have proposed a rider for this item if there were not a price cap plan being proposed in this case. Assuming adoption of Mr. Carver's adjustment for the first year impact of SOP 98-1, and further assuming the adoption of a price cap plan, the Company would be in the hole on this issue. Consequently, as further capitalization takes place, the revenue requirement related to this item will automatically increase from the first year decrease without any ability for the Company to recover these costs. Even Mr. Smith's three-year average leaves the Company short since the price cap plan being proposed will last five years. The preferable treatment is still not to adopt this change for purposes of this revenue requirement determination.

IMAGE ADVERTISING

Q. ALL OF THE PARTIES EXCEPT FOR AT&T ADDRESS IMAGE ADVERTISING AND CONTINUE TO PROPOSE ITS EXCLUSION. DO YOU HAVE ANY FURTHER THOUGHTS ON THEIR COMMENTS?

A. Yes, I do. This is one of those issues where the basis for making the adjustment has changed. When the Company was a monopoly provider of local services, there were much stronger arguments related to the

exclusion of image advertising. But times have changed and quickly. Qwest now faces competition in almost every area of its business. There is strong competition for business and toll services, and competition is growing in the residential sector. Cox Cable, in Arizona, is offering local residential access in portions of the Phoenix metropolitan area. When competition is present, the need for image advertising to retain current customers and set up the sale of new products becomes mandatory. With competition, the arguments that support product advertising also support image advertising. When there is competition, the Company must first promote its brand in order to sell additional products. The two types of advertising are inextricably tied together.

Q. MR. CARVER CITES A NUMBER OF CASES WHERE IMAGE ADVERTISING HAS BEEN EXCLUDED AND CLAIMS THAT THE SAME RATIONALE SHOULD APPLY HERE. HAS HE MISSED SOMETHING?

A. Yes, he has. The scenario of emerging competition that I outlined above has, by and large, come into existence since the passage of the Telecommunications Act of 1996. Mr. Carver cites several cases that support his contention, namely, the last Arizona order in 1995, a Utah order from 1997 and a 1996 Washington order. None of these cases were decided based on the explosive growth of competition that has occurred in the past couple of years. I certainly do not view any of these cases as valid precedent given the dramatic change in market conditions.

Q. MR. LARKIN ALSO OPPOSES IMAGE ADVERTISING. WHAT IS HIS BASIS?

A. Like Mr. Carver, Mr. Larkin does not take cognizance of the changed factual situation. He cites past precedent and still regards local service as a monopoly, which it no longer is, especially in Arizona. Furthermore, it is indisputable that there is very robust competition in other areas such as long distance.

FCC DEREGULATED PRODUCTS

Q. HAS MR. SMITH NOW QUANTIFIED HIS AJUSTMENT FOR THIS ISSUE?

A. Yes, he has. However, he has failed to make the companion adjustments made by Mr. Carver to remove the separations effects of including FCC deregulated services with regulated results. I do not agree that this adjustment is necessary unless these deregulated results are removed from regulation. Mr. Carver's adjustment has the same effect as removing these products from regulated results. As I stated in my rebuttal testimony, I believe this adjustment is proper if the Commission grants the Company's request to remove these deregulated results from regulation.

Q. NEITHER MR. CARVER NOR MR. SMITH ADVOCATE REMOVING THE FCC DEREGULATED PRODUCTS FROM REGULATION. HAVE THEY JUSTIFIED THIS TREATMENT?

A. No. It is entirely inconsistent to argue that there should be a profit imputation to ensure that regulated products do not subsidize deregulated

products and at the same time argue that these products should remain under regulation. The most logical way to achieve the desired result is to deregulate these FCC deregulated products at the state level.

ISSUES RELATED TO SALE OF EXCHANGES

Q. MR. SMITH AGAIN BRINGS UP THE SHARING OF THE GAIN ON THE SALE OF EXCHANGES. WHAT IS YOUR RESPONSE?

A. He reiterated his testimony. I will only state that the disposition of this gain is a question that should be resolved in the sale of exchanges docket. Once it is disposed of there, then the impact, if any, on this case may be determined. Until that time it is premature to discuss disposition of the gain in this case.

Q. MR. BROSCH CONTINUES HIS ARGUMENTS RELATING TO THE ALLOCATION OF INCREASED MARKETING EXPENSE AND CORPORATE OVERHEADS. DO YOU HAVE ANY FURTHER COMMENTS?

A. Only briefly. I was surprised by Mr. Brosch's statement that when the Company brings up anticipated growth, as here in conjunction with corporate overheads, it is considered invalid. However, it appears to be entirely proper for Staff to use anticipated growth to bolster some of their arguments.

As to the marketing expense, Mr. Brosch is entirely correct that some of the advertising in urban markets is received in rural markets through the

media. However, that is a spillover effect and does not alter the fact that the marketing push is in the urban centers and directed toward the urban customer. Also, not all media spills over. Radio advertising tends to be more localized as does newspaper advertising. Furthermore, the spillover effect will disappear after the exchanges are sold; i.e. the advertising aimed at the urban markets will impact only those urban markets.

Q. MS. GATELY ATTEMPTED TO CLARIFY HER ADJUSTMENT RELATED TO THE SALE OF EXCHANGES. DO YOU NOW AGREE WITH HER ADJUSTMENT?

A. No, I do not. She is apparently arguing that since the net operating income of the exchanges being sold is positive that this somehow or other benefits Qwest. What she fails to show is that when all elements of the exchange sale are accounted for the removal of these costs decreases the overall revenue requirement. This is because the return on investment generated by the exchanges being sold is only 4% (see Exhibit GAR-S7G). This return is far below the requested return; therefore, removal of all elements of the proposed sale actually lowers the requested revenue requirement.

EMPLOYEE CONCESSIONS

Q. MR. BROSCH ACKNOWLEDGES THAT QWEST COULD NOT RECOVER THE INTERSTATE PORTION OF EMPLOYEE CONCESSIONS IF THEY WERE ALLOCATED BETWEEN THE

JURISDICTIONS, BUT MAINTAINS THAT THIS IS NOT A DISALLOWANCE. DO YOU AGREE?

A. I do not agree. What Mr. Brosch is proposing is to remove part of a benefit that has historically been recovered in intrastate rates from the cost of service. Regardless of what it is called, this change would decrease the recovery of a benefit that formerly was fully recoverable. In my opinion this is a disallowance and Mr. Brosch's proposed adjustment should be rejected.

BROADBAND SERVICES

Q. MR. SMITH HAS NOW PROPOSED TO ADOPT STAFF'S ADJUSTMENT FOR BROADBAND SERVICES. WHAT IS YOUR REACTION?

A. As I stated in my rebuttal, I do not find Staff's adjustment to be unreasonable. Therefore, I have no additional comment on RUCO's adjustment.

RECIPROCAL COMPENSATION

Q. BOTH MR. BROSCH AND MR. SMITH ADDRESSED THE COMPANY'S PROPOSED TREATMENT OF RECIPROCAL COMPENSATION IN THEIR SURREBUTTAL. DO YOU HAVE ANY COMMENTS BEYOND YOUR REBUTTAL?

A. I do have one additional comment. Mr. Smith lists a number of points regarding automatic adjustment clauses at page 32 of his surrebuttal. I

would like to focus on item 5, which states that "under Arizona law, automatic adjustment clauses are reserved for those expenses that are extremely volatile and which widely fluctuate." This describes the reciprocal compensation issue perfectly. There are existing agreements with some carriers that provide for reciprocal compensation related to ISP service. There are also new agreements with other carriers which provide that reciprocal compensation for ISP traffic is inappropriate. The issue of whether ISP traffic is interstate or intrastate and the impact of the designation on reciprocal compensation is under review by both the courts and the FCC. Also, there is legislation pending in Congress on this subject. This all adds up to high volatility and uncertainty. Qwest's proposal merely requests that all parties be held harmless from this volatility by providing an automatic adjustment clause.

COSTS ASSOCIATED WITH LNP

Q. MS. GATELY PERSISTS THAT COSTS NOT ACCEPTED BY THE FCC FOR SPECIFIC RECOVERY UNDER THE LNP SURCHARGE SHOULD BE REMOVED FROM THE DETERMINATION OF THE REVENUE REQUIREMENT. DO YOU AGREE?

A. Absolutely not. The FCC defined the costs that could be recovered under the LNP surcharge very narrowly. They agreed that other costs were supportive of the provision of LNP, but only allowed direct LNP costs to be recovered under the LNP surcharge. All of the costs incurred were necessary to prepare the network to handle LNP, but some of the costs were associated with both general upgrades of the network and LNP.

These costs were not considered direct or specific enough to be recovered under the LNP surcharge. These are the costs that should be recovered in the ordinary course of business.

Q. CAN YOU PROVIDE A CONCRETE EXAMPLE OF THE FCC'S THINKING?

A. Yes. In its *Memorandum Opinion and Order* dated December 14, 1998, the Commission states

> In the *First Report and Order*, the Commission concluded that the 1996 Act provided for an extraordinary mechanism to recover certain eligible costs of providing number portability, in addition to the existing price caps and rate-of-return recovery mechanisms. In the *Third Report and Order*, the Commission limited the costs eligible for recovery through this new federal mechanism to "costs carriers incur specifically in the provision of number portability services, such as for the querying of calls and the porting of telephone numbers from one carrier to another." The Commission further specified that costs "that carriers incur as an incidental consequence of number portability, however, are not costs directly related to providing number portability." The Commission, therefore, concluded that these latter costs have become ordinary costs of doing business in this new environment, and, thus, represent general network upgrades. LECs must distinguish the costs of providing local number portability itself, recoverable through the federal charges provided in the Third Report and Order, from general network upgrade costs recoverable through the price caps and rate-or-return mechanisms. (footnotes omitted)[2] *[emphasis added]*

This paragraph clearly indicates that costs disallowed from recovery under the federal LNP mechanism had already become, as of December 1998, ordinary costs of doing business. It is precisely these ordinary costs of

[2] In the Matter of Telephone Number Portability Cost Classification Proceeding, CC Docket 95-116 and RM 8535, *Memorandum Opinion and Order*, released December 14, 1998 at 9.

doing business that Qwest seeks to recover in both interstate and intrastate prices through existing recovery mechanisms.

OTHER INTERCONNECTION COSTS

Q. MS. GATELY ALSO PERSISTS IN ARGUING THAT ALL COSTS RELATED TO INTERCONNECTION SHOULD BE EXCLUDED. DO YOU HAVE ANY FURTHER COMMENTS ON THIS SUBJECT?

A. The interconnection costs, other than the specific LNP costs recoverable under the FCC's LNP surcharge, flow through the normal separations process. So do the revenues associated with these costs. Ms. Gately seems to be under the impression that the revenues associated with interconnection are not recognized in the development of the revenue requirement and therefore, the costs may be double recovered. She is in error. All of the interconnection revenues properly assignable to the intrastate jurisdiction are included in the Company's intrastate revenues. There is no double recovery.

FCC CPR AUDIT

Q. MS. GATELY PERSISTS IN BELIEVING THAT THE CPR AUDIT RESULTS INDICATE THAT QWEST'S INVESTMENT IS INFLATED. PLEASE COMMENT.

A. This contention is, and has been, vehemently denied by Qwest as well as all of the other RBOCs. There has been no adjudication of this issue by the FCC, whose Staff conducted the original audit. Until the FCC has

reached a decision on this issue, there is no determination to be made by the Arizona Commission.

I must also repeat certain points I made in my rebuttal. The FCC audit was not an audit of Qwest's books with respect to investment in plant. It was a review of the individual property records. The audit did not test for understatement errors and no mention was made in the audit if additional pieces of equipment were counted. Further, the audit did not use dollar based sampling techniques. These facts render the audit results incapable of determining the dollar value of any errors noted.

Q. DOES THIS CONCLUDE YOUR REJOINDER TESTIMONY?

A. Yes, it does.

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 APPPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN.	)	DOCKET NO. T-1051B-99-105 AFFIDAVIT OF GEORGE REDDING
STATE OF COLORADO	) :	ss
COUNTY OF DENVER	)	

George Redding, of lawful age being first duly sworn, depose and states:

1. My name is George Redding. I am Director – Regulatory Finance of Qwest Corporation in Denver, Colorado. I have caused to be filed written rejoinder testimony in support of Qwest in Docket No. T-01051B-99-0105

2. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct to the best of my knowledge and belief.

Further affiant sayeth not.

George Redding

SUBSCRIBED AND SWORN to before me this 15TH day of SEPTEMBER, 2000.

Notary Public

My Commission Expires: _____

WILLIAM R. CURTIS NOTARY PUBLIC STATE OF COLORADO

My Commission Expires 10/28/2003

BEFORE THE

ARIZONA CORPORATION COMMISSION

EXHIBIT
Q-42
Admitted

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

REJOINDER TESTIMONY OF

KERRY DENNIS WU

ON BEHALF OF

QWEST CORPORATION

SEPTEMBER 19, 2000

REJOINDER TESTIMONY OF KERRY DENNIS WU
INDEX OF TESTIMONY

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EXECUTIVE OVERVIEW

In Decision 62507, the Commission issued its final Decision on depreciation matters in Docket No. T-01051B-97-0689. In that Decision, the Company was directed to file depreciation rates consistent with the Decision. The Company complied and the rates were accepted. Decision 62507 concluded, "Advancements in technology, coupled with a desire to create robust competition in Arizona's telecommunications industry, warrant's setting U S WEST's depreciation lives with the range of competitors."

Various parties to this proceeding have attempted to revisit the Commission's depreciation decision. Mr. Dunkel, on behalf of Staff, argues that Qwest should grant refunds to customers if Qwest does not retire its assets according to a schedule linked to Qwest's depreciation rates. He claims his proposal is justified by the need to ensure that Qwest modernizes its network. His proposal should be rejected because it confuses retirements with modernization. Modernization is best evidenced by investment and, on that score, it is absolutely clear that Qwest is modernizing its network. Qwest has invested substantially more in Arizona over the last ten years than it has recovered through depreciation.

Mr. Brosch recommends reducing depreciation expense based on an assumption that certain vintage investment represents unrecorded retirements. This assumption does not justify a reduction in depreciation expense, however.

Had the retirements been made, the result would have been higher depreciation rates in the recently concluded depreciation docket.

Mr. Lee recommends making the depreciation rates decided in May 2000, effective 1/1/97. His proposal is in substance a request for a write-off of plant assets. His proposal is inconsistent with the Commission's intent to grant Qwest more rapid capital recovery going forward. The effect of his proposal is to actually reduce Qwest's capital recovery.

IDENTIFICATION OF WITNESS

Q. PLEASE STATE YOUR NAME, OCCUPATION, AND BUSINESS ADDRESS.

A. My name is Kerry Dennis Wu. My title is Director - Capital Recovery for Qwest Corporation (Qwest). My business address is 1600 7th Avenue, Room 3006, Seattle, Washington 98191.

Q. ARE YOU THE SAME DENNIS WU THAT FILED DIRECT AND REBUTTAL TESTIMONY IN THIS CASE?

A. Yes I am.

PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. In my testimony, I am responding to the statements made by Department of Defense witness Richard Lee and Staff witnesses William Dunkel and Michael Brosch relating to their statements regarding certain depreciation issues.

DEPARTMENT OF DEFENSE TESTIMONY

Q. CAN YOU SUMMARIZE MR. LEE'S DEPRECIATION REBUTTAL TESTIMONY?

A. Yes. Mr. Lee's rebuttal restates his earlier position that since the Arizona Commission's May 2000 order was based on a study as of 1/1/97, depreciation rates should also be effective as of that date. He effectively contends that: (1) either Qwest write down its Arizona investment before implementing its recently approved Arizona depreciation rates; or, (2) that Qwest use a 1/1/97 implementation date for the revised depreciation rates. Mr. Lee further states that as an additional alternative he reviewed and also supports Staff's position.

Q. WHAT IS WRONG WITH MR. LEE'S POSITION?

A. The depreciation study was as of 1/1/97. Decision No. 62507 prescribing revised depreciation rates was not issued until May, 2000, nearly three and a half years after the study date. If his proposal is adopted, Qwest will be denied capital recovery for that entire period. Indeed, the upshot of his proposal is that the Commission's order which was predicated on improving Qwest's capital recovery, should be interpreted in such a way as to deny Qwest capital recovery. His proposal violates the letter and spirit of Decision No. 62507.

Q. WHAT ELSE IS UNUSUAL ABOUT MR. LEE'S PREMISE TO MAKE ARIZONA DEPRECIATION RATES EFFECTIVE 1/1/97?

A. In the depreciation Docket T-01015B-97-0689, Mr. Lee vigorously supported a position to lower depreciation rates, which absent any other changes, would have reduced revenue requirement. In Decision No. 62507, Mr. Lee's recommended lives were not accepted and Qwest's depreciation rates were **increased** in order to improve Qwest's rate of capital recovery. Now Mr. Lee contrarily argues that the Commission's decision increasing Qwest's depreciation rates should result in **reduced** revenue requirement. His proposal is ad hoc in the sense that he believes that any outcome of the depreciation docket should result in reduced capital recovery.

STAFF TESTIMONY – WILLIAM DUNKEL

Q. WHY IS MR. DUNKEL'S UPDATE RECOMMENDATION IN CONFLICT WITH ARIZONA'S FINAL DEPRECIATION ORDER?

A. Decision 62507 states, "It is ordered that U S WEST Communications, Inc. shall no later than ten days from the effective date of this Order file updated depreciation rates consistent with the Discussion herein." The Company filed a 1/1/97 depreciation study, which was litigated by all parties including Staff. The final Order was based upon that study.

Depreciation rates were filed and accepted in May, 2000. Now Mr. Dunkel seeks to substitute another study date in direct conflict with Decision 62507.

Q. MR. DUNKEL RECOMMENDS QWEST'S ASSET RETIREMENTS BE MONITORED TO ENSURE MODERNIZATION OF QWEST'S NETWORK AND HE PROPOSES THAT CUSTOMERS RECEIVE RATE REDUCTIONS IF QWEST'S RETIREMENT LEVEL DOES NOT EQUAL THE LEVEL HE HAS IMPLIED FROM DECISION NO. 62507. WOULD YOU COMMENT?

A. It makes no sense to focus on retirements. Modernization should be evaluated based on Qwest's investment in Arizona. Qwest's past and anticipated track record with respect to investment is outstanding. The intent of depreciation is to allocate costs of capital investments in a systematic and rational matter. The Commission's depreciation order gives Qwest ample incentive to continue to invest in the state.

Q. DOES MR. DUNKEL'S PROPOSAL TO LINK CUSTOMER CREDITS WITH RETIREMENT OF ASSETS MAKE ANY SENSE?

A. No. Shown below is a table of historical depreciation expense, gross additions and retirements:

	Tot Depreciation	Gross Adds*	Retirements
1991	$211.0 million	$257.6 million	$100.1 million

1992	$232.5	$247.1	$118.0
1993	$243.4	$237.7	$ 82.8
1994	$262.0	$271.9	$ 66.0
1995	$278.1	$312.5	$100.0
1996	$295.7	$395.5	$ 97.3
1997	$308.5	$291.5	$146.1
1998	$302.9	$294.3	$ 71.6
1999	$307.0	$406.0	$134.1

*Includes other debits and credits.

As indicated, the level of depreciation expense has no direct correlation with retirements. Nor does the level of investment relate systematically with retirements.

Q. WHY IS MR. DUNKEL'S EMPHASIS ON RETIREMENTS MISPLACED?

A. FCC practices for developing depreciation rates utilize a two-step process; companies select survivor curves based on historical retirement **patterns**, and then subsequently rescale those curves based on future life expectations. It is the combination of the two concepts by which final depreciation rates are developed. The manner in which depreciation rates are calculated, however, has never been intended to drive actual retirements, but that is exactly how Mr. Dunkel is twisting the procedure..

Q. MR. DUNKEL STATED ON PAGE 9, LINES 3 AND 4 OF HIS SURREBUTTAL, "IN HIS REBUTTAL, MR. WU ACKNOWLEDGES

THAT THE COMPANY MUST INVEST IN NEW EQUIPMENT IN ORDER TO RETIRE THE EXISTING EQUIPMENT." WOULD YOU COMMENT?

A. Mr. Dunkel mischaracterized my statement. What I stated was,

> In his testimony, Mr. Dunkel has erroneously equated modernization and retirement. These are really different concepts. Modernization refers to investment in new plant and equipment and new technologies. Retirement is the process by which assets are removed from service. While retirement may occur simultaneously with modernization, it need not. For example, when Qwest invests in a new switch, it may intend that the switch will one day replace another switch that continues to be used. Investment in the new switch may very well precede retirement of the older switch.
>
> Wu Rebuttal Testimony, p. 7, lns. 6 – 14.

Q. IN HIS DISCUSSION OF COPPER PAIR USAGE, ON PAGES 9 AND 10 OF MR. DUNKEL'S REBUTTAL TESTIMONY, HE STATES AS SUPPORT FOR HIS PREMISE THAT USAGE IS GROWING "THE NUMBER OF METALLIC PAIRS WORKING IN 1999 WAS THE HIGHEST OF ANY YEAR IN HISTORY." WOULD YOU COMMENT?

A. Mr. Dunkel confuses the issue of "working" versus "usage." Mr. Dunkel cites his source as ARMIS data, but ARMIS data does not show usage. It reports copper cable pairs as "working" even if only a small percentage of a cable is actually being utilized. Because of transition and migration to new technologies, a better indicator of usage is the increase in fiber percentage of total working channels over the last ten years. Over that period of time, fiber has increased over 400%. This is clear evidence that

usage of copper is actually decreasing. Mr. Dunkel's proposal to monitor retirements ignores defacto retirement that occurs as actual usage of the copper in the ground declines.

Q. WHY ARE MR. DUNKEL'S RECOMMENDATIONS REGARDING YOUR REBUTTAL TESTIMONY EXHIBIT MISGUIDED?

A. In Decision 62507, the Commission issued its final Decision on depreciation matters in Docket No. T-01051B-97-0689. In that Decision the Company was directed to file depreciation rates consistent with the Decision. The Company complied and the rates accepted. According to Decision No. 60928, those rates were to be used in the subsequent rate review. Now in an attempt to rehear depreciation, Mr. Dunkel recommends recalculating depreciation rates as of 1/1/2000.

STAFF TESTIMONY – MICHAEL BROSCH

Q. WHAT DID MR. BROSCH PROPOSE REGARDING DEPRECIATION?

A. Mr. Brosch proposed a $55.3 million reduction in investment which results in a $2.9 million reduction in depreciation expense related to this investment. The reason for his proposed adjustment is that in his opinion, the amount represents unrecorded retirements.

1 **Q. WHAT IS YOUR RESPONSE?**

2 A. Mr. Brosch's recommendation does not follow from the facts he bases it
3 on.
4

5 **Q. WHY IS THAT?**

6 A. On page 15 and 16 of my rebuttal testimony, I clearly demonstrated if
7 certain investment represented unrecorded retirements as Mr. Brosch
8 alleged, and that if those amounts were actually retired, it would have
9 resulted in higher depreciation rates in the recently concluded
10 depreciation docket. I have enclosed the example as Exhibit KDW-1.
11

12 **Q. IN HIS REBUTTAL TESTIMONY, HOW DID MR. BROSCH ADDRESS**
13 **THIS POINT?**

14 A. Mr. Brosch did not comment and stated that Mr. Dunkel would respond to
15 my example in his surrebuttal testimony. However, Mr. Dunkel did not
16 respond to the example I used to illustrate my point.
17

18 **Q. SHOULD MR. BROSCH'S PROPOSED INVESTMENT AND**
19 **DEPRECIATION EXPENSE REDUCTION BE ACCEPTED?**

20 A. No. The proposed adjustment is not appropriate and should be rejected.
21

22 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

A. Yes.

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

EXHIBITS OF

KERRY DENNIS WU

ON BEHALF OF

QWEST CORPORATION

SEPTEMBER 19, 2000

Assume the following:

Gross Investment	$100		
Depreciation Reserve	$ 50	or	50% Reserved
Remaining Life	5 years		

Under the remaining life formula, assuming no future net salvage, the depreciation rate calculation would be

$$\frac{100\% \text{ less } 50\%}{5 \text{ years}} \quad \text{equals} \quad 10\%$$

Let's assume a $10 retirement, the depreciation calculation would be as follows:

Gross Investment	$90		
Depreciation Reserve	$40	or	44.4% Reserved
Remaining Life	5.1 years		

The new depreciation rate calculation would be:

$$\frac{100\% \text{ less } 44.4\%}{5.1 \text{ years}} \quad \text{equals} \quad 10.9\%$$

As demonstrated above, one cannot arbitrarily remove vintage information without considering the effects of what would have happened had its retirement been part of Arizona's recently completed depreciation study.

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 APPPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN.	)	DOCKET NO. T-1051B-99-105 AFFIDAVIT OF KERRY DENNIS WU
STATE OF WASHINGTON	) :	ss
COUNTY OF KING	)	

Kerry Dennis Wu, of lawful age being first duly sworn, depose and states:

1. My name is Kerry Dennis Wu. I am Director – Capital Recovery of Qwest Corporation in Seattle, Washington. I have caused to be filed written testimony and exhibits in support of Qwest in Docket No. T-01051B-99-0105.

2. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct to the best of my knowledge and belief.

Further affiant sayeth not.

Kerry Dennis Wu

Kerry Dennis Wu

SUBSCRIBED AND SWORN to before me this 14th day of September, 2000, 2000.

Elizabeth M. Tabor

Notary Public residing at
Seattle, Washington.

My Commission Expires: 09/15/02

NEW APPLICATION

EXHIBIT
Q-43
admitted

RECEIVED
AZ CORP COMMISSION

AT&T

Patricia L. vanMidde
Assistant Vice President
Western Region

JUL 25 10 08 AM '00

DOCUMENT CONTROL

Suite 1201
111 West Monroe
Phoenix, Arizona 85003
602 257-4466 Ext. 1
FAX 602 340-0994
vanmidde@att.com

Advice No. T-00-01

DOCKET NO. T 03016A-00-0539

July 25, 2000

HAND DELIVERED

Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

To The Commission:

AT&T Communications of the Mountain States, Inc., submits for approval and authorization of the Arizona Corporation Commission, four pages for filing in TCG Phoenix, Services Tariff and Price List. With this filing, TCG Phoenix is requesting approval of price cap and price list rate increases for its Call Completion Access Service. TCG's current authorized list price is below rates imposed by US West on its Arizona customers.

Under separate cover in a supplemental filing, AT&T will submit copies of letters sent to its Arizona access services customers along with certification of service, and Call Completion access service revenue impact. Since the number of TCG Phoenix access customers is minimal, TCG has determined their access customers will be better served with a separate letter providing prior notification of TCG's request for approval of price cap increases.

The pages affected in the TCG Phoenix Services Tariff are:

Section 4
Call Completion Service, Second Revised Page 100
Call Completion Service, Second Revised Page 101

SALT LAKE 2002
PROUD PARTNER

The pages affected in the TCG Phoenix Price List are:

Section 5
Call Completion Rates, Second Revised Page 124
Call Completion Rates, Second Revised Page 125

TCG is requesting an effective date of September 1, 2000. Please call me if there are any questions concerning this filing.

Sincerely,

Patricia van Midde (TH)

Patricia L. vanMidde
Assistant Vice President
Government Affairs

Attachments

4.9 Call Completion Service

4.9.6 Call Completion Rates

SERVICE ORDERS

Service Component	Non-Recurring Charge
-Installation Charge (per line\trunk) -1st -Add'l	 $4,000.00 $4,000.00
-Access Order Charge - Per Access Request	$50.00
-Engineering Change Charge - Per Access Request	$100.00
-Service Date Change - Per Access Request	$80.00
-Design Change - Per Access Request	$90.00

SWITCHED TRANSPORT

Service Component	Rates	
	Non-Recurring	Recurring
Entrance Facility-DS3	Use DS3 Local Distribution Channel Rates	Use DS3 Local Distribution Channel Rates
Entrance Facility-DS1	Use DS1 Local Distribution Channel Rates	Use DS1 Local Distribution Channel Rates
Direct Trunked Transport Mileage		
- DS3 Fixed - DS3 Per Mile	Use DS3 Interoffice Channel Mileage Rates	Use DS3 Interoffice Channel Mileage Rates
- DS1 Fixed - DS1 Per Mile	Use DS1 Interoffice Channel Mileage Rates	Use DS1 Interoffice Channel Mileage Rates
Tandem Switched Transport	Non-Recurring	Per Access Minute
- Tandem Trans. Fixed - Tandem Trans. Per Mile - Tandem Switching	None None None	$.000862 $.000048 $.008500 (I)
Common Channel Signaling Access	Non-Recurring	Recurring
STP Port Termination (per port) STP Link Transport (per mile)	ICB None	None ICB

Issued By:
Kathy Boegershausen
Teleport Communications Group
One Teleport Drive, Suite 300
Staten Island, NY 10311

4.9 Call Completion Service

END OFFICE

Service Component	Originating ($ Per MOU)	Terminating ($ Per MOU)
Call Completion - No Minimum Volume	$.04692	$.06500 (I)
(D)	(D)	(D)
(D)	(D)	(D)
(D)	(D)	(D)

800 DATABASE ACCESS

Service Component	Non-Recurring	Per Query
800 Data Base Query	None	$0.02

OPERATOR TRANSFER

Service Component	Non-Recurring	Per Call
Operator Transfer (per call)	None	$0.22

PRESUBSCRIPTION

Service Component	Non-Recurring	Recurring
Presubscription (per line)	$20.00	None

Issued By:
Kathy Boegershausen
Teleport Communications Group
One Teleport Drive, Suite 300
Staten Island, NY 10311

SECTION 5 - PRICE SHEET (continued)

5.8 Call Completion Rates

SERVICE ORDERS

Service Component	Non-Recurring Charge
-Installation Charge (per line\trunk) -1st -Add'l	 $2,004.00 $2,004.00
-Access Order Charge - Per Access Request	$50.00
-Engineering Change Charge - Per Access Request	$50.00
-Service Date Change - Per Access Request	$42.00
-Design Change - Per Access Request	$42.00

SWITCHED TRANSPORT

Service Component	Rates	
	Non-Recurring	Recurring
Entrance Facility-DS3	Use DS3 Local Distribution Channel Rates	Use DS3 Local Distribution Channel Rates
Entrance Facility-DS1	Use DS1 Local Distribution Channel Rates	Use DS1 Local Distribution Channel Rates
Direct Trunked Transport Mileage		
- DS3 Fixed - DS3 Per Mile	Use DS3 Interoffice Channel Mileage Rates	Use DS3 Interoffice Channel Mileage Rates
- DS1 Fixed - DS1 Per Mile	Use DS1 Interoffice Channel Mileage Rates	Use DS1 Interoffice Channel Mileage Rates
Tandem Switched Transport	Non-Recurring	Per Access Minute
-Tandem Trans. Fixed -Tandem Trans. Per Mile -Tandem Switching	None None None	$.000480 (I) $.000048 (I) $.006750 (I)
Common Channel Signaling Access	Non-Recurring	Recurring
STP Port Termination (per port) STP Link Transport (per mile)	ICB None	None ICB

Issued By:
Kathy Boegershausen
Teleport Communications Group
One Teleport Drive, Suite 300
Staten Island, NY 10311

SECTION 5 – PRICE SHEET (continued)

5.8 Call Completion Rates (continued)

END OFFICE

Service Component	Originating ($ Per MOU)	Terminating ($ Per MOU)
Call Completion – No Minimum Volume	$.033524 (I)	$.047724 (I)
(D)	(D)	(D)
(D)	(D)	(D)
(D)	(D)	(D)

800 DATABASE ACCESS

Service Component	Non-Recurring	Per Query
800 Data Base Query	None	$0.01

OPERATOR TRANSFER

Service Component	Non-Recurring	Per Call
Operator Transfer (per call)	None	$0.22

PRESUBSCRIPTION

Service Component	Non-Recurring	Recurring
Presubscription (per line)	$10.00	None

5.9 Operator Service Rates

Local exchange and IntraLATA calls may be placed on an Operator Assisted basis. Usage charges for Operator Handled local calls are the same as those set forth in preceding sections.

In addition, to the usage charges identified above, the following operator-assisted charges will apply:

Type of Call	Per Call
Person-to-Person	$3.50
Station-to-Station	$1.30
Operator Dialed Charge	$1.50
Billed to LEC Calling Card	$0.50

ORIGINAL

4.9 Call Completion Service

4.9.6 Call Completion Rates

SERVICE ORDERS

Service Component	Non-Recurring Charge
-Installation Charge (per line\trunk) -1st -Add'l	 $4,000.00 (I) $4,000.00 (I)
-Access Order Charge - Per Access Request	$50.00
-Engineering Change Charge - Per Access Request	$100.00 (I)
-Service Date Change - Per Access Request	$80.00 (I)
-Design Change - Per Access Request	$90.00 (I)

SWITCHED TRANSPORT

Service Component	Rates	
	Non-Recurring	Recurring
Entrance Facility-DS3 (N)	Use DS3 Local Distribution Channel Rates (N)	Use DS3 Local Distribution Channel Rates (N)
Entrance Facility-DS1	Use DS1 Local Distribution Channel Rates (C)	Use DS1 Local Distribution Channel Rates (C)
Direct Trunked Transport Mileage		
- DS3 Fixed - DS3 Per Mile	Use DS3 Interoffice Channel Mileage Rates (N)	Use DS3 Interoffice Channel Mileage Rates (N)
- DS1 Fixed - DS1 Per Mile	Use DS1 Interoffice Channel Mileage Rates (C)	Use DS1 Interoffice Channel Mileage Rates C)
Tandem Switched Transport	Non-Recurring	Per Access Minute
-Tandem Trans. Fixed -Tandem Trans. Per Mile -Tandem Switching	None None None	$.000862 (I) $.000048 (I) $.001948 (I)
Common Channel Signaling Access	Non-Recurring	Recurring
STP Port Termination(per port) STP Link Transport(per mile)	ICB (C) None	None (C) ICB (C)

Issued By:
Lori-Ann Mirenda
Teleport Communications Group
One Teleport Drive, Suite 300
Staten Island, NY 10311

ADMINISTRATIVELY APPROVED FOR FILING

ORIGINAL

4.9 Call Completion Service

END OFFICE

Service Component	Originating ($ Per MOU)	Terminating ($ Per MOU)
Call Completion - No Minimum Volume	$.04692 (I)	$.04692 (I)
Minimum Volume 500,000 MOU/per month	$.04642 (C)	$.04642 (C)
Minimum Volume 2,500,000 MOU/per month	$.04592 (C)	$.04592 (C)
Minimum Volume 6,000,000 MOU/per month	$.05540 (C)	$.05540 (C)

800 DATABASE ACCESS

Service Component	Non-Recurring	Per Query
800 Data Base Query	None	$0.02 (I)

OPERATOR TRANSFER

Service Component	Non-Recurring	Per Call
Operator Transfer (per call)	None	$0.22

PRESUBSCRIPTION (N)

Service Component	Non-Recurring	Recurring
Presubscription (per line)(N)	$20.00 (N)	None (N)

ADMINISTRATIVELY
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SECTION 5 - PRICE SHEET (continued)

ORIGINAL

5.8 Call Completion Rates

SERVICE ORDERS

Service Component	Non-Recurring Charge
-Installation Charge (per line\trunk) -1st -Add'l	 $2,004.00 (I) $2,004.00 (I)
-Access Order Charge - Per Access Request	$50.00
-Engineering Change Charge - Per Access Request	$50.00
-Service Date Change - Per Access Request	$42.00 (R)
-Design Change - Per Access Request	$42.00 (R)

SWITCHED TRANSPORT

Service Component	Rates	
	Non-Recurring	Recurring
Entrance Facility-DS3 (N)	Use DS3 Local Distribution Channel Rates (N)	Use DS3 Local Distribution Channel Rates (N)
Entrance Facility-DS1	Use DS1 Local Distribution Channel Rates (C)	Use DS1 Local Distribution Channel Rates (C)
Direct Trunked Transport Mileage		
- DS3 Fixed (N) - DS3 Per Mile (N)	Use DS3 Interoffice Channel Mileage Rates (N)	Use DS3 Interoffice Channel Mileage Rates (N)
- DS1 Fixed - DS1 Per Mile	Use DS1 Interoffice Channel Mileage Rates (C)	Use DS1 Interoffice Channel Mileage Rates C)
Tandem Switched Transport	Non-Recurring	Per Access Minute
-Tandem Trans. Fixed -Tandem Trans. Per Mile -Tandem Switching	None None None	$.000431 (I) $.000024 (R) $.000974 (R)
Common Channel Signaling Access	Non-Recurring	Recurring
STP Port Termination(per port) STP Link Transport(per mile)	ICB (C) None	None (R) ICB (C)

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Staten Island, NY 10311

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SECTION 5 - PRICE SHEET (continued) ORIGINAL

END OFFICE

Service Component	Originating ($ Per MOU)	Terminating ($ Per MOU)
Call Completion - No Minimum Volume	$0.023460 (R)	$0.023460 (R)
Minimum Volume 500,000 MOU/per month	$0.23210 (C)	$0.023210 (C)
Minimum Volume 2,500,000 MOU/per month	$0.22960 (C)	$0.022960 (C)
Minimum Volume 6,000,000 MOU/per month	$0.27700 (C)	$0.021440 (C)

800 DATABASE ACCESS

Service Component	Non-Recurring	Per Query
800 Data Base Query	None	$0.01 (I)

OPERATOR TRANSFER

Service Component	Non-Recurring	Per Call
Operator Transfer (per call)	None	$0.22

PRESUBSCRIPTION (N)

Service Component	Non-Recurring	Recurring
Presubscription (per line)(N)	$10.00 (N)	None (N)

5.9 Operator Service Rates

Local exchange and IntraLATA calls may be placed on an Operator Assisted basis. Usage charges for Operator-Handled local-calls are the same as those set forth in preceding sections.

In addition, to the usage charges identified above, the following operator-assisted charges will apply:

Type of Call	Per Call
Person-to-Person	$3.50
Station-to-Station	$1.30
Operator Dialed Charge	$1.50
Billed to LEC Calling Card	$0.50

Issued By:
Lori-Ann Mirenda
Teleport Communications Group
One Teleport Drive, Suite 300
Staten Island, NY 10311

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OPEN MEETING ITEM

Arizona Corporation Commission
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2000 NOV 15 P 4: 31

AZ CORP COMMISSION
DOCUMENT CONTROL

MEMORANDUM

TO: THE COMMISSION

FROM: Utilities Division

DATE: November 15, 2000

RE: AT&T COMMUNICATIONS OF THE MOUNTAIN STATES, INC. - FILING TO INCREASE ITS ACCESS RATES (DOCKET NO. T-03016A-00-0539)

On July 25, 2000, AT&T Communications of the Mountain States, Inc. ("AT&T") filed revisions on behalf of its subsidiary's TCG Phoenix, Services Tariff and Price List. With this filing, approval of maximum rate and price list rate increases are being requested for TCG Phoenix's Call Completion Access Services.

Since this filing increases the maximum rates for components of a service that have been classified as competitive under the Commission's Competitive Telecommunications Services Rules, A.A.C. Rule R14-2-1110 applies to this proposal. Staff requested information from the company to allow Staff to determine the potential effects of approval of the filing. The information indicated that the expected revenue effect of approval of the filing is a net revenue increase of less than 5 percent of TCG Phoenix's annual Arizona revenue. Staff has determined that the increase in revenues resulting from this filing will increase TCG Phoenix's Arizona specific rate of return by at most less than one half percent. Therefore, Staff recommends approval of the filing.

Deborah R. Scott
Director
Utilities Division

DRS:MJR:lhh\MAS

ORIGINATOR: Matt Rowell

BEFORE THE ARIZONA CORPORATION COMMISSION

CARL J. KUNASEK
Commissioner - Chairman
JIM IRVIN
Commissioner
WILLIAM MUNDELL
Commissioner

IN THE MATTER OF AT&T COMMUNICATIONS OF THE MOUNTAIN STATES APPLICATION TO INCREASE ITS RATES FOR ACCESS SERVICE	)))))	DOCKET NO. T-03016A-00-0539 DECISION NO. _____ ORDER

Open Meeting
November 28 and 29, 2000
Phoenix, Arizona

BY THE COMMISSION:

FINDINGS OF FACT

1. AT&T Communications of the Mountain States ("AT&T") and TCG Phoenix are certified to provide intrastate telecommunications service as a public service corporation in the State of Arizona.

2. On July 25, 2000, AT&T filed revisions on behalf of its subsidiary's TCG Phoenix, Services Tariff and Price List: TCG Phoenix A.C.C. No. 1

Second Revises Page 100
Second Revises Page 101
Second Revises Page 124
Second Revises Page 125

3. With this filing, approval of maximum rate and price list rate increases are being requested for TCG Phoenix's Call Completion Access Services.

4. Since this filing increases the maximum rates for components of a service that have been classified as competitive under the Commission's Competitive Telecommunications Services Rules, A.A.C. Rule R14-2-1110 applies to this proposal.

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...

5. Staff requested information from the company to allow Staff to determine the potential effects of approval of the filing. The information indicated that the expected revenue effect of approval of the filing is a net revenue increase of less than 5 percent of TCG Phoenix's annual Arizona revenue.

6. Staff has determined that the increase in revenues resulting from this filing will increase TCG Phoenix's Arizona specific rate of return by at most less than one half percent.

7. Staff has recommended approval of the filing.

CONCLUSIONS OF LAW

1. AT&T and TCG Phoenix are Arizona public service corporations within the meaning of Article XV, Section 2, of the Arizona Constitution.

2. The Commission has jurisdiction over AT&T and TCG Phoenix and over the subject matter of the application.

3. The Commission, having reviewed the tariff pages (copies of which are contained in the Commission's tariff files) and Staff's Memorandum dated November 9, 2000 concludes the tariff filing is reasonable, fair and equitable, and is therefore in the public interest.

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ORDER

THEREFORE, IT IS ORDERED that the filing be and hereby is approved.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION

CHAIRMAN COMMISSIONER COMMISSIONER

IN WITNESS WHEREOF, I, BRIAN McNEIL, 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 _____ day of _____, 2000.

BRIAN McNEIL
Executive Secretary

DISSENT: _____

DRS:MJR:lhh/MAS

AT&T

Two Teleport Drive
Staten Island, NY 10311
718 355-2000

August 2, 2000

US WEST
Rm 570
150 5TH St. S
Minneapolis, MN 55402

Attention: Tom Pontinen

Dear Valued AT&T Customer:

On July 25, 2000, TCG Phoenix, Inc. ("TCG") (an AT&T company) filed an application with the Arizona Corporation Commission requesting approval to increase its tariff rates and price list in Section 4.9.6-Call Completion Rates and Section 5 - Price Sheet (5.8 Call Completion Rates).

Upon Arizona Corporation Commission approval, these rates will be at parity with the current intrastate access rates charged by the incumbent local exchange carrier ("ILEC") in TCG's authorized service area. Consistent with AT&T's company policy, its rates for interstate and intrastate switched access **do not** exceed those of the ILEC in its authorized service territory. AT&T has requested that the Arizona Corporation Commission authorize its requested rate increase effective on September 1, 2000.

Please contact your AT&T Account Executive or call AT&T at the number listed on your AT&T bill if you require additional information on this or other aspects of your access needs.

Sincerely,

Elisa Burnstein

Elisa Burnstein
AT&T
Switched Access Product Manager

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25½" x 32½"

Paper

To Big To Copy

EXHIBIT
Q-44
Admitted.

exemption as determined by the Arizona Corporation Commission (Supp. 95-2).

Editor's Note: The Arizona Corporation Commission has determined that the following Section is exempt from the Attorney General certification provisions of the Arizona Administrative Procedure Act (A.R.S. § 41-1041) by a court order (State ex. rel. Corbin v. Arizona Corporation Commission, 174 Ariz. 216 848 P.2d 301 (App. 1992)).

R14-2-1109. Pricing of Competitive Telecommunications Services

A. Pricing of Competitive Services. A telecommunications company governed by this Article may price a competitive telecommunications service at any level at or below the maximum rate stated in the company's tariff on file with the Commission, provided that the price for the service is not less than the company's total service long-run incremental cost of providing the service.

B. Changing a Price. A telecommunications company governed by this Article may effect a price change for a competitive service so long as 2 conditions are met:
   1. The changed price comports with the limitations stated in subsection (A); and
   2. The Commission is provided with concurrent, written notice of the price change.

C. No Cross-subsidization. A competitive telecommunications service shall not be subsidized by any rate or charge for any noncompetitive telecommunications services. To ensure that no cross-subsidization exists, each competitive telecommunications service must provide revenues that equal or exceed the company's total service long-run incremental cost of providing the service.

Historical Note

Adopted effective June 27, 1995, under a court-ordered exemption as determined by the Arizona Corporation Commission (Supp. 95-2).

Editor's Note: The Arizona Corporation Commission has determined that the following Section is exempt from the Attorney General certification provisions of the Arizona Administrative Procedure Act (A.R.S. § 41-1041) by a court order (State ex. rel. Corbin v. Arizona Corporation Commission, 174 Ariz. 216 848 P.2d 301 (App. 1992)).

R14-2-1110. Competitive Telecommunications Services – Procedures for Rate Change

A. Telecommunications companies governed by this Article may apply to the Commission for an increase in any rate for a competitive service using the procedures set forth below. All applications and supporting information shall be submitted with 10 copies and filed with Docket Control Center.

B. In order to increase the maximum tariffed rate for a competitive telecommunications service, the applicant shall submit an application to the Commission containing the following information:
   1. A statement setting forth the reasons for which a rate increase is required;
   2. A schedule of current rates and proposed rates and the additional revenues to be derived from the proposed rates;
   3. An affidavit verifying that appropriate notice of the proposed rate increase has been provided to customers of the service;
   4. The Commission or staff may request any additional information in support of the application.

C. The Commission may, at its discretion, act on the requested rate increase with or without an evidentiary hearing; in an expeditious manner.

Historical Note

Adopted effective June 27, 1995, under a court-ordered exemption as determined by the Arizona Corporation Commission (Supp. 95-2).

Editor's Note: The Arizona Corporation Commission has determined that the following Section is exempt from the Attorney General certification provisions of the Arizona Administrative Procedure Act (A.R.S. § 41-1041) by a court order (State ex. rel. Corbin v. Arizona Corporation Commission, 174 Ariz. 216 848 P.2d 301 (App. 1992)).

R14-2-1111. Requirement for IntraLATA Equal Access

A. Each local exchange carrier shall provide 2-PIC toll equal access where technically and economically feasible, and in accordance with any procedures the Commission may order.

B. The sequence for implementation of intraLATA equal access shall occur in the following manner:
   1. In response to a bona fide request for intraLATA equal access, a local exchange carrier shall complete implementation of intraLATA equal access within 9 months of receiving the request. A person making such a bona fide request shall also provide a copy to the Arizona Corporation Commission.
   2. The local exchange carrier may implement intraLATA equal access in any central office on its own initiative but, in any event, shall make intraLATA equal access available in all its central offices no later than July 1, 1996, unless otherwise ordered by the Commission.

C. A local exchange carrier may petition the Commission for a waiver of the requirement in subsection (B)(1) on the grounds that compliance is not technically or economically feasible. A local exchange carrier may also petition the Commission for an extension of the requirement in subsection (B)(2) on the grounds that intraLATA equal access cannot reasonably or economically be provided within any specific exchanges within the required time frame. The Commission may grant either of these waivers with or without a hearing. The local exchange carrier filing the waiver petition shall bear the burden of proof.

Historical Note

Adopted effective June 27, 1995, under a court-ordered exemption as determined by the Arizona Corporation Commission (Supp. 95-2).

Editor's Note: The Arizona Corporation Commission has determined that the following Section is exempt from the Attorney General certification provisions of the Arizona Administrative Procedure Act (A.R.S. § 41-1041) by a court order (State ex. rel. Corbin v. Arizona Corporation Commission, 174 Ariz. 216 848 P.2d 301 (App. 1992)).

R14-2-1112. Interconnection Requirements

All local exchange carriers must provide appropriate interconnection arrangements with other telecommunications companies at reasonable prices and under reasonable terms and conditions that do not discriminate against or in favor of any provider, including the local exchange carrier. Appropriate interconnection arrangements shall provide access on an unbundled, nondiscriminatory basis to physical, administrative, and data-base network components. Local exchange carriers shall provide appropriate interconnection arrangements within 6 months of receiving a bona fide request for interconnection. The interconnection arrangements must be in the form of a tariff and shall be filed with the Commission for its approval before becoming effective.

EXHIBIT
Supp. 99-4
Q-45
Admitted

D. All telecommunication providers who terminate traffic into an exchange, or exchanges, in which the local number portability database solution has been implemented shall utilize the database solution to ensure efficient and appropriate routing of traffic to Arizona customers.

Historical Note
Adopted effective September 6, 1996, under an exemption as determined by the Arizona Corporation Commission (Supp. 96-3).

Editor's Note: The Arizona Corporation Commission has determined that the following Section is exempt from the Attorney General approval provisions of the Arizona Administrative Procedure Act (A.R.S. § 41-1041) by a court order (State ex. rel. Corbin v. Arizona Corporation Commission, 174 Ariz. 216 848 P.2d 301 (App. 1992)).

R-14-2-1309. Cost Methodology
TSLRIC is the cost standard to be employed by the incumbent local exchange carrier in conducting the cost studies that establish the underlying cost of local exchange carrier services including unbundled essential facilities and services.

Historical Note
Adopted effective September 6, 1996, under an exemption as determined by the Arizona Corporation Commission (Supp. 96-3).

Editor's Note: The Arizona Corporation Commission has determined that the following Section is exempt from the Attorney General approval provisions of the Arizona Administrative Procedure Act (A.R.S. § 41-1041) by a court order (State ex. rel. Corbin v. Arizona Corporation Commission, 174 Ariz. 216 848 P.2d 301 (App. 1992)).

R14-2-1310. Pricing

A. Pricing of Basic Communication Services.
   1. The incumbent local exchange carrier shall provide the Commission with price floor calculations for local exchange and long distance services to ensure the avoidance of anti-competitive pricing practices. A NELEC can price below an incumbent LEC's TSLRIC price.
   2. Whenever the incumbent local exchange carrier introduces a new local exchange service or long distance service, or proposes to change the rate for an existing local exchange service or long distance service, the local exchange carrier shall provide to the Commission information that demonstrates that the proposed rate equals or exceeds a price floor calculation for that service using an imputation test described in subsection (C).

B. Pricing of Interconnection Services by Local Exchange Providers.
   1. Incumbent local exchange carriers shall establish the price of each interconnection service, including access to databases and other network functions as described in R14-2-1306, at a level equivalent to its TSLRIC-derived costs which may include an assignment of verifiable indirect costs or a 10% addition for indirect costs to the TSLRIC direct costs at the choice of the incumbent LEC.
   2. Interim number portability shall be provided by the incumbent local exchange carrier at a price equal to TSLRIC. Any compensation which would otherwise have been received had a local or EAS call to a forwarded number been terminated directly to a customer's chosen carrier, should be passed through from the carrier from whose network the forwarded number is assigned, to the customer's chosen carrier to whose network the number is forwarded.

C. Imputation
   1. 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.
   2. Imputation requirements of this Section shall be applied in a manner that will permit a carrier providing a service to a customer that is or that becomes eligible for universal service support by order of the Commission to provide such retail service at a price that is net of any Commission-ordered universal service support funding, pursuant to the provisions of the Arizona Universal Service Fund rules.

Historical Note
Adopted effective September 6, 1996, under an exemption as determined by the Arizona Corporation Commission (Supp. 96-3).

Editor's Note: The Arizona Corporation Commission has determined that the following Section is exempt from the Attorney General approval provisions of the Arizona Administrative Procedure Act (A.R.S. § 41-1041) by a court order (State ex. rel. Corbin v. Arizona Corporation Commission, 174 Ariz. 216 848 P.2d 301 (App. 1992)).

R14-2-1311. Waivers
The Commission may consider variations or exemptions from the terms or requirements of any of the rules included herein (14 A.A.C. 2, Article 13) upon application of an affected party. The application must set forth the reasons why the public interest will be served by the variation or exemption from the Commission rules. Any variation or exemption granted shall require an order of the Commission. Where a conflict exists between these rules and an approved tariff or order of the Commission, the provision of the approved tariff or order of the Commission shall apply.

Historical Note
Adopted effective September 6, 1996, under an exemption as determined by the Arizona Corporation Commission (Supp. 96-3).

ARTICLE 14. EMERGENCY EXPIRED

R14-2-1401. Emergency Expired

Historical Note
Emergency rule adopted effective December 22, 1995, effective for a maximum of 180 days, under a court-ordered exemption as determined by the Arizona Corporation Commission (Supp. 95-4). Emergency expired.

R14-2-1402. Emergency Expired

Historical Note
Emergency rule adopted effective December 22, 1995, effective for a maximum of 180 days, under a court-ordered exemption as determined by the Arizona Corporation Commission (Supp. 95-4). Emergency expired.

R14-2-1403. Emergency Expired

Historical Note
Emergency rule adopted effective December 22, 1995, effective for a maximum of 180 days, under a court-ordered exemption as determined by the Arizona Corporation Commission (Supp. 95-4). Emergency expired.

EXHIBIT
Q-46
Admitted

SETTLEMENT AGREEMENT

This agreement is entered into this 27th day of ~~April~~ May, 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

EXHIBIT
Q-48
Admitted

EXHIBIT NO. 1

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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

602 916 5999 TO 16416781700023 54 P.06
NOV 27 '00 15:45 FR #2
0-24-90 10:24AM

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

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ACTION _____

DIVISION 1
COURT OF APPEALS
STATE OF ARIZONA
FILED
FEB - 8 1996
GLEN D. CLARK, CLERK
By _____

IN THE COURT OF APPEALS
STATE OF ARIZONA
DIVISION ONE

U S WEST COMMUNICATIONS, INC., a Colorado corporation,	1 CA-CC 95-0001
Appellant,	DEPARTMENT C
v.	O P I N I O N
THE ARIZONA CORPORATION COMMISSION,	
Appellee.	

Appeal from the Arizona Corporation Commission

Docket No. E-1051-93-183

AFFIRMED IN PART; REVERSED IN PART AND REMANDED

U S West Law Department
by Gary L. Lane — Phoenix
Fennemore Craig, P.C.
by Timothy Berg — Phoenix
Attorneys for Appellant

Arizona Corporation Commission, Legal Division
by Christopher C. Kempley
and Bradford A. Borman
Attorneys for Appellee — Phoenix

F I D E L, Judge

U S West Communications, Inc. ("US West") appeals from Decision No. 58927 of the Arizona Corporation Commission ("the Commission") establishing the telephone rates that US West may charge its Arizona customers. US West argues that the Commission

EXHIBIT
Q-49
admitted

14:29 FR FENNEMORE CRAIG #1 1 602 916 5999 TO 16416781/0002254 P.02

unreasonably and unlawfully (1) imputed to US West an excessive amount of operating income for directory revenues that a related company earned, (2) disallowed a portion of US West's lease expenses, and (3) disallowed a transition cost adjustment to cover US West's change from cash to accrual accounting for non-pension retirement benefits. We find error on the first ground and none on the latter grounds.

BACKGROUND

US West, a public service corporation that provides telecommunication services, applied to the Commission on July 15, 1993, for permission to increase its Arizona rates. Following extensive proceedings, the Commission determined US West's revenue requirement based on its reasonable test-year[1] operating costs and its fair value rate base.[2] The Commission then set rates intended to cover US West's reasonable operating costs and provide its shareholders a 7.61 percent rate of return. *See Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 534, 578 P.2d 612, 615 (App. 1978). The new rates became effective January 16, 1995.

US West filed this appeal pursuant to Arizona Revised Statutes Annotated ("A.R.S.") § 40-254.01, which provides for an expedited direct appeal to this court from Commission orders relating to rate making or design. The statute does not provide for *de novo*

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[1] US West's test year ended March 31, 1993.

[2] US West's fair value rate base is the fair value of its property used to provide telephone service to Arizona customers. Ariz. Const. art. 15, § 14.

review. *Consolidated Water Utils., Ltd. v. Arizona Corp. Comm'n*, 178 Ariz. 478, 481, 875 P.2d 137, 140 (App. 1993). US West "must make a clear and satisfactory showing that the [Commission's] order is unlawful or unreasonable." A.R.S. § 40-254.01(E).

DIRECTORY REVENUE IMPUTATION

US West first argues that the Commission erred when it imputed operating income revenue of $60,684,000 to US West based on the allegedly excess revenue earned by an affiliate, U S West Direct (USWD). US West proposed in its rate application, and agrees on appeal, that $43 million of USWD's profits should be imputed as income; it argues that the Commission's larger imputation violated the terms of the Commission's 1988 settlement agreement with US West's predecessor, Mountain Bell, in which the Commission accepted USWD's spin-off as a separate, unregulated entity.

In recommending an imputation of $60,684,000, the Commission staff attributed to US West all USWD profits that exceeded the 11.4 percent rate of return that would have been permitted had USWD remained a regulated entity. Staff explained, "The intent [of the adjustment] is to provide ratepayers the same benefit from the directory publishing business as they had before the assets were transferred." The Commission adopted this rationale. We consider whether, in so doing, the Commission violated the terms of the 1988 settlement agreement.

At the outset of the inquiry, we must address the Commission's argument that we should defer to its interpretation of the

settlement agreement. The purpose of contract interpretation is to determine and enforce the parties' intent. *Taylor v. State Farm Mut. Auto. Ins. Co.*, 175 Ariz. 148, 152, 854 P.2d 1134, 1138 (1993). Determining the intent of contracting parties may require fact finding, but "[w]hether contract language is reasonably susceptible to more than one interpretation so that extrinsic evidence is admissible is a question of law for the court." *Id.* at 158-59, 854 P.2d at 1144-45. Although the Commission staff offered evidence to support its view that the methodology used to determine the $60,684,000 imputation was consistent with the settlement agreement, the agreement contained no language to support the Commission's interpretation, and the meaning of the contract must be determined as a matter of law. *See Maxwell v. Fidelity Fin. Servs.*, ___ Ariz. ___, 907 P.2d 51, 62 (1995). Because interpreting the agreement is a question of law for the court and not a discretionary matter constitutionally entrusted to the Commission, we owe no deference to the Commission's interpretation.

The seeds of this dispute were sown when, in the course of the reorganization of AT&T, Mountain Bell, US West's predecessor, was separated from AT&T and was assigned the assets used to publish regional yellow and white page directories. *See United States v. AT&T*, 552 F. Supp. 131, 193-95, and 200-01 (D.D.C. 1982), *aff'd sub nom Maryland v. United States*, 460 U.S. 1001 (1983). Mountain Bell transferred these assets to USWD, a subsidiary of Mountain Bell's parent company, U S West, Inc. ("USWI"). The

Commission objected and, in October 1987, declared the transfer of directory publishing assets void because of Mountain Bell's failure to comply with A.R.S. § 40-285.[3] Mountain Bell filed an action in superior court challenging this decision; the Commission and Mountain Bell settled the matter in May of 1988.

Under the terms of the settlement, the Commission agreed to "take no further action to challenge" Mountain Bell's transfer of yellow pages assets to USWD. The parties also agreed:

> 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.

---

[3] A.R.S. § 40-285(A) provides:

> Disposition of plant by public service corporations; acquisition of capital stock of public service corporation by other public service corporations
>
> A. A public service corporation shall not sell, lease, assign, mortgage or otherwise dispose of or encumber the whole or any part of its railroad, line, plant, or system necessary or useful in the performance of its duties to the public, or any franchise or permit or any right thereunder, nor shall such corporation merge such system or any part thereof with any other public service corporation without first having secured from the commission an order authorizing it so to do. Every such disposition, encumbrance or merger made other than in accordance with the order of the commission authorizing it is void.

US West argues that the Commission has violated the settlement agreement by treating USWD's assets as if they were still a part of the regulated utility, rather than calculating the imputed income in terms of the fees and value of services US West receives. We agree. The Commission unequivocally agreed in 1988 to accept the transfer of directory publication to an unregulated subsidiary. It is wholly inconsistent with this agreement to impute to US West all of USWD's profits exceeding the rate of return USWD would have been permitted to receive had it remained regulated and to seek thereby for "ratepayers the same benefit from the directory publishing business as they had before the assets were transferred." By such a methodology the Commission in effect pretends that the transfer it previously accepted did not occur.

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.

The disputed provision is this:

> 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.

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 US 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 US 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.

In this case, however, the Commission did not rely on evidence of the value of 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.

DISALLOWANCE OF LEASE EXPENSES

We next consider US West's argument that no substantial evidence supports the Commission's disallowance of $2,710,816 of test-year lease expenses.

Shortly after the breakup of AT&T, USWI, US West's parent company, created a real estate development subsidiary, BetaWest Properties, to handle the real estate needs of USWI and its affiliates. As part of its development strategy, USWI moved Mountain Bell (later US West) from Class B and C office buildings to more expensive Class A office buildings owned by USWI. In 1989-90, during the extended local real estate depression, USWI changed its strategy, dissolved BetaWest, transferred its assets to a new company, U S West Real Estate, Inc., and sold a number of properties occupied by and subject to long-term leases with US West.

In a lengthy report, an investigative team hired by the Commission staff concluded that US West's lease expenses were substantially too high. After considering that report and US West's rebuttal, the Commission allowed US West all the operating expenses related to its lease expenses. It then adopted its staff's recommendation and found that US West's test-year lease expenses were 50 percent too high. This finding would have

supported a disallowance of $5,421,633, but the Commission also found that US West's shareholders and customers shared the benefits of US West's centrally located, consolidated, Class A office space. So that the shareholders and customers might likewise share the burdens, the Commission halved the disallowance to $2,710,816.

US West claims on appeal that the investigative report the Commission relied on was not substantial evidence but rather an exercise in hindsight that failed to assess properly the reasonableness of US West's real estate leasing decisions at the time they were made. *See* A.A.C. R14-2-103(A)(3)(1) (The prudence of expenditures must be "viewed in the light of all relevant conditions known or which in the exercise of reasonable judgment should have been known, at the time such [expenditures] were made.").

We disagree that the Commission based its decision on hindsight. The investigative report permitted the Commission to conclude that *at the time* crucial leasing decisions were made -- the mid-1980s, when USWI moved Mountain Bell from Class B and C office buildings to expensive Class A buildings owned by USWI -- adequate alternatives were available at lower cost. The report looked at the space other large corporate clients leased in the mid-1980s and concluded that similar, less expensive space was then available to US West, making the move imprudent from US West's, if not USWI's, point of view. The investigators concluded that, as early as the mid-1980s, US West should have

recognized and pursued more cost-effective alternatives. This substantial evidence supports the Commission's decision.

The Commission has broad powers to scrutinize transactions between a regulated company and its unregulated affiliates. *See Arizona Corp. Comm'n v. State ex rel. Woods*, 171 Ariz. 286, 830 P.2d 807 (1992); Lee R. Russ, Annot., *Amount Paid by Public Utility to Affiliate for Goods and Services as Includable in Utility's Rate Base and Operating Expenses in Rate Proceeding*, 16 A.L.R.4th 454 (1982). The Commission also has the power to disallow excessive lease payments, especially those made to an affiliate. *Cf., e.g., U S West Communications, Inc. v. Public Serv. Comm'n*, 901 P.2d 270, 275 (Utah 1995) (upholding conclusion that above-market rental payments to affiliate could be disallowed). Because there was substantial evidence to support the Commission's disallowance of lease expenses, we will not disturb this part of its decision.

CASH OR ACCRUAL ACCOUNTING

Finally, US West argues that the Commission erred in refusing to recognize for ratemaking purposes US West's accounting change from a cash to an accrual basis for employee post-retirement benefits other than pension and life insurance ("OPEBs").[4] In the past, both US West and the Commission have reflected OPEBs as they are paid, not as they accrue, as costs to be recovered in current rates. In keeping with recently adopted accounting

[4] Because the Company and the Commission already account for retirees' pension and life insurance benefits on an accrual basis, these benefits are not at issue in this appeal.

standards, however, US West has now changed to accrual basis accounting and appeals from the Commission's refusal to follow suit.

The advantages of accrual accounting over cost accounting are these: (1) OPEB costs will increase substantially as the number of retirees increase in coming years; (2) continued cost accounting for OPEBs will predictably subject future US West customers to substantial rate increases to cover substantially higher future OPEB costs; (3) by shifting to accrual accounting, US West has established interest-earning OPEB trust accounts that will reduce such future costs and the associated intergenerational inequity.

The Commission does not dispute that, for these reasons, accrual accounting may better match costs and benefits and be fairer to future generations. It has declined to adopt accrual accounting, however, because the change entails more than $28 million in transition costs, which the Commission is unwilling to assign to present ratepayers.

US West attacks the Commission's decision on the ground that it violates the Arizona constitutional requirement that

> The Corporation Commission shall . . . make and enforce reasonable rules, regulations, and orders for the convenience, comfort, and safety, and the preservation of the health, of the employees and patrons of [public service corporations].

Ariz. Const. art. 15, § 3. We find no constitutional violation. US West may be correct when it argues that external trust funds established through accrual accounting would better enable it to

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cover the future OPEB costs. But the Commission has historically provided for OPEBs as they come due and has stated its intention to continue to do so in the future. Thus, whatever the fiscal prudence of the Commission's chosen method, there is no current basis for a finding that the Commission is now neglecting, or plans in the future to neglect, its responsibilities to the company's employees under article 15, section 3.

US West also argues that the Commission's disallowance of the adjustment for its OPEB expenses was arbitrary, unreasonable, and unsupported by substantial evidence. Again we disagree. US West essentially attacks the long-range fiscal prudence of the Commission's decision, and we will not subordinate the Commission's fiscal judgment to our own. Whether to subject present ratepayers to the substantial cost of transition to accrual accounting or to subject future ratepayers to the foreseeably increasing costs of cost accounting is uniquely a policy decision, constitutionally entrusted to the Commission, and not one that the courts have authority to preempt. Article 15, section 3, of the Arizona Constitution provides:

> The Corporation Commission shall . . . make reasonable rules, regulations, and orders, by which [public service] corporations shall be governed in the transaction of business within the State, *and may prescribe* the forms of contracts and *the systems of keeping accounts* to be used by such corporations in transacting such business.

(Emphasis added.) We defer to the Commission's constitutionally granted power to determine appropriate "systems of keeping accounts."

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CONCLUSION

For the foregoing reasons, we affirm the Commission's handling of real estate expenses and OPEB accounting, reverse the Commission's imputation of directory revenue greater than $43 million, and remand to the Commission for proceedings consistent with this decision.

NOEL FIDEL, Judge

CONCURRING:

EDWARD C. VOSS, Presiding Judge

PHILIP E. TOCI, Judge

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EXHIBIT
APA-1

BEFORE THE ARIZONA CORPORATION COMMISSION

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AZ CORP COMMISSION
DOCUMENT CONTROL

CARL J. KUNASEK
Chairman
JIM IRVIN
Commissioner
WILLIAM A. MUNDELL
Commissioner

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	DOCKET NO. T-01051B-99-0105 **ARIZONA PAYPHONE ASSOCIATION'S NOTICE OF TESTIMONY**

The Arizona Payphone Association ("APA"), through undersigned counsel, hereby provides notice that on this day it has filed the Testimony of Gary Joseph in the docket captioned above.

RESPECTFULLY SUBMITTED this 28th day of November, 2000.

ROSHKA HEYMAN & DEWULF, PLC

By: _____ for

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BEFORE THE ARIZONA CORPORATION COMMISSION

CARL J. KUNASEK
Chairman
JIM IRVIN
Commissioner
WILLIAM A. MUNDELL
Commissioner

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	DOCKET NO. T-01051B-99-0105

TESTIMONY OF GARY JOSEPH
PRESIDENT
OF THE
ARIZONA PAYPHONE ASSOCIATION

Q. PLEASE STATE YOUR NAME AND POSITION WITH THE ARIZONA PAYPHONE ASSOCIATION.

A. My name is Gary Joseph. I am President of the Arizona Payphone Association.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THE COMMISSION?

A. Yes. I have testified before the Commission on behalf of the APA on several occasions.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS DOCKET?

A. I want to inform the Commission that APA and QWEST have reached a settlement in this case that allows the APA to support the Commission's approval of the Settlement Agreement that was filed in this docket by the Commission Staff and QWEST on October 20, 2000 ("Settlement Agreement"). Accordingly, the APA is requesting that the Commission approve the Settlement Agreement.

Q. WHAT ARE THE PAL RATE LEVELS THAT THE APA AND QWEST HAVE AGREED TO?

A. Contingent upon the Commission approving the Settlement Agreement and for the time of the initial term of the Rate Proceeding Moratorium Period (as defined in the Settlement Agreement), the following PAL rates will be in effect:

Basic Flat PAL: The rate set for QWEST's Flat Business Line (1 FB) which is currently set at $32.78

Basic Measured PAL: A monthly charge of $15.35, plus (a) a measured usage charge of .05¢ for the first minute and .015¢ for each additional minute subject to time of

day discounts of 35% in the evening and 60% for nights and weekends; or, (b) a message-usage rate of .08¢ per call, subject to the same time of day discounts.

Additionally, the APA and QWEST have agreed to resolve the pending appeal of the Commission's Decision No. 61304, which involved PAL rates.

Q. WHY DOES THE APA SUPPORT THE SETTLEMENT AGREEMENT?

A. The APA's main concern in this docket has been and continues to be that the public access line ("PAL") rates that QWEST charges to customers in Arizona be just and reasonable. As we have seen in Arizona as well as other state and federal venues across the country, there is substantial debate, at this time, as to the criteria that should be applied to determine whether PAL rates are just and reasonable. The APA and QWEST have had many discussions about what PAL rate levels would be acceptable to both parties at this time. While the rate levels that have been agreed to are a compromise for both parties, we have agreed that, within the context of the Settlement Agreement's Price Cap Plan they are acceptable for the initial term of the Rate Proceeding Moratorium Period. We believe that it is in the best interests of the APA's members and QWEST to put these rates in place for this time period while other proceedings in other jurisdictions continue to refine the applicable criteria. Of course, both the APA and QWEST are reserving their rights to request a modification of the PAL rates and ancillary services after the initial term of the Rate Proceeding Moratorium Period.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

EXHIBIT
Cox-1
Admitted

BEFORE THE ARIZONA CORPORATION COMMISSION

CARL J. KUNASEK
CHAIRMAN
JIM IRVIN
COMMISSIONER
WILLIAM A. MUNDELL
COMMISSIONER

IN THE MATTER OF THE APPLICATION OF US WEST COMMUNICATION, 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-99-0105

TESTIMONY OF
DR. FRANCIS R. COLLINS
ON BEHALF OF
COX ARIZONA TELCOM, L.L.C.
REGARDING PROPOSED SETTLEMENT AGREEMENT

NOVEMBER 13, 2000

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I. INTRODUCTION OF WITNESS

Q. WHAT IS YOUR NAME AND BUSINESS ADDRESS?

A. My name is Francis R. Collins and my business address is P.O. Box 272, Newton, MA 02459.

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

A. I am employed by CCL Corporation, a company that provides public policy, technical, and economic counsel in the fields of telecommunications and cable television. I am the president of CCL Corporation.

Q. DR. COLLINS, ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

A. My testimony is presented on behalf of Cox Arizona Telcom, L.L.C. ("Cox"), which is a facilities-based provider of local telecommunications services in Arizona.

II. QUALIFICATIONS OF WITNESS

Q. DID YOU FILE TESTIMONY IN THIS DOCKET PREVIOUSLY AND SUBMIT YOUR QUALIFICATIONS AT THAT TIME?

A. Yes. I filed both Direct and Surrebuttal Testimony and submitted qualifications with the Direct Testimony.

III. PURPOSE OF TESTIMONY

Q. DR. COLLINS, WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. My testimony addresses the proposed Settlement Agreement's potential adverse impact on telecommunications competition in Arizona. Two of the fundamental concerns in the proposed Settlement Agreement are: (i) a provision which would

allow anti-competitive spot/zone-based flexible pricing, even in areas where there is little, if any, competition and (ii) TSLRIC price floors that could lead to predatory pricing and cross-subsidization. Both provisions could act to stifle emerging competition. I also am concerned about the process used to develop an alternative form of regulation. Here it is done through a settlement agreement arising from a rate case without the full participation by affected parties from the beginning. There are other issues of importance as well and these are discussed in the testimony below.

IV. SUMMARY OF TESTIMONY

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. To put my testimony in the proper context, I incorporate my prior Direct and Surrebuttal Testimony in this Docket by reference. In that testimony, I addressed Qwest's testimony from three witnesses concerning the existence of competition in Arizona. The Qwest testimony of Mr. Teitzel was supported by a collection of anecdotal documents which revealed only that competitive carriers have entered the telecommunication services marketplace in the Phoenix and Tucson areas and were marketing their services – it did not prove that real competition exists. In fact, Mr. Teitzel provided information that showed a reasonable level of competition did not and does not exist. The testimony of Dr. Wilcox and Mr. Allcott regarding the existence of true competition for services drew upon the testimony of Mr. Teitzel and did not add any new substance or support to claims of competition.

My Direct and Surrebuttal Testimony proved that competition for local exchange telephone services has not yet arrived in Arizona at any significant level. Moreover, I explained that the claimed revenue losses by Qwest, even at a small level of competition, were predominantly revenue transfers from Qwest retail to Qwest wholesale products. Specifically, at the time of my testimony, competitors

had achieved less than a 3% market penetration of the total number of access lines in Arizona. Of this 3% market penetration, slightly more than one third of the loss has been a transfer from retail to wholesale products in the Phoenix area and just over half of the loss in the Tucson area has been an intra-Qwest service transfer. This leaves a *de minimus* market share loss (around 2%) by Qwest in which Qwest had not realized this revenue transfer and in which Qwest actually lost all of its revenue. This minute percentage represents revenue loss market penetration.

Qwest also had identified a number of wire centers in the Phoenix and/or Tucson area which it claimed were fully competitive for business and residence services and for which it requested pricing flexibility through designation of a "competitive zone." My previous testimony demonstrated that the market penetration in those areas also was *de minimus* and that pricing flexibility could be used to chill competition in those fledgling market areas.

With that background, Cox has several significant concerns with the proposed Settlement Agreement. First, the Settlement Agreement's pricing flexibility must be considered in the context of the market conditions provided above. The Settlement Agreement now attempts to accomplish by fiat what could not be accomplished by a compelling showing of facts. The proposed Price Cap Plan provides that "[n]ew 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 substitutes "spot" pricing and "customer specific pricing" (with or without the presence of competition) for the "competitive zone" proposal had Qwest requested in its previous filings. Moreover, the Settlement Agreement has no express requirement to find the existence of competition for those new services and packages before they are allowed flexible pricing in a potentially vary narrow market. That is, the Settlement Agreement proposes flexible pricing independent of the existence of a suitable level of

competition. That situation, from a competitive viewpoint, is even more onerous, biased, and chilling of competition than the "competitive zone" proposal.

Second, the Settlement Agreement proposes to establish price caps and price floors for different baskets of services. Generally, price caps are intended to mitigate cross subsidization and price floors are intended to mitigate predatory pricing. However, the price floor for all Qwest services is set at the TSLRIC and this presents a major problem. The Qwest services are provided through the combination of network elements that provide the technological basis for the service offering. The Commission's imputation rule (A.A.C. R14-2-1310.C) implies that the cost of these network elements must be imputed when considering the base (TSLRIC) cost of the service. Competitive neutrality demands that the cost of the service should be the same whether it is provided by Qwest or by a new market entrant using the same unbundled network elements (UNEs) to formulate the service. Therefore, the imputed aggregate cost of the UNEs should match the TSLRICs. That should be the price floor. But that is not what the Settlement Agreement provides.

Moreover, setting aside the impropriety of TSLRIC as a price floor, the Commission (or any Qwest competitor) is not in a position to know if Qwest is complying with the proposed price floor. In order to determine Qwest's compliance with the Settlement Agreement's prices-floor, it is necessary to know what the TSLRIC for each service and package is. In fact, it appears the Commission Staff does not believe there are approved TSLRICs for all the services under consideration [see Staff Response to Cox Data Requests 1-012, 1-013 (Tab A)] and, therefore, there is no visible benchmark. Qwest also has refused to agree not to recover the unassigned shared family costs and unrecovered direct costs that normally would be assigned to a service priced at TSLRIC, from other services. [See Qwest Response to Cox Data Request 1-008 (Tab B)] This

indicates that the Settlement Agreement, as currently structured, has opened the door to cross subsidization.

Third, the Settlement Agreement provision concerning "packages of services" is flawed. The Settlement Agreement provides that Basket-1 (non-competitive) services can be combined with Basket-3 (fully competitive) services to form service packages. When doing so, Qwest can price the package of services at any level above the TSLRIC (presumably aggregate TSLRIC of the components) of the package. Cox's position is that the Basket-1 services should carry their Basket-1 price into the Basket 3 package and not their TSLRIC. The Settlement Agreement contains that requirement only for 1FR service in Basket 1 but does not appear to do so for any other Basket-1 service.

Fourth, Cox has a concern about the "Support and Defend" provision in the Settlement Agreement in that it is so ambiguous as to not be enforceable. In addition, the degree to which financial and other resources must be provided to support this provision simply cannot be ascertained and accrued to meet potential obligations.

Fifth, Cox has a concern about the reduction in intra-state switched access charges of $5 million dollars in the second and third years of the plan with a concomitant increase in Basket-3 revenues. The Staff has explained that the goal is to bring intrastate access charges in line with inter-state access charges. However, a recent FCC filing by Qwest has realigned inter-state access charges by unbundling Signaling System Seven services and removing their rates from the switching costs. This move alone has increased Cox's operating costs in Arizona by approximately one million dollars a year. Cox believes the nexus between this Qwest FCC filing and the Settlement Agreement access charge provisions should be clarified.

V. RECOMMENDATIONS FOR MODIFICATION OF THE SETTLEMENT AGREEMENT

Q. DR. COLLINS, WHAT ARE YOUR RECOMMENDATIONS TO THE COMMISSION FOR MODIFICATION OF THE SETTLEMENT AGREEMENT?

A. First, Qwest has failed to demonstrate that the Arizona telecommunications market has robust competition and has, in fact, provided evidence that significant competition does not exist. Therefore, the Commission should not approve any provision in the Settlement Agreement that provides for flexible pricing without Qwest having to meet the current standards set forth in A.A.C. R14-2-1108.

Second, if there is to be flexible pricing, the Commission should provide a visible reference for the price floors, which as detailed below does not now exist. The Commission should require the establishment of a measurable floor price that, at a minimum, is the sum of the attributed UNE prices for all UNEs that constitute the service as well as a mark-up of 18% (the resale discount) which represents the service marketing cost. Certainly, there should be no downward pricing flexibility for services currently priced at or below cost.

Third, the Commission should require that service packages which combine Basket-1 (non-competitive) services with Basket-3 (competitive) services carry with them their Basket-1 retail price. To do otherwise defeats the "stand alone" provision for Basket-1 services which is in the Settlement Agreement.

Fourth, the Commission should require the establishment of a fourth service basket for services which have emerging competition, but are not yet fully competitive – that is, competition which is robust, is provided by financially strong competitors, and whose aggregate penetration exceeds 15% of the market share.

Fifth, the Commission should not approve the "Support and Defend" provision in the Settlement Agreement because of its ambiguity and arguably potentially limitless demand for financial and other resources.

Sixth, the Commission should require Qwest to explain its recent unbundling of SS7 services from inter-state access charges and how it will assure that this unbundling will be revenue neutral to other local exchange carriers.

VI. GENERAL COMMENTS ON THE PROPOSED SETTLEMENT AGREEMENT

Q. DR. COLLINS, WHAT ARE YOUR GENERAL COMMENTS ON THE PROPOSED SETTLEMENT AGREEMENT?

A. Cox does not generally object to price cap regimes similar to that recommended in the proposed Settlement Agreement because many of the factors and their levels are those which Cox has supported in other jurisdictions. The formula for the price ceilings appears to be reasonable. The inflation factors, the total productivity offset of 4.2% (3.7% and 0.5%), the fair value return on rate base of 9.61%, and the treatment of quality of service issues are within the bounds of reasonableness for use in a "settlement" approach. The term of three years for the Price Cap Plan appears to be a reasonable period of time for a "first look" at how the process will work and what major corrections are required. However, other price cap plans require that "start up" rates and price floors be clearly identified and approved *before* the price cap plan begins. That is not proposed here.

Cox has not addressed the level of Qwest's investment in Arizona for the test year of $1,446.0 million and has no opinion about the Staff's conclusion that this is a fair value. Cox also has no opinion about the overall net revenue change determined by the Staff at $42.9 million.

Cox does have a concern about the three "baskets" (non-competitive, wholesale, and competitive) within which services are categorized. In Cox's view

non-competitive services generally enter a period of being partially competitive before being fully competitive and there should be a "basket" for such services.

Cox has a concern about the "service package" provisions in the Settlement Agreement.

Cox has a significant concern about the Settlement Agreement's provision for "spot" pricing in general and specifically when allowed in the absence of demonstrated and robust competition.

Cox is concerned that the Settlement Agreement provides the opportunity for cross subsidization and predatory below cost pricing because of the manner in which the price floor is established and the manner in which packages of services are allowed.

Cox has a concern about the reduction in intra-state switched access charges of $5 million dollars in the second and third years of the plan with a concomitant increase in Basket-3 revenues.

Cox has a concern about the "Support and Defend" provision in the Settlement Agreement.

These concerns are more fully spelled out below.

Q. DO YOU HAVE CONCERNS ABOUT THE PROCESS UNDERLYING THE SETTLEMENT AGREEMENT?

A. Cox believes the process of this Docket is unusual and inappropriate. The title of a docket generally indicates the content of the docket. In this instance it would be to "determine the earnings of the Company, the fair market 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 a return." However, from the outset, the Docket *also* raised the issue of zone-based flexible pricing. As a result, the Docket proceeded to accomplish what the title suggested *plus* shifting rate schedules that were dependent on the existence of alleged competition. However, with the advent of the Settlement Agreement, the Docket changed from a revenue

requirement, fair return, and rate design (with variable rates) approach to the introduction of an alternative regulation docket, combined with revenue requirement, fair return, rate design with spot varying rates, and quality of service. The outcome of the new direction is now based on negotiations between the Staff and Qwest with a virtual take it or leave it choice for the other Parties. This has clearly been a process different from the usual forms of due process with which dockets generally are conducted. Indeed, alternative forms of regulation typically are processed in a separate docket and result in a plan that is much more detailed than the six-page Price Cap Plan here. These dockets also provide an opportunity for competitors and consumers to participate fully from the beginning. This is particularly important because the competitive landscape will be significantly modified by an alternative form of regulation.

That being said, and with the intent of being constructive, Cox will present Cox's concerns with – and proposed modifications to – the proposed Settlement Agreement as set forth above and presented in more detail below.

VII. SPECIFIC CONCERNS WITH THE SETTLEMENT AGREEMENT

Q. DR. COLLINS, WHAT IS COX'S CONCERN WITH THE ABSENCE OF A BASKET FOR SERVICES FOR WHICH COMPETITION IS EMERGING.

A. The existence of only two baskets for non-wholesale services in the Settlement Agreement is not granular enough. It implies that services can go from being fully non-competitive to fully competitive in one jump. This means that the service under consideration will be in the non-competitive basket (Basket 1) for a period wherein it truly has a level of competition, or will be prematurely treated as a fully competitive service before its time. That is, under any effective price cap regime, non-competitive services continue to require close regulatory oversight over both how high prices can be raised (to protect consumers), and over how low prices can

be set (to protect the competitive market from prevent predatory pricing). Once a service becomes fully competitive, price ceiling controls can be substantially relaxed because competitive forces will determine how high the incumbent can raise prices. For example, if the incumbent attempts to raise prices too high, customers will choose lower-priced competitive alternatives. However, even in a fully competitive marketplace, predatory pricing must continue to be a regulatory concern with companies like Qwest that retain significant market power.

Nevertheless, there remains a need for a "transitional mechanism" for handling services that are no longer monopoly/non-competitive services, but are not yet fully competitive, either. Specifically, if full pricing flexibility is permitted for services that are only partially competitive, the incumbent will be free to price those services well-above costs without concern that competitors will challenge those prices. In Cox's view, a greater degree of granularity in measuring the presence of competition with respect to a specific service is required so that this problem is avoided. This has been done in other alternate regulation plans.

This greater degree of granularity can be accomplished by creating an "Emerging Competition" basket. Services would transfer into this basket upon experiencing a market share competitive penetration of 15%, which is not yet fully competitive but is on the right track.

Q. YOU INDICATED THAT COX HAS A CONCERN ABOUT THE "SERVICE PACKAGE" PROVISIONS IN THE SETTLEMENT AGREEMENT. WHAT IS THAT CONCERN?

A. Cox believes that the provisions concerning service packages is flawed. The proposed Settlement Agreement provides that Basket-1 (non-competitive) services can be combined with Basket-3 (fully competitive) services to form service packages. When doing so, Qwest can price the package of services at any level above the TSLRIC (presumably aggregate TSLRIC of the components, although

that is not clear by the terms of the Price Cap Plan) of the package. Cox believes that the Basket-1 services should carry their Basket-1 price into the Basket 3 package and not their TSLRIC. The Settlement Agreement provides for that instance when the Basket-1, 1FR service is included as part of a package, but not for other Basket-1 services.

The Settlement Agreement requires that Basket-1 services which are combined with Basket-3 services also be available as stand alone Basket-1 services but is silent as to any price differential which would be allowed. That is, a Basket-1 service (other than 1FR) could carry a TSLRIC price in the package and a higher retail price as a stand-alone service. This invites opportunities for pricing mischief. In the instance of the 1FR service, Qwest has claimed that its price is below TSLRIC and this brings its current price into question, particularly when packaged with Basket-3 services.

The Staff, on the other hand, has indicated that it believes the 1FR is priced at or above TSLRIC, yet Staff was unable to provide TSLRICs when asked to do so in data requests. [*See* ACC Staff Responses to Cox Data Request Nos. 1-12 and 1-13, attached at Tab A]

Q. DR. COLLINS, YOU INDICATED THAT ONE OF COX'S GENERAL CONCERNS WAS THE EXISTENCE OF A "SPOT PRICING" PROVISION IN THE SETTLEMENT AGREEMENT. WHAT ARE THE SPECIFICS UNDERLYING THIS CONCERN?

A. In Cox's view it is clear that the Settlement Agreement attempts to accomplish by fiat what could not be accomplished by a compelling showing of facts in Qwest's initial and subsequent filings. The Price Cap Plan provides that –

> "[n]ew 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 substitutes "spot" pricing and "customer specific pricing" (with or without the presence of competition) for the "competitive wire center" criteria Qwest requested in its previous filings. That results in flexible pricing *independent* of the existence of a suitable level of competition – a situation which, from a competitive viewpoint, is even more onerous, biased, and chilling of competition.

Of equal concern is that the proposed Settlement Agreement provides no clear standard for approval of a new service or package, particularly if it is a "spot" pricing proposal. Although the Price Cap Plan contemplates that new services and packages are subject to review and approval by the Commission (Section 4(a)), the need for consideration of competitive impact and the appropriateness of flexible pricing are not spelled out. Indeed, Qwest could offer a new package of services (one that could include 1FR, for example) in a narrow geographic area, but it would not have to meet Rule 1108 standards (nor would competition necessarily have to exist) for Qwest to gain flexible pricing. This possibility is much worse than the flexible pricing process proposed by Proposition 108, which was overwhelmingly rejected by the voters, or the "competitive zone" proposal, which at least required some competition in an area before flexible pricing.

In fact, A.A.C. R14-2-1108 provides Qwest with the appropriate freedom to modify their service offerings and their price structures to gain appropriate pricing flexibility without chilling emerging competition. It is unclear to me why Qwest could not use this pathway to achieve the end rather than to attempt yet another end run on the Commission's rules.

In sum, the Commission should reject the Settlement Agreement provision that would allow new services or packages to be offered to selected customer groups based on geographic location or purchaser patterns. This provision is rife

with potential abuse that could devastate competition. Moreover, as currently stated, it is too vague and ambiguous, which only exacerbates the potential abuse.

Q. WHAT IS COX'S CONCERN ABOUT THE PRICE FLOOR BEING SET AT TSLRIC?

A. Services that are priced at TSLRIC simply do not recover all of their costs. When the price for a service is set at TSLRIC, that price does not recover the associated and attributable shared cost of the family of services of which the service in question is a member. It is a characteristic of a TSLRIC determination that if one, some or all of the services in the family – in the aggregate – recover the TSLRIC plus shared cost, then there is no economic theory opportunity to observe cross subsidization within the family.

This failure to recover all of a services cost is the reason the FCC abandoned the TSLRIC methodology in its UNE pricing order and required TELRIC pricing. The TSLRIC concept is not appropriate to use in doing cost studies in an emerging competitive environment because it, in practice, allows for cross subsidization within services in the service family to the extent of some or all of the shared cost. It is a concept that historically never achieved the desired regulatory result of the elimination of cross subsidies. Additionally, Cox asked Qwest in discovery if Qwest would agree not to recover the unassigned shared family costs and unrecovered direct costs that normally would be assigned to a service (but had not been so assigned due to TSLRIC prices) from other services. Qwest indicated that they would not agree. [*See* Qwest Response to Cox Data Request No. 1-008 (attached at Tab B)] Thus, the door to cross subsidization has been opened by the proposed Settlement Agreement.

In today's world of emerging telecommunications competition, encouraged by Congress' and the FCC's mandate to state commissions to create a competitively neutral environment, it is clear that 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. Failure to include any of these cost components on a service basis – while Qwest recovers its total costs in its total revenue – implies cross subsidization is taking place in some manner. That is not proper and it hurts competition. Therefore, Cox urges the Commission to modify the price floor for Qwest's services.

Q. DO YOU HAVE OTHER CONCERNS WITH THE TSLRIC PRICE FLOOR?

A. A settlement agreement that is not enforceable is a flawed agreement. To be enforceable, the terms of the agreement must be capable of being judged as to the degree to which they are met by the parties. In this instance the entire price floor concept has no metric for determining whether or not it is being met. To assess the potential enforceability, Cox asked Commission Staff the following data requests and received the following responses (Staff's Responses are attached at Tab A):

> COX 1-12: For each of the services or package of services in Baskets 1, 2 and 3, state the TSLRIC price floor under the Price Cap Plan. For each service or package of services, please identify the (a) service or package of services, (b) the TSLRIC for that service or package of services, (c) documentary support in filings in this docket for the TSLRIC, and (d) other documentation showing how the TSLRIC was calculated.
>
> RESPONSE: Please see the tariff for all services or packages offered by Qwest. The price of each existing service or basket of services has been previously approved by the Commission. In considering the pricing, whether in a rate case or in an initial tariff, the Commission determined the rate to be above TSLRIC. No separate examination of the TSLRIC for each service has been undertaken in connection with this Agreement. As new services have been introduced, Staff has reviewed cost support information to determine whether the proposed rates exceed the cost of providing the service.

COX 1-13: Does the Staff have the Commission approved TSLRIC price floors for the services in the Settlement Agreement that the Staff has requested the Parties to approve? If so what is the source of that information and please provide copies of it.

RESPONSE: No. See response to 1 – 12

The only conclusion that can be drawn from these responses is that, in Staff's view, the basic information to determine the price floors does not exist. Therefore, the Settlement Agreement's price floor is not capable of being enforced and Cox cannot support this provision of the Agreement.

Q. YOU INDICATED THAT COX HAD A CONCERN ABOUT THE "SUPPORT AND DEFEND" PROVISION IN THE SETTLEMENT AGREEMENT. WHAT IS THAT CONCERN?

A. Cox's concern is based on the ambiguous nature of the provision as it is written and its potential for exposing carriers to unlimited financial and other resource losses. Cox asked Commission Staff for clarification, and received the following responses (Staff's Response is attached at Tab A):

COX 1-10: In the Section of the Agreement entitled "SUPPORT AND DEFEND" (at p. 12), it indicates that "[e]ach Party will support and defend this Agreement and any order entered by the Commission approving this Agreement before the Commission or other regulatory agency or before any court in which it may be at issue." The Staff is a Party to the Agreement. As to that participation:

a. What resources would the Staff expect to apply to such a defense.

b. Which Party would lead the support and defense team?

c. In the situation where the Parties disagreed about the nature and content of the support/defense, how would the situation be rationalized?

d. Would the resources (financial and otherwise) expected to be committed by the Staff be capped or limited in any

way and would those same limitations apply to the remaining Parties?

RESPONSE:

a. Staff would expect to devote the resources that are available and appropriate to such a defense, dependent on the nature and forum involved.

b. Staff has no reason to anticipate that a decision would be necessary as to which Party would lead a "support and defense team". The Agreement speaks for itself as to the nature and extent of the Parties' agreement. Staff would anticipate proceeding as it deemed appropriate in response to any situation which might arise.

c. Staff has no reason to anticipate that the Parties might disagree about the nature and content of the "support/defense". The Agreement speaks for itself as to the nature and extent of the Parties agreement. Staff would anticipate proceeding as it deemed appropriate in response to any situation which might arise.

d. The Agreement does not provide for a cap or limitation on resources to be committed by Staff or any remaining Parties.

That response did not clarify the "Support and Defend" provision. The continuing ambiguity is introduced by the response to part (b) and (c) and provided above for reference. The concern about the level of commitment of financial and other resources is introduced by the response to (d). Consequently, Cox cannot support this provision.

Q. DR. COLLINS, YOU INDICATED THAT THE REDUCTION IN INTRA-STATE SWITCHED ACCESS CHARGES PROVIDED IN THE SETTLEMENT AGREEMENT AND THE NOTION OF BRINGING THEM IN LINE WITH INTER-STATE ACCESS CHARGES WAS A CONCERN. WHAT ASPECT OF THIS PROVISION CAUSES COX THAT CONCERN?

A. Cox has a concern about the annual $5 million reduction in intrastate switched access charges with a concomitant increase in Basket-3 revenues. This concern is based on a lack of detail which describes the relationship, if any, between this

reduction and Qwest's recent inter-state access charge price elements being unbundled. Qwest (then US West Communications (USWC)) recently restructured its FCC Tariff No. 5 Access Service, Section 6, Switched Access Service, and Section 20, Common Channel Signaling Network. In these sections, USWC unbundled its Signaling System Seven (SS7) call set-up function from the Local Switching Function.

Although Qwest indicated that the restructuring would be revenue neutral, a preliminary analysis of this USWC action by Cox indicates that it will increase Cox's operating expenses in Arizona by an amount which would range between $0.7 million and $1 million a year. Cox does not have the information that would be needed to determine what effect the proposed $5.0 million dollar decrease in intra-state switched access charges with any concomitant increase in local switching, switched transport, and SS7 charges will be. Cox is concerned that these potential increased operating expenses for new market entrants will chill their entry and perhaps impact their ability to remain in the competitive market. The Commission should satisfy itself that no such mischief will take place before approving this provision of the proposed Settlement Agreement.

Q. DR. COLLINS, DO YOU HAVE ANY OTHER CONCERNS OR PROPOSED MODIFICATIONS FOR THE PRICE CAP PLAN, ASSUMING THE GENERAL STRUCTURE OF THAT PLAN IS ADOPTED?

A. Yes. I am concerned about the potential lack of notice to CLECs regarding: (i) pricing changes; (ii) moving services from one basket to another; or (iii) introducing new services or packages. Qwest should be required to provide notice upon any filing related to the Price Cap Plan to a Commission-maintained list of interested CLECs or other interested parties (such as consumers groups). Given the potential short-time frames for approval and the potential for

1 detrimental impacts on competition, those entities should have a full opportunity
2 to participate in those dockets.

3 **Q. DR. COLLINS, DOES THIS CONCLUDE YOUR TESTIMONY?**

4 A. Yes, it does.

A

ARIZONA CORPORATION COMMISSION STAFF'S RESPONSES TO COX ARIZONA TELCOM, L.L.C.'S FIRST SET OF DATA REQUESTS TO ACC STAFF RE PROPOSED SETTLEMENT DOCKET NO. T-01051B-99-0105 OCTOBER 27, 2000

Cox 1-10 In the Section of the Agreement entitled "SUPPORT AND DEFEND" (at p. 12), it indicates that "[e]ach Party will support and defend this Agreement and any order entered by the Commission approving this Agreement before the Commission or other regulatory agency or before any court in which it may be at issue." The Staff is a Party to the Agreement. As to that participation:

a. What resources would the Staff expect to apply to such a defense.

b. Which Party would lead the support and defense team?

c. In the situation where the Parties disagreed about the nature and content of the support/defense, how would the situation be rationalized?

d. Would the resources (financial and otherwise) expected to be committed by the Staff be capped or limited in any way and would those same limitations apply to the remaining Parties?

RESPONSE:

a. **Staff would expect to devote the resources that are available and appropriate to such a defense, dependent on the nature and forum involved.**

b. **Staff has no reason to anticipate that a decision would be necessary as to which Party would lead a "support and defense team". The Agreement speaks for itself as to the nature and extent of the Parties' agreement. Staff would anticipate proceeding as it deemed appropriate in response to any situation which might arise.**

c. **Staff has no reason to anticipate that the Parties might disagree about the nature and content of the "support/defense". The Agreement speaks for itself as to the nature and extent of the Parties agreement. Staff would anticipate proceeding as it deemed appropriate in response to any situation which might arise.**

d. **The Agreement does not provide for a cap or limitation on resources to be committed by Staff or any remaining Parties.**

Respondent(s): Christopher C. Kempley, Assistant Chief Counsel

ARIZONA CORPORATION COMMISSION STAFF'S RESPONSES TO COX ARIZONA TELCOM, L.L.C.'S FIRST SET OF DATA REQUESTS TO ACC STAFF RE PROPOSED SETTLEMENT DOCKET NO. T-01051B-99-0105 OCTOBER 27, 2000

Cox 1-12 For each of the services or package of services in Baskets 1, 2 and 3, state the TSLRIC price floor under the Price Cap Plan. For each service or package of services, please identify the (a) service or package of services, (b) the TSLRIC for that service or package of services, (c) documentary support in filings in this docket for the TSLRIC, and (d) other documentation showing how the TSLRIC was calculated.

RESPONSE: **Please see the tariff for all services or packages offered by Qwest. The price of each existing service or basket of services has been previously approved by the Commission. In considering the pricing, whether in a rate case or in an initial tariff, the Commission determined the rate to be above TSLRIC. No separate examination of the TSLRIC for each service has been undertaken in connection with this Agreement. As new services have been introduced, Staff has reviewed cost support information to determine whether the proposed rates exceed the cost of providing the service.**

Respondent(s): William Dunkel, ACC Consultant; and
Wilfred M. Shand, Chief Economist

ARIZONA CORPORATION COMMISSION STAFF'S RESPONSES TO COX ARIZONA TELCOM, L.L.C.'S FIRST SET OF DATA REQUESTS TO ACC STAFF RE PROPOSED SETTLEMENT DOCKET NO. T-01051B-99-0105 OCTOBER 27, 2000

Cox 1-13 Does the Staff have the Commission approved TSLRIC price floors for the services in the Settlement Agreement that the Staff has requested the Parties to approve? If so what is the source of that information and please provide copies of it.

RESPONSE: **No. See response to 1 - 12**

Respondent(s): William Dunkel, ACC Consultant

B

Arizona 10/2 1/00
Docket No. T-1051B-99-105
COX 1-008

INTERVENOR: Cox Arizona Telecom

REQUEST NO: 008

Section 2-c of the Price Cap Plan provides the TSLRIC of a service as the price floor.

a. Does Qwest agree that, in doing so, it will not recover the unassigned shared family costs and unrecovered common costs.

b. Will Qwest agree not to recover the unrecovered costs of "a" above from other services?

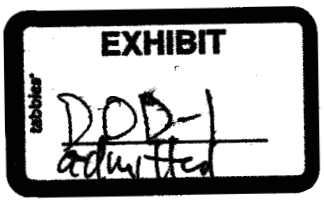
RESPONSE:

a. No.

b. No.

Jerrold Thompson
Executive Director- Cost Advocacy
1801 California St.
Denver, CO

BEFORE THE ARIZONA CORPORATION COMMISSION



CARL J. KUNASEK
Chairman
JIM IRVIN
Commissioner
WILLIAM A. MUNDELL
Commissioner

IN THE MATTER OF THE APPLICATION OF U S WEST COMMMUNICATIONS, 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-01051B-99-0105**

DIRECT TESTIMONY
of

RICHARD B. LEE

on behalf of

THE UNITED STATES DEPARTMENT OF DEFENSE
And
ALL OTHER FEDERAL EXECUTIVE AGENCIES

ROBERT N. KITTEL, CHIEF
Regulatory Law Office
Office of The Judge Advocate General
U.S. Army Litigation Center
901 N. Stuart Street, Suite 713
Arlington, Virginia 22203-1837

by

Peter Q. Nyce, Jr.
General Attorney

July 25, 2000

Direct Testimony of Richard B. Lee

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1 **INTRODUCTION**

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

3 A. My name is Richard B. Lee. I am Vice President of the economic consulting firm
4 of Snavely King Majoros O'Connor & Lee, Inc. ("Snavely King"). My business
5 address is 1220 L Street, N.W., Suite 410, Washington, D.C. 20005.

6 **Q. PLEASE DESCRIBE SNAVELY KING.**

7 A. Snavely King, formerly Snavely, King & Associates, Inc., was founded in 1970 to
8 conduct research on a consulting basis into the rates, revenues, costs and
9 economic performance of regulated firms and industries. The firm has a
10 professional staff of 12 economists, accountants, engineers and cost analysts.
11 Most of its work involves the development, preparation and presentation of
12 expert witness testimony before Federal and state regulatory agencies. Over the
13 course of its 27-year history, members of the firm have participated in over 500
14 proceedings before almost all of the state commissions and all Federal
15 commissions that regulate utilities or transportation industries.

16 **Q. PLEASE DESCRIBE THE TYPE OF WORK YOU HAVE PERFORMED WHILE**
17 **AT SNAVELY KING.**

18 A. Since joining Snavely King in 1991, I have assisted clients in proceedings before
19 the Federal Communications Commission ("FCC") related to a variety of matters.
20 Attachment 1 is a list of the FCC filings I have prepared on behalf of the General
21 Services Administration ("GSA"). The GSA represents the customer interests of
22 the Federal Executive Agencies in matters before the FCC.

I have also assisted clients in proceedings before twenty-three state commissions related to the telephone, cellular telephone and electric industries.

Q. HAVE YOU PREVIOUSLY SUBMITTED TESTIMONY IN ANY REGULATORY PROCEEDING?

A. Yes, I have. Attachment 2 is a list of my appearances before regulatory agencies on behalf of various clients.

Q. WHAT WAS YOUR EMPLOYMENT PRIOR TO JOINING SNAVELY KING?

A. From 1980 to 1990, I was employed by American Telephone and Telegraph Company ("AT&T") in its Federal Regulatory Affairs Division. As Regulatory Vice President - Financial and Accounting Matters, I represented AT&T before the FCC in all financial and accounting matters. In that capacity, I directed the preparation and presentation to the FCC of all AT&T Communications rate case revenue requirement filings. I was also responsible for the preparation and presentation to the FCC of all AT&T Communications monthly earnings reports and annual earnings forecasts.

Q. WHAT WAS YOUR EMPLOYMENT HISTORY PRIOR TO 1980?

A. From 1963 to 1980, I was employed by the New York Telephone Company. I held a variety of progressively responsible positions leading to a position representing the Company in accounting matters before the New York Public Service Commission. In this capacity, I participated in the development of Company revenue requirements in a number of general rate cases and related proceedings.

1 My complete resume is attached as Attachment 3.

2 **Q. WHAT IS YOUR EDUCATIONAL BACKGROUND?**

3 A. I earned a Bachelor of Science degree in Industrial Administration with High
4 Honors from Yale University in 1961. I earned a Master of Business
5 Administration degree with Distinction from the Harvard Business School in
6 1963.

7 **Q. FOR WHOM ARE YOU APPEARING IN THIS PROCEEDING?**

8 A. I am appearing on behalf of the United States Department of Defense and all
9 other Federal Executive Agencies ("DOD/FEA").

10 **Q. WHAT IS DOD/FEA'S INTEREST IN THIS PROCEEDING?**

11 A. As a user of telecommunications services provided by U S WEST
12 Communications, Inc. ("U S WEST"), DOD/FEA's interest is in the maintenance
13 of just and reasonable rates.

14 **Q. WAS THIS TESTIMONY PREPARED BY YOU OR UNDER YOUR DIRECT**
15 **SUPERVISION?**

16 A. Yes, it was.

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

18 A. The purpose of my testimony is to present adjustments to the revenue
19 requirements presented in the testimonies of U S WEST witnesses George
20 Redding and Kerry Dennis Wu.

1 **Q. PLEASE SUMMARIZE YOUR FINDINGS.**

2 A. Mr. Redding contends that U S WEST has a need for $201.2 million in additional
3 revenues.[1] After adjustment, I find that U S WEST has a revenue requirement
4 excess of $46.9 million.

5 U S WEST requests approval of a net rate increase of $88.6 million.[2] I
6 am reserving judgment as to what U S WEST's net rate change should be until I
7 have had the opportunity to review the filings of the other parties to this case.

8

9 **ADJUSTMENT SUMMARY**

10 **Q. HAVE YOU RESTATED U S WEST'S REVENUE REQUIREMENT FOR THE**
11 **TEST YEAR ENDED DECEMBER 31, 1999?**

12 A. Yes, I have. In Column a of Attachment 4 to this testimony I have shown the
13 change in revenue requirements presented by Mr. Redding. My adjustments are
14 shown in Column b, and my proposed Adjusted Test Year is shown in Column c.

15 **Q. HAVE YOU SUMMARIZED YOUR TEST YEAR ADJUSTMENTS?**

16 A. Yes, I have. The seven adjustments I propose are summarized on Attachment 5
17 to this testimony.

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[1] Redding Supplemental Direct Testimony, p. 3.

[2] U S WEST Supplemental Response to UTI 43-19S1.

1 **ADJUSTMENT 1 – CUSTOMER OPERATIONS EXPENSE**

2 **Q. WHAT IS YOUR FIRST ADJUSTMENT?**

3 A. My first adjustment reduces U S WEST's revenue requirements by $20.1 million
4 to reflect a correction to Mr. Redding's estimate of end-of-period customer
5 operations expense.

6 Mr. Redding explains that he performed a number of calculations to bring
7 revenue, expense and taxes to end-of-period levels to match his December 31,
8 1999, rate base.[3] He states:

9 > Once December is normalized, it must
10 > then be compared to a trend of
11 > operational results. This is done to
12 > ensure that the month being annualized
13 > is representative of the trends in
14 > operational results, both revenues and
15 > expenses. In the case of the updated
16 > test year, a few items were not in
17 > alignment with trend. When this occurs,
18 > additional analysis must be undertaken
19 > and alternatives to the annualization of
20 > December must be used.[4]
21

22 Mr. Redding's calculations result in an end-of-period customer operations
23 expense adjustment of $23.3 million over 1999 actuals.[5]

24 To test Mr. Redding's estimate, I performed a regression analysis of total

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[3] Redding Supplemental Testimony, pp. 6-8.

[4] Id., p. 7.

[5] Id., GAR-S7.

company customer operations expense by month from January 1997 through December 1999. This analysis results in an end-of-period total company customer operations expense of $248.9 million, as shown on Page 1 of Attachment 6 to this testimony. On page 3 of Attachment 6, I calculate that end-of-period intrastate customer operations expense should be $179.0 million, or $20.1 million less than Mr. Redding's estimate.

Based upon this analysis, I calculate a revenue requirement reduction of $20.5 million on Page 4 of Attachment 6.

ADJUSTMENT 2 – CORPORATE OPERATIONS EXPENSE

Q. WHAT IS YOUR SECOND ADJUSTMENT?

A. My second adjustment reduces U S WEST's revenue requirements by $11.5 million to reflect a correction to Mr. Redding's estimate of end-of-period corporate operations expense.

Mr. Redding's calculations result in an end-of-period corporate operating expense adjustment of $17.9 million over 1999 actuals.[6] My regression analysis results in an end-of-period total company corporate operations expense of $243.4 million, as shown on Page 1 of Attachment 7 to this testimony. On Page 3 of Attachment 7, I calculate that end-of-period intrastate corporate operations expense should be $172.3 million, or $11.5 million less than Mr. Redding's

[6] Id.

estimate.

Based upon this analysis, I calculate a revenue requirement reduction of $11.7 million on Page 4 of Attachment 7.

ADJUSTMENT 3 – SERVICES DEREGULATED BY FCC

Q. WHAT IS YOUR THIRD ADJUSTMENT?

A. My third adjustment reduces U S WEST's revenue requirement by $13.0 million to reflect a disallowance of one-half of the effect on the test period of services deregulated by the FCC. This adjustment is consistent with the Commission's decision in Docket No. E-1051-93-183.[7]

In his testimony, Mr. Redding did not oppose this adjustment.[8] In response to a data request, however, U S WEST stated that its disagreement is reflected by its failure to propose such an adjustment.[9]

In Docket No. E-1051-93-183, the Commission stated that "neither the interstate nor the intrastate jurisdiction should bear the entire deficiency" of services deregulated by the FCC.[10] While I am not convinced that intrastate ratepayers should subsidize such services at all, I have proposed the removal of

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[7] Decision No. 58927, pp. 21-23.

[8] Redding Direct Testimony, p. 18.

[9] U S WEST Response to UTI 16-7, c.

[10] Decision No. 58927, pp. 22-23.

only one-half of the deficiency at this time.

Based upon U S WEST's response to my data request,[11] I calculate my adjustment on Page 1 of Attachment 8, and the revenue requirement effect on Page 2 of Attachment 8.

ADJUSTMENT 4 – DIRECTORY ADVERTISING

Q. WHAT IS YOUR FOURTH ADJUSTMENT?

A. My fourth adjustment reduces U S WEST's revenue requirement by $42.7 million to reflect the imputation of directory advertising revenues. This adjustment conforms to the imputation proposed by U S WEST in Docket No. E-1051-93-183.

Mr. Redding makes no adjustment for directory advertising because U S WEST believes " the appropriate fees and value of services provided by DEX are already reflected in the books."[12] Mr. Redding states that the rationale for his position is provided in the testimony of U S WEST witness Ann Koehler-Christensen.

Q. DO YOU AGREE WITH U S WEST'S POSITION?

A. No, I don't. As the Commission noted in Docket No. E-1051-93-183, the court refused to transfer the Directory operation to AT&T at divestiture so that the

[11] U S WEST Response to DOD 4-7.

[12] Redding Direct Testimony, p. 20.

"significant profits" of this operation could continue to be used to reduce local telephone rates.[13]

Since divestiture, the annual amount imputed in Arizona to support local telephone rates has been $43 million. In Docket No. E-1051-93-183, U S WEST argued with ultimate success that an imputation in excess of $43 million would conflict with the "spirit and terms of the 1998 Settlement Agreement as approved in Decision No. 56020."[14] I believe the reverse is also true, and an adjustment of less than $43 million would be inappropriate in this case.

Q. ARE THERE ANY CIRCUMSTANCES UNDER WHICH YOU WOULD CONSIDER AN IMPUTATION OF LESS THAN $43 MILLION APPROPRIATE?

A. Yes. I believe that the amount could reasonably be reduced if U S WEST demonstrated that the profits generated by the Directory operation had fallen since 1984. U S WEST has not made such showing.

To the extent that competitors now provide local telephone services in U S WEST's territory, I would also find it appropriate for the Commission to establish a system by which the $43 million is imputed or paid to all local service providers in proportion to the number of lines they serve.

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[13] Decision No. 58927, p. 10.

[14] Id., p. 12.

1 **Q. HAVE YOU CALCULATED THE REVENUE REQUIREMENT EFFECT OF THIS**
2 **ADJUSTMENT?**
3 A. Yes. On Page 1 of Attachment 9, I show an imputation of $42,657,000 as
4 proposed by U S WEST in Docket No. E-1051-93-183.[15]
5
6 **ADJUSTMENT 5 – PRODUCTIVITY**
7 **Q. WHAT IS YOUR FIFTH ADJUSTMENT?**
8 A. My fifth adjustment reduces U S WEST's revenue requirement by $25.6 million
9 to reflect expected productivity improvements.
10 **Q. WHY DO YOU PROPOSE THIS ADJUSTMENT?**
11 A. Mr. Redding proposes a pro forma adjustment to reflect wage and salary
12 increases subsequent to the test year.[16] It would be inappropriate to increase
13 test year requirements for such input price increases and ignore offsetting
14 productivity increases subsequent to the test year.
15 **Q. DID MR. REDDING PROPOSE A PRODUCTIVITY ADJUSTMENT?**
16 A. No, he did not. He states that productivity is "one of the means the Company
17 has of maintaining its earnings between rate cases."[17]
18 **Q. DO YOU AGREE WITH MR. REDDING'S STATEMENT?**

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[15] Id., p. 11.

[16] Redding Direct Testimony, p. 11.

[17] Id., p. 36.

1 A. I agree that productivity improvements reduce revenue requirements between
2 rate cases, and that input price increases (such as wage increases) increase
3 revenue requirements between rate cases. If productivity improvements exceed
4 input price increases, earnings will go up between rate cases. If input price
5 increases exceed productivity improvements, earnings will go down.

6 But the task at hand is setting rates in this rate case at just and
7 reasonable levels. If an adjustment is made to reflect input price increases
8 subsequent to the test period, an appropriate productivity offset must also be
9 calculated.

10 **Q. HOW DID YOU CALCULATE YOUR PROPOSED PRODUCTIVITY**
11 **ADJUSTMENT?**

12 A. On Page 1 of Attachment 10, to this testimony, I applied the average annual
13 productivity increase over the years 1994 to 1998 to the expense categories
14 used in Mr. Redding's productivity calculation.[18] The average annual productivity
15 increase for this period was 3.5 percent.[19] This calculation results in $25.1
16 million in reduced expenses. On Page 2 of Attachment 10, I calculate the
17 revenue requirement effect of this change.

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[18] U S WEST Response to Data Request UTI 1-12.

[19] Redding Direct Testimony, GAR-12.

1 **ADJUSTMENT 6 – DEPRECIATION**

2 **Q. WHAT IS YOUR SIXTH ADJUSTMENT?**

3 A. My sixth adjustment reduces U S WEST's revenue requirement by $108.9 million
4 to reflect a correction to Mr. Redding's estimate of end-of-period depreciation
5 expense and depreciation reserve.

6 On May 4, 2000, the Commission ordered U S WEST to file updated
7 depreciation rates based upon newly prescribed depreciation parameters.[20] U S
8 WEST witness Kerry Dennis Wu calculates rates using 1/1/97 reserve percents
9 and shows these rates under the heading "Rates Effective in 1997" on his Exhibit
10 KDW 1. On Page 4 he shows a change in accruals of $79.2 million due to these
11 rates based upon investment as of 1/1/97.

12 However, U S WEST did not book depreciation accruals pursuant to these
13 new rates retroactive to 1/1/97. Indeed, U S WEST did not begin booking
14 accruals at these new rates until May 2000.[21] Nevertheless, Mr. Wu multiplied
15 these rates by 12/31/99 investment to calculate end-of-period depreciation
16 expense.[22]

17 There are two problems with Mr. Wu's calculations. First, depreciation
18 rates should be made effective as of the study date on which the rates are

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[20] Decision No. 62507.

[21] U S WEST Response to DOD 4-6.

[22] Wu Testimony, KDW 2, Page 1.

1 based, in this case, 1/1/97. The FCC affirmed this policy nearly a decade ago.[23]
2 Second, depreciation rates based upon the parameters now prescribed by the
3 Commission should be determined as of the end of 1999 for purposes of this
4 rate case. The use of depreciation rates based upon 1/1/97 depreciation reserve
5 levels results in materially distorted depreciation expense.

6 I have corrected these two problems in Attachment 11 to this testimony.
7 On Page 1 of Attachment 11, I estimated what the depreciation reserve would be
8 as of 12/31/99 had the rates calculated by Mr. Wu been made effective as of
9 1/1/97. On Page 2 of Attachment 11, I calculate depreciation rates based upon
10 Mr. Wu's calculations, but using my estimate of 12/31/99 depreciation reserve
11 levels. In Column f, I determine end-of-period accruals based upon these rates
12 and 12/31/99 intrastate investment. The use of this updated data results in
13 $60.6 million less test period depreciation expense, as shown at the bottom of
14 Column f.

15 Based upon this analysis, I calculate a revenue requirement reduction of
16 $108.9 million on Page 3 of Attachment 11.

17 **Q. BY IMPUTING DEPRECIATION ACCRUALS FOR 1997-1999, ARE YOU NOT**
18 **EFFECTIVELY RECOMMENDING RETROACTIVE RATEMAKING?**

19 A. No. In Decision No. 62507 the Commission approved depreciation lives as short

[23] The Prescription of Revised Percentages of Depreciation pursuant to the Communications Act of 1934, as amended for Alascom, Inc., et al., Memorandum Opinion and Order, FCC 91-31, released January 31, 1991.

or shorter than those used by U S WEST on its financial books. The FCC allows such short lives only after a below-the-line write-off of the difference between the carrier's regulatory and financial book reserves.[24] My calculation effectively lowers the regulatory net book cost for ratemaking purposes to be consistent with the high depreciation rates derived from the use of short depreciation lives. The FCC's procedures perform a similar matching through its conditions. The FCC states:

> These conditions are important because they provide assurance that carriers do not engage in a practice that would disadvantage consumers and competition by using high financial depreciation rates with high regulatory net book costs or by applying inappropriate depreciation rates to regulatory plant accounts.[25]

ADJUSTMENT 7 – RATE OF RETURN

Q. WHAT IS YOUR SEVENTH ADJUSTMENT?

A. My seventh adjustment reduces U S WEST's revenue requirement by $25.6 million to reflect the use of a reduced rate of return.

Mr. Redding uses a 10.86 percent rate of return in the development of his

[24] 1998 Biennial Regulatory Review – Review of Depreciation Requirements for Incumbent Local Exchange Carriers, CC Docket No. 98-137, Report and Order, FCC 99-397, released December 30, 1999, para. 24-35.

[25] Id., para. 26.

revenue requirement proposal.[26] He states that support for his rate of return is provided in the testimony of U S WEST witness Peter C. Cummings.[27]

In his testimony in this proceeding, DOD/FEA witness Charles W. King explains that the appropriate rate of return for use in this proceeding is 9.54 percent.[28] On Page 1 of Attachment 12 to this testimony, I calculate that the use of this lower rate of return reduces U S WEST's required earnings by $15.0 million. On Page 2 of Attachment 12, I calculate the revenue requirement effect of this adjustment.

CONCLUSION

Q. WHAT DO YOU CONCLUDE AS A RESULT OF YOUR ANALYSIS OF U S WEST'S REVENUE REQUIREMENT?

A. I conclude that U S WEST has a revenue requirement excess of $46.9 million, as shown on Attachment 4 to this testimony.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

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[26] Redding Supplemental Direct Testimony, GAR-S1.

[27] Redding Direct Testimony, p. 7.

[28] King Testimony, p. 37.

RICHARD B. LEE

FCC FILINGS ON BEHALF OF GENERAL SERVICES ADMINISTRATION

PROCEEDING	SUBJECT	TYPE	DATE
CC Docket No. 87-568	AT&T Communications Revisions to Tariff FCC No. 12	Reply	3/25/91
CC Docket No. 91-141	Expanded Interconnection with Local Telephone Company Facilities	Comments	8/6/91
		Reply	9/20/91
		Reply	12/10/91
		Comments	1/14/93
		Reply	2/19/93
		Comments	4/2/93
		Reply	4/30/93
DA Docket No. 91-698	New York Telephone Co. Petition for Waiver of Part 61.49(g) of the Commission's Rules	Comments	8/9/91
		Reply	9/9/91
CC Docket No. 89-79	Amend. of Part 69 of the Commission's Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture	Comments	8/26/91
			9/25/91
			10/2/91
CC Docket No. 87-313	Policy and Rules Concerning Rates for Dominant Carriers	Comments	8/26/91
		Reply	9/25/91
		Reply	10/2/91

PROCEEDING	SUBJECT	TYPE	DATE
CC Docket No. 91-213	Transport Rate Structure and Pricing	Comments	11/22/91
		Reply	1/22/91
		Comments	2/1/93
		Reply	3/19/93
Petition	ONA Access Charge Tariff Filings	Petition to Suspend	11/26/91
DA No. 91-1452	Federal-State Joint Conference on ONA Staff Report on UniformTariffing Guidelines for ONA Services	Comments	12/20/91
		Reply	1/21/92
CC Docket No. 91-346	Intelligent Networks	Reply	4/6/92
		Comments	11/1/93
		Reply	12/1/93
CC Docket No. 92-133	Amend. of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Represcription and Enforcement Processes	Comments	9/11/92
		Reply	10/13/92
CC Docket No. 92-91	ONA Tariffs of Bell Operating Companies	Comments	10/16/92
CC Docket No. 92-222	Amendment of the Part 69 Allocation of General Support Facility Costs	Comments	12/4/92
		Reply	12/18/92
CC Docket No. 92-256	Application of ONA and Nondiscrimination Safeguards to GTE Corporation	Comments	2/1/93
		Reply	3/24/93

PROCEEDING	SUBJECT	TYPE	DATE
CC Docket No. 92-296	Simplification of the Depreciation Prescription Process	Reply Reply Reply	4/13/93 1/21/94 12/14/94
DA 93-481	Ameritech's Petition for Declaratory Ruling and Related Waivers to Establish a New Regulatory Model for the Ameritech Region	Reply	7/12/93
DA 93-687	Rochester Telephone Corp. Petition for Waivers of Part 61 Tariff Rules and Part 69 Access Charge Rules to Implement Its Open Market Plan	Comments Reply	7/19/93 8/9/93
CC Docket No. 91-273 DA Docket No. 93-1537	Amendment of Part 63 of the Commission's Rules to Provide for Notifications by Common Carriers NYNEX Transition Plan to Preserve Universal Service in a Competitive Environment	Comments Reply Reply	1/21/94 2/22/94 3/2/94
Petition	Petition for Declaratory Ruling Assigning an N11 Dialing Code for use by the Public in Gaining Access to the Services of the Federal Executive Agencies	Petition	3/11/94

PROCEEDING	SUBJECT	TYPE	DATE
CC Docket No. 94-1	Price Cap Performance Review for Local Exchange Carriers	Comments	5/9/94
		Reply	6/29/94
		Comments	1/31/95
		Comments	4/17/95
		Comments	10/27/95
		Reply	11/20/95
		Comments	12/18/95
		Reply	3/1/96
CC Docket No. 94-54	Equal Access and Interconnection Obligations Pertaining to Commercial Mobile Radio Services	Comments	8/30/94
		Reply	10/13/94
IAD File No. 94-101	Requests of Federal Agencies and Others for the Assignment of N11 Codes	Reply	9/23/94
CC Docket No. 80-286	Amendment of Part 36 of the Commission's Rules and Establishment of a Joint Board	Reply	12/2/94
		Comments	9/12/95
		Reply	11/9/95
CC Docket No. 92-237	Administration of the North American Numbering Plan	Nomination	8/7/95
		Application	9/12/95
CC Docket No. 95-115	Amendment of the Commission's Rules and Policies to Increase Subscribership and Usage of the Public	Comments	9/27/95
		Reply	11/13/95

PROCEEDING	SUBJECT	TYPE	DATE
CC Docket No. 95-155	Toll Free Service Access Codes	Comments Reply	11/1/95 11/20/95
CCB-IAD 95-110	Telecommunications Access Provider Survey	Comments Reply	12/11/95 1/16/96
CC Docket No. 87-124	Access to Telecommunications Equipment and Services by Persons With Disabilities	Comments Reply	1/12/96 2/29/96
AAD 96-28	Rate of Return Inquiry	Comments Reply	3/11/96 4/15/96
CS Docket No. 96-46	Implementation of Section 302 of the Telecommunications Act of 1996	Comments Reply	4/1/96 4/11/96
CC Docket No. 96-45	Federal-State Joint Board on Universal Service	Comments Reply Comments	4/12/96 5/7/96 10/17/97
CC Docket No. 96-61	Policy and Rules Concerning the Interstate, Interexchange Marketplace	Reply	5/3/96
CC Docket No. 96-98	Implementation of the Local Competition Provisions in the Telecommunications Act of 1996	Comments Reply	5/16/96 6/3/96

PROCEEDING	SUBJECT	TYPE	DATE
CC Docket No. 96-112	Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services	Comments Reply	5/28/96 6/12/96
CC Docket No. 96-150	Accounting Safeguards Under the Telecommunications Act of 1996	Comments Reply	8/26/96 9/10/96
CC Docket No. 91-141 CCB-IAD File No. 98-102	Local Competition Survey	Comments Reply	6/8/98 6/22/98
CC Docket No. 98-81	1998 Biennial Regulatory Review - Review of Accounting and Cost Allocation Requirements	Reply	9/4/98
CC Docket No. 98-117	1998 Biennial Regulatory Review Review of ARMIS Reporting Requirements	Reply	9/4/98
CC Docket No. 98-166	Prescribing the Authorized Unitary Rate of Return for Interstate Services of Local Exchange Carriers	Comments	1/19/99 3/16/99
CC Docket No. 96-45 CC Docket No. 97-160	Federal-State Joint Board on Universal Service Forward-Looking Mechanism for High Cost Support for Non-Rural LECs	Comments Reply	7/23/99 8/6/99
CC Docket No. 98-147	Deployment of Wireline Services Offering Advanced Telecommunications Capability	Comments	9/24/99

PROCEEDING	SUBJECT	TYPE	DATE
CC Docket No. 98-137	1998 Biennial Regulatory Review - Review of Depreciation Requirements for Incumbent Local Exchange Carriers	Comments Reply	4/17/00 4/28/00

RICHARD B. LEE

APPEARANCES BEFORE REGULATORY AGENCIES

STATE	CLIENT	UTILITY	CASE	SUBJECT	TYPE	FILE DATE	CROSS DATE
CA	US Department Of Defense	All LECs	I.87-11-033 Phase III	IntraLATA Competition	Direct Reply	9/23/91 10/2/91	10/7/91 10/7/91
CA	US Department Of Defense	All LECs	I.87-11-033 Phase III	Rate Design	Direct Reply Suppl.	12/16/91 1/17/92 4/18/92	4/28/92 4/28/92 4/28/92
CO	US Department Of Defense	All LECs	92R-050T	Interconnection	Direct	8/20/92	8/31/92
WV	Consumer Advocate Division of WV PSC	C&P	90-424-T-PC	Cost Allocation	Direct Reply	10/6/92 12/18/92	1/14/93 1/14/93
CA	US Department Of Defense	Pacific Bell	A.92-05-004	Incentive Regulation	Direct Reply	4/8/93 5/5/93	6/9/93 6/9/93
DC	US Department Of Defense	C&P	926	Productivity	Direct	7/30/93	10/7/93

STATE	CLIENT	UTILITY	CASES	SUBJECT	TYPE	FILE DATE	CROSS DATE
NJ	US Department Of Defense	All LECs	TX90050349 TE92111047 TE93060211	IntraLATA Competition	Direct Reply	4/5/94 4/25/94	-- --
CT	Connecticut Resellers	Cellular Carriers	94-03-27	Financial Performance	Direct	--	6/7/94
NY	US Executive Agencies	Niagara Mohawk	94-E-0098 94-E-0099 94-G-0100	Incentive Regulation	Direct	8/31/94	10/26/94
DC	DC Office Of People's Counsel	Pepco	939	Productivity	Direct	1/17/95	3/17/95
GA	GA Public Service Commission	Southern Bell	5503-U	Cost Allocation	Direct Reply	1/27/95 4/14/95	2/14/95 4/25/95
HI	US Department Of Defense	GTE Hawaiian	94-0298	Rate Case	Direct	5/7/96	--
CANADA	AT&T Canada	Stentor Companies	96-8	Depreciation	Direct	8/27/96	11/5/96

STATE	CLIENT	UTILITY	CASE	SUBJECT	TYPE	FILE DATE	CROSS DATE
NJ	AT&T	Bell Atlantic	T096070519	Depreciation	Direct	9/18/96	10/3/96
MA	AT&T	New England Telephone	DPU96-80/81	Depreciation	Direct	10/11/96	--
NY	AT&T	New York Telephone	95-C-0657 94-C-0095 91-C-1174	Depreciation	Rebuttal	10/15/96	11/8/96
VA	AT&T	GTE	PUC960117	Depreciation	Direct	10/30/96	--
NJ	AT&T	All LECs	TX95120631	Depreciation	Direct Rebuttal	11/1/96 12/20/96	1/24/97 1/24/97
PA	AT&T/MCI	Bell Atlantic	A-310203F0002	Depreciation	Rebuttal Direct Surrebuttal	1/13/97 2/7/97 2/21/97	1/28/97 2/25/97 2/25/97
DE	AT&T/MCI	Bell Atlantic	96-324	Depreciation	Rebuttal	2/4/97	2/18/97
WY	AT&T	U S West	7200-TF-96-95 7000-TF-96-319	Depreciation	Direct	2/5/97	2/12/97

STATE	CLIENT	UTILITY	CASE	SUBJECT	TYPE	FILE DATE	CROSS DATE
WV	AT&T	Bell Atlantic	96-1516-T-PC 96-1561-T-PC 96-1009-T-PC 96-1533-T-T	Depreciation	Direct Rebuttal	2/13/97 2/20/97	2/27/97 2/27/97
MD	AT&T/MCI	Bell Atlantic	8731, Phase II	Depreciation	Direct	3/7/97	4/14/97
UT	AT&T/MCI	U S West	94-999-01	Depreciation	Direct Rebuttal Surrebuttal Sup. Surr.	3/19/97 3/31/97 4/23/97 5/2/97	5/13/97 5/13/97 5/13/97 5/13/97
DC	AT&T/MCI	Bell Atlantic	962	Depreciation	Direct Rebuttal	3/24/97 5/2/97	6/11/97 6/11/97
VA	AT&T/MCI	Bell Atlantic	970005	Depreciation	Affidavit Direct Rebuttal	4/7/97 4/23/97 6/10/97	6/27/97 6/27/97 6/27/97
HI	US Department Of Defense	GTE	7702	Depreciation	Direct Reply	7/03/97 8/28/97	10/22/97 10/22/97
LA	AT&T/MCI	Bell South	22022/22093	Depreciation	Direct	8/25/97	9/16/97

STATE	CLIENT	UTILITY	CASE	SUBJECT	TYPE	FILE DATE	CROSS DATE
ME	AT&T	Bell Atlantic	96-781	Depreciation	Direct Surrebuttal	9/15/97 12/22/97	1/20/98 1/20/98
TENN	AT&T/MCI	Bell South	97-01262	Depreciation	Direct	10/10/97 10/17/97	2/25/98 2/25/98
VT	AT&T	Bell Atlantic	5713	Depreciation	Direct Surrebuttal	10/30/97 12/4/97	12/11/97 12/11/97
KY	AT&T/MCI	BellSouth, GTE, CBT	360	Depreciation	Reply	11/4/97	--
PA	AT&T	GTE	A-310125F002 GTEN-11	Depreciation	Direct	11/13/97	--
NC	AT&T/MCI	BellSouth, GTE, Sprint	P-100, SUB133b	Depreciation	Direct	12/10/97 1/30/98	--
NC	AT&T/MCI	BellSouth, GTE, Sprint	P-100, SUB133d	Depreciation	Direct	12/15/97 3/9/98	--
OHIO	AT&T/MCI	CBT	96-899-TP-ALT	Depreciation	Direct Reply	12/17/97 12/23/98	3/22/99 3/22/99
LA	AT&T/MCI	BellSouth	U-20883 Subdocket A	Depreciation	Direct Reply	1/9/98 1/20/98	--

STATE	CLIENT	UTILITY	CASE	SUBJECT	TYPE	FILE DATE	CROSS DATE
OK	AT&T	SBC	970000213 970000442	Depreciation	Direct	1/12/98	--
MISS	AT&T	BellSouth	97-AD-544	Depreciation	Direct Reply	1/28/98 3/13/98	--
MISS	AT&T	BellSouth	98-AD-035	Depreciation	Direct Reply	2/23/98 3/6/98	--
TENN	AT&T	BellSouth, GTE, Sprint	9700888	Depreciation	Direct Reply	3/18/98 3/25/98	--
RI	AT&T	Bell Atlantic	2681	Depreciation	Direct Surrebuttal	6/30/98 12/11/98	1/7/99
AZ	U S Department Of Defense	U S West	T-01051B- 97-0689	Depreciation	Direct Suppl Surrebuttal Comments Suppl Direct Reply	7/13/98 7/15/98 8/17/98 10/30/98 4/2/99 2/7/00 2/22/00	11/13/98 11/13/98 11/13/98 11/13/98 4/27/99 2/28/00 2/28/00

STATE	CLIENT	UTILITY	CASE	SUBJECT	TYPE	FILE DATE	CROSS DATE
MICH	Michigan Cable Television Association	All	U-11016	Affiliate Transactions	Direct Reply	5/27/98 7/1/99	7/29/99 7/29/99
HI	U S Department of Defense	GTE	7702	Collocation and Nonrecurring Charges	Direct	6/2/00	
NY	AT&T/MCI	Bell Atlantic	98-C-1357	Depreciation	Reply	6/26/00	

Richard B. Lee

Attachment 3

Experience

Snavely King Majoros O'Connor & Lee, Inc. Washington, DC

Vice President (1996 to Present)
Senior Consultant (1991 to 1995)

Mr. Lee provides consulting services that reflect his depth of experience with regulated utilities. For over a quarter of a century, he has been extensively involved in regulatory financial and accounting matters.

Mr. Lee has provided expert witness testimony, technical assistance and strategic support to clients in state commission proceedings related to the telephone, cellular telephone and electric industries. His testimony has addressed such matters as intraLATA competition, rate design, interconnection, cost allocation, incentive regulation, productivity, and overall financial performance. Mr. Lee has also conducted a cost allocation and affiliate transaction audit of a major telephone company on behalf of its state commission.

Mr. Lee has assisted clients in proceedings before the Federal Communications Commission (FCC) related to integrated long distance service packages, enhanced services, expanded local exchange interconnection, open network architecture, intelligent networks, rate of return, depreciation, network reliability, incentive regulation, and video dialtone. Recently, Mr. Lee performed a study on plant writedowns in the U.S. telecommunications industry on behalf of the Canadian Radio-Television and Telecommunications Commission.

AT&T, Basking Ridge, NJ

Regulatory Vice President (1988-1990)
Division Manager (1980-1988)

Mr. Lee represented AT&T before the FCC in all financial and accounting matters. In this capacity, he directed the preparation of all financially related AT&T filings and coordinated the analysis of commission and intervenor responses. In addition, he was responsible for the periodic review of AT&T financial operating results and the development of related capital and expense forecasts.

Mr. Lee directed the design and implementation of AT&T's automated system for the reporting of financial information to the FCC. He also was responsible for the implementation of AT&T's manual for the separation of regulated and unregulated costs and the conversion of the company to the revised Uniform System of Accounts. His responsibilities included liaison with the FCC's audit staff and coordination of their activities with respect to AT&T. During his tenure, Mr. Lee brought scores of FCC investigations involving many billions of dollars to equitable conclusions.

Mr. Lee participated in the strategic development of price cap incentive regulation proposals and performed numerous related financial analyses. He also conceived and developed a methodology which reduced the administrative burden of AT&T's depreciation filings by over 90%.

Prior to divestiture, Mr. Lee coordinated all Bell System depreciation filings, rate of return pleadings and interstate rate cases. He was responsible for securing FCC approval of the accounting entries which implemented the Modified Final Judgment.

New York Telephone Company New York, NY

District Manager (1970-1980)
Accounting Manager (1963-1970)

Mr. Lee held a variety of progressively responsible positions leading to his selection as the Company's accounting representative before the New York Public Service Commission. In this capacity, he participated in numerous general rate cases and related proceedings.

In an earlier assignment, Mr. Lee directed an inter-departmental study of the company's "Lost Telephone Set" problem. The study resulted in both operational improvements and major strategy changes by the company.

While in a rotational assignment to AT&T, Mr. Lee developed a cost accounting and productivity measurement system that was implemented in all Bell System Comptrollers Departments.

Mr. Lee also managed numerous line organizations of up to 200 persons responsible for billing and collection, property and cost and data processing functions.

Education

Yale University, B.S. (High Honors)
Harvard Business School, MBA (Distinction)

Professional Affiliations

Society of Depreciation Professionals

U S WEST Intrastate Revenue Requirements
Test Year Ended December 31, 1999
$(000)

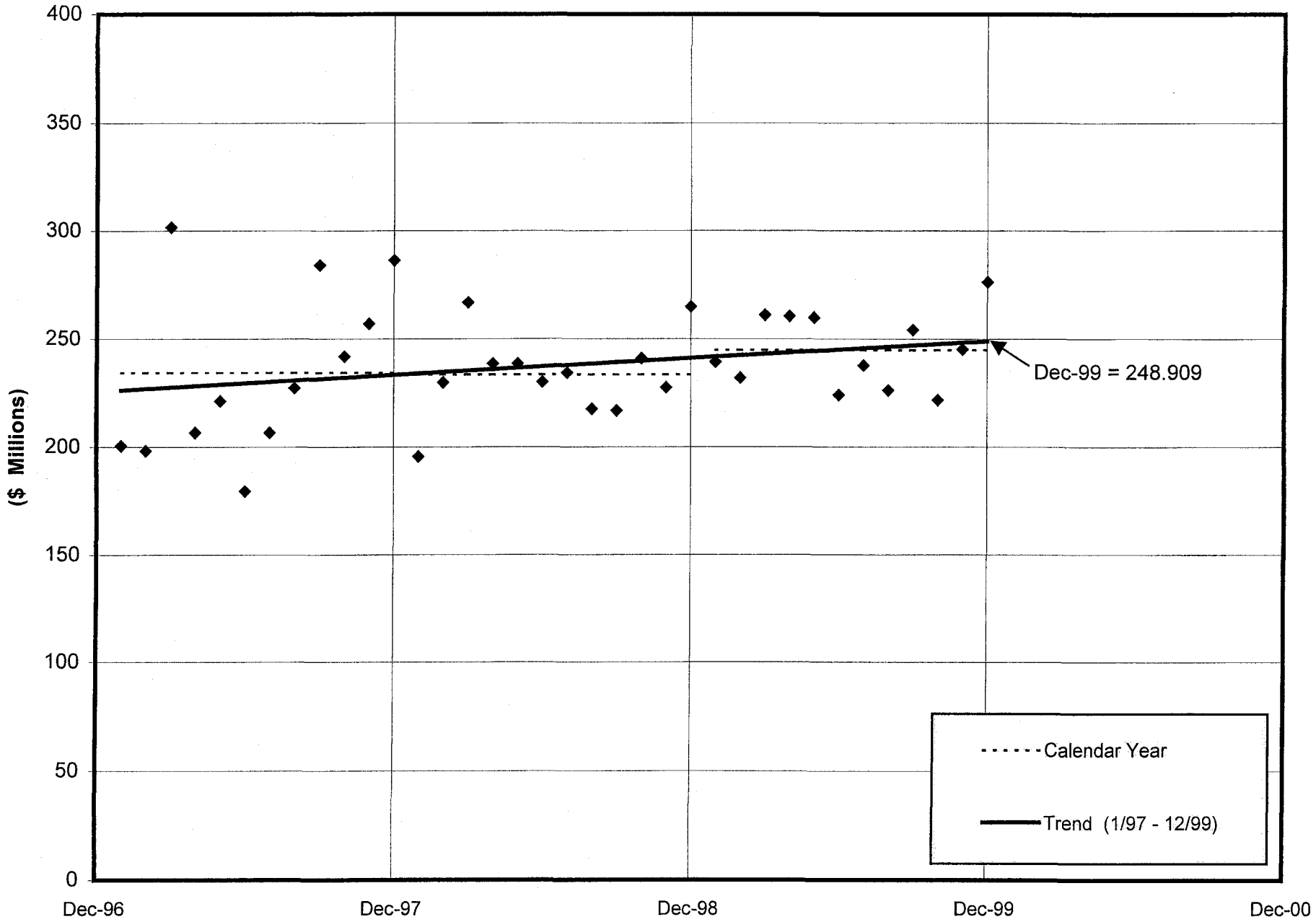
		U S WEST Test Year (a)	DOD / FEA Test Year Adjustments (b=c - a)	Adjusted Test Year (c)
1.	Adjusted Rate Base	$1,422,099	($283,247)	$1,138,852
2.	Adjusted Net Operating Income	$43,822	$99,673	$143,495
3.	Current Rate of Return (L2 / L1)	3.08%	9.52%	12.60%
4.	Required Operating Income (L1 x L5)	$154,430	($45,792)	$108,638
5.	Required Rate of Return	10.86%	-1.32%	9.54%
6.	Operating Income Deficiency (L4 - L2)	$110,608	($145,464)	($34,856)
7.	Gross Revenue Conversion Factor	1.7056	1.7056	1.7056
8.	Increase in Revenue Requirement (L6 x L7)	$188,654	($248,100)	($59,446)
9.	BellCore 3 Year Revenue Requirement	($686)	$0	($686)
10.	Automatic Adj. Revenue Requirement	$13,252	$0	$13,252
11.	Increase in Gross Revenue Requirement (L8 + L9 + l10)	$201,220	($248,100)	($46,880)

Sources: Col. a = GAR-S1
Col. c = Attachment 5.

DOD/FEA Test Year Adjustment Summary
$(000)

		U S WEST Test Year (a)	Adj. 1 Customer Operations (b)	Adj. 2 Corporate Operations (c)	Adj. 3 FCC Deregulated Services (d)	Adj. 4 Directory Advertising (e)	Adj. 5 Productivity Adjustment (f)	Adj. 6 Depreciation Adjustment (g)	Adj. 7 Rate of Return Adjustment (h)	Adjusted Test Year (i=Sum(a..h))
1.	Adjusted Rate Base	1,422,099	_	_	(29,021)	-	-	(254,226)	-	1,138,852
2.	Adjusted Net Operating Income	43,822	12,038	6,870	4,474	25,010	15,036	36,245	-	143,495
3.	Current Rate of Return	3.08%	-	-	-	-	-	-	-	12.60%
4.	Required Operating Income	154,430	-	-	(3,151)	-	-	(27,607)	(15,033)	108,638
5.	Required Rate of Return	10.86%	-	-	-	-	-		-1.32%	9.54%
6.	Operating Income Deficiency	110,608	(12,038)	(6,870)	(7,625)	(25,010)	(15,036)	(63,852)	(15,033)	(34,856)
7.	Gross Revenue Conversion Factor	1.7056	1.7056	1.7056	1.7056	1.7056	1.7056	1.7056	1.7056	1.7056
8.	Increase in Gross Revenue Requirements	188,654	(20,531)	(11,716)	(13,004)	(42,657)	(25,646)	(108,906)	(25,640)	(59,446)
9.	Three Year Revenue Requirement	(686)	-	-	-	-	-		-	(686)
10.	Adjustment to Revenue Requirements	13,252								13,252
11.	Total Increase in Revenue Requirement	201,220	(20,531)	(11,716)	(13,004)	(42,657)	(25,646)	(108,906)	(25,640)	(46,880)
	Source	GAR-S1	Att. 6	Att. 7	Att. 8	Att. 9	Att. 10	Att. 11	Att. 12	

Annualized Customer Operations Expenses



Customer Operations Expense Trend Data

YR / MO	Customer Operations a	Annualized b = 12a	Annualized (for graph)
Dec-96			
Jan-97	16,720,443	200,645,316	201
Feb-97	16,520,764	198,249,168	198
Mar-97	25,143,173	301,718,076	302
Apr-97	17,223,713	206,684,556	207
May-97	18,429,500	221,154,000	221
Jun-97	14,963,836	179,566,032	180
Jul-97	17,229,120	206,749,440	207
Aug-97	18,938,783	227,265,396	227
Sep-97	23,682,508	284,190,096	284
Oct-97	20,161,619	241,939,428	242
Nov-97	21,422,517	257,070,204	257
Dec-97	23,864,705	286,376,460	286
Jan-98	16,300,196	195,602,352	196
Feb-98	19,157,246	229,886,952	230
Mar-98	22,238,304	266,859,648	267
Apr-98	19,880,682	238,568,184	239
May-98	19,883,789	238,605,468	239
Jun-98	19,172,672	230,072,064	230
Jul-98	19,524,349	234,292,188	234
Aug-98	18,131,637	217,579,644	218
Sep-98	18,069,367	216,832,404	217
Oct-98	20,093,087	241,117,044	241
Nov-98	18,957,780	227,493,360	227
Dec-98	22,069,756	264,837,072	265
Jan-99	19,949,677	239,396,124	239
Feb-99	19,330,094	231,961,128	232
Mar-99	21,757,953	261,095,435	261
Apr-99	21,709,291	260,511,491	261
May-99	21,649,037	259,788,438	260
Jun-99	18,672,400	224,068,806	224
Jul-99	19,809,729	237,716,744	238
Aug-99	18,848,829	226,185,946	226
Sep-99	21,181,252	254,175,028	254
Oct-99	18,477,937	221,735,247	222
Nov-99	20,438,169	245,258,029	245
Dec-99	23,020,939	276,251,272	276

1997	234,300,681
1998	233,478,865
1999	244,845,307

Source: US WEST Responses to UTI 4-3 and UTI 42-3.

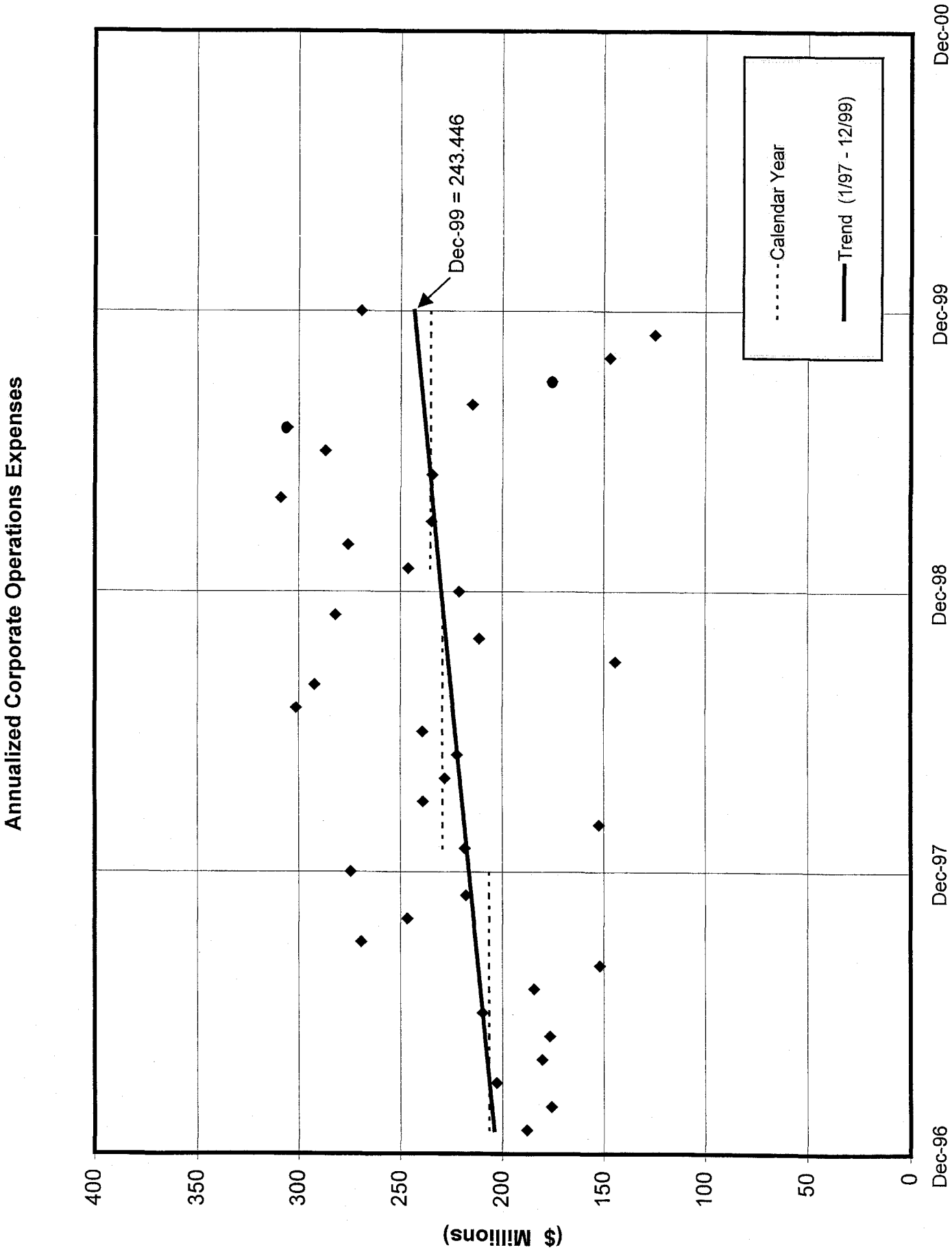
DOD/FEA Test Year Adjustment 1
Customer Operations Expenses
$(000)

1.	**USW-AZ Customer Operations Expense Level - 12/31/99** (Attachment 6, p. 1)	**248,909**
2.	**Intrastate Regulated Factor** (RUCO 22-1, Attachment A, WP1-AZ Factor, Col. i)	**0.7770**
3.	**Regulated Intrastate** (L1 x L2)	**193,402**
4.	**Less: FCC Deregulated** (RUCO 22-1, Attachment A, WP1-AZ Factor, Col. e)	**26,493**
5.	**Add: Payphones & Wireless** (RUCO 22-1, Attachment A, WP1-AZ Factor, Col. f)	**12,056**
6.	**Intrastate Expense** (L3 - L4 + L5)	**178,965**
7.	**US West Estimate** (UTI 42-1, WP10-AZ EopNib(PA), Col. S)	**199,095**
8.	**Expense Adjustment** (L6 - L7)	**(20,130)**

DOD/FEA Test Year Adjustment 1
Customer Operations Expenses
$(000)

Operating Revenue	-
Operating Expenses	(20,130)
Total Operating Income Taxes	8,092
Net Operating Income	12,038
Rate Base	-
Revenue Requirements	(20,531)

This adjustment revises test year Customer Operations Expense.


Annualized Corporate Operations Expenses
($ Millions)
400
350
300
250
200
150
100
50
0
Dec-96
Dec-97
Dec-98
Dec-99
Dec-00
Dec-99 = 243.446
Calendar Year
Trend (1/97 - 12/99)

Corporate Operations Expense Trend Data

YR / MO	Corporate Operations a	Annualized b = 12a	Annualized (for graph)
Dec-96			
Jan-97	15,672,883	188,074,596	188
Feb-97	14,652,942	175,835,304	176
Mar-97	16,900,272	202,803,264	203
Apr-97	15,034,699	180,416,388	180
May-97	14,718,728	176,624,736	177
Jun-97	17,490,737	209,888,844	210
Jul-97	15,372,710	184,472,520	184
Aug-97	12,671,508	152,058,096	152
Sep-97	22,446,203	269,354,436	269
Oct-97	20,558,302	246,699,624	247
Nov-97	18,166,327	217,995,924	218
Dec-97	22,885,668	274,628,016	275
Jan-98	18,216,069	218,592,828	219
Feb-98	12,712,523	152,550,276	153
Mar-98	19,927,301	239,127,612	239
Apr-98	19,032,551	228,390,612	228
May-98	18,525,663	222,307,956	222
Jun-98	19,936,508	239,238,096	239
Jul-98	25,107,922	301,295,064	301
Aug-98	24,356,943	292,283,316	292
Sep-98	12,038,740	144,464,880	144
Oct-98	17,619,974	211,439,688	211
Nov-98	23,499,777	281,997,324	282
Dec-98	18,435,694	221,228,328	221
Jan-99	20,515,902	246,190,824	246
Feb-99	22,983,839	275,806,068	276
Mar-99	19,565,256	234,783,066	235
Apr-99	25,735,624	308,827,491	309
May-99	19,558,691	234,704,291	235
Jun-99	23,920,697	287,048,360	287
Jul-99	25,485,663	305,827,958	306
Aug-99	17,908,222	214,898,663	215
Sep-99	14,640,590	175,687,081	176
Oct-99	12,250,854	147,010,242	147
Nov-99	10,406,925	124,883,099	125
Dec-99	22,449,999	269,399,987	269

1997	206,570,979
1998	229,409,665
1999	235,422,261

Source: US WEST Responses to UTI 4-3 and UTI 42-3.

DOD/FEA Test Year Adjustment 2
Corporate Operations Expenses
$(000)

1.	**USW-AZ Corporate Operations Expense Level - 12/31/99** (Attachment 7, p. 1)	**243,446**
2.	**Intrastate Regulated Factor** (RUCO 22-1, Attachment A, WP1-AZ Factor, Col. i)	**0.7922**
3.	**Regulated Intrastate** (L1 x L2)	**192,858**
4.	**Less: FCC Deregulated** (RUCO 22-1, Attachment A, WP1-AZ Factor, Col. e)	**26,416**
5.	**Add: Payphones & Wireless** (RUCO 22-1, Attachment A, WP1-AZ Factor, Col. f)	**5,848**
6.	**Intrastate Expense** (L3 - L4 + L5)	**172,290**
7.	**US West Estimate** (UTI 42-1, WP10-AZ EopNib(PA), Col. S)	**183,778**
8.	**Expense Adjustment** (L6 - L7)	**(11,488)**

DOD/FEA Test Year Adjustment 2
Corporate Operations Expenses
$(000)

Operating Revenue	-
Operating Expenses	(11,488)
Total Operating Income Taxes	4,618
Net Operating Income	6,870
Rate Base	-
Revenue Requirements	(11,716)

This adjustment revises test year Corporate Operations Expense.

DOD/FEA Test Year Adjustment 3
Services Deregulated By FCC
$(000)

		FCC Deregulated Services (a)	1/2 FCC Deregulated Services (b = a / 2)
1.	Revenues	102,104	51,052
2.	Expenses	117,065	58,533
3.	Rate Base	58,042	29,021

Source: Col. a = U S WEST's Response to DOD 4-7.

DOD/FEA Test Year Adjustment 3
Services Deregulated By FCC
$(000)

Operating Revenue	(51,052)
Operating Expenses	(58,533)
Total Operating Income Taxes	3,007
Net Operating Income	4,474
Rate Base	(29,021)
Revenue Requirements	(13,004)

This adjustment reflects half of the impact of services deregulated by the FCC on the test year.

DOD/FEA Test Year Adjustment 4
Directory Advertising
$(000)

Operating Revenue	42,657
Operating Expenses	834
Total Operating Income Taxes	16,813
Net Operating Income	25,010
Rate Base	-
Revenue Requirements	(42,657)

This adjustment imputes directory advertising revenue to the test year.

DOD/FEA Test Year Adjustment 5
Productivity
$(000)

1.	Test Year Expenses	
a.	Maintenance	$266,053
b.	Engineering/ Network/ Access/ Other	75,609
c.	Customer Operations	190,243
d.	Corporate Operations	186,490
e.	Total (Sum L1a - L1d)	$718,395
2.	1994-1998 Average Productivity	3.5%
3.	Estimated Expense Reduction (L1e x L2)	$25,144

Source Line 1 = GAR-5, p.1, col. e.
Line 2 = GAR-12.

DOD/FEA Test Year Adjustment 5
Productivity
$(000)

Operating Revenue	0
Operating Expenses	(25,144)
Total Operating Income Taxes	10,108
Net Operating Income	15,036
Rate Base	-
Revenue Requirements	(25,646)

This adjustment reflects expected productivity improvement.

DOD/FEA TEST YEAR ADJUSTMENT 6
DEPRECIATION
($000)

Account Number	Account Name or Subclass of Plant	Intrastate Investment 12/31/99 (a)	Change In Accruals Annual (b)	Change In Accruals 3 Year (c=3*b)	12/31/99 Reserve (d)	Adjusted Reserve (e=c+d)	Reserve Percent (f=e/a)
2112	Motor Vehicles	47,502	(2,308)	(6,924)	34,912	27,988	58.9%
2114	Spec Purpose Vehicles	18	1	3	0	3	16.7%
2115	Garage Work Equipment	961	90	270	(684)	(414)	-43.1%
2116	Other Work Equipment	15,891	1,851	5,553	2,269	7,822	49.2%
2121	Buildings	115,383	(476)	(1,428)	39,573	38,145	33.1%
2122	Furniture	1,208	174	522	(20)	502	41.6%
2123.1	Ofc. Support Eqpt	3,883	610	1,830	1,649	3,479	89.6%
2123.2	Company Communications Eqpt	1,040	(728)	(2,184)	1,594	(590)	-56.7%
2124	Gen. Purpose Computers	79,409	(10,237)	(30,711)	67,857	37,146	46.8%
2211	Analog Switching Equipment	110,824	16,400	49,200	47,604	96,804	87.3%
2212	Digital Switching Equipment	655,053	15,529	46,587	278,255	324,842	49.6%
2220	Operator Systems	6,498	0 *	0	4,187	4,187	64.4%
2231	Radio Systems	23,571	(895)	(2,685)	19,450	16,765	71.1%
2232.1	Circuit DDS	5,667	(663)	(1,989)	6,006	4,017	70.9%
2232.2	Circuit Digital	752,751	6,040	18,120	395,804	413,924	55.0%
2232.3	Circuit Analog	32,631	(3,906)	(11,718)	31,098	19,380	59.4%
2351	Public Telephone Terminal Eqpt.	17,969	(181)	(543)	8,792 **	8,249	45.9%
2362	Other Terminal Equipment	40,092	(1,000)	(3,000)	21,273	18,273	45.6%
2411	Pole Lines	34,403	125	375	27,203	27,578	80.2%
2421.1	Aerial Cable - Metallic	121,417	2,419	7,257	94,889	102,146	84.1%
2421.2	Aerial Cable - Nonmetallic	4,563	33	99	1,303	1,402	30.7%
2422.1	Underground Cable - Metallic	257,054	7,936	23,808	160,771	184,579	71.8%
2422.2	Underground Cable - Nonmetallic	64,194	2,310	6,930	24,788	31,718	49.4%
2423.1	Buried Cable - Metallic	927,241	50,736	152,208	414,376	566,584	61.1%
2423.2	Buried Cable - Nonmetallic	12,727	171	513	4,860	5,373	42.2%
2424.1	Submarine Cable - Metallic	2	2	0	0	0	-
2424.2	Submarine Cable - Nonmetallic	0	0	0	0	0	-
2426.1	Intrabldg Cable - Metallic	30,275	(197)	(591)	22,912	22,321	73.7%
2426.2	Intrabldg Cable - Nonmetallic	429	3	9	177	186	43.4%
2431	Aerial Wire	6,494	504	1,512	2,117	3,629	55.9%
2441	Conduit Systems	225,140	401	1,203	54,795	55,998	24.9%
	Total	3,594,290	84,744	254,226	1,767,810	2,022,036	56.3%

Source: Col. a = Wu Testimony, 5/3/00, Exhibit KDW-2, p.1, Col A.
Col. b = Wu Testimony, 5/3/00, Exhibit KDW-1, p.4, Col P.
Col. d = Response to WDA 21-001, Attachment D.

* Assumes no accruals since 1/1/97.
** 12/31/97 Reserve, WU Testimony, 5/3/00, Exhibit KDW 1, p. 5, Col. B.

DOD/FEA TEST YEAR ADJUSTMENT 6
DEPRECIATION
($000)

Account Number	Account Name or Subclass of Plan	Reserve Percent (a)	Future Net Salvage Percent (b)	Average Remaining Life (c)	Remaining Life Rate (d= (100-a-b)/c)	Intrastate Investment 12/31/99 (e)	Test Period Accruals (f=d*e)
2112	Motor Vehicles	58.9%	16%	3.6	7.0%	47,502	3,325
2114	Spec Purpose Vehicles	16.7%	0%	7.3	11.4%	18	2
2115	Garage Work Equipment	-43.1%	-4%	9.7	15.2%	961	146
2116	Other Work Equipment	49.2%	7%	5.7	7.7%	15,891	1,224
2121	Buildings	33.1%	-6%	25.5	2.9%	115,383	3,346
2122	Furniture	41.6%	0%	4.8	12.2%	1,208	147
2123.1	Ofc. Support Eqpt	89.6%	0%	3.0	3.5%	3,883	136
2123.2	Company Communications Eqpt	-56.7%	0%	3.7	42.4%	1,040	441
2124	Gen. Purpose Computers	46.8%	5%	2.1	23.0%	79,409	18,264
2211	Analog Switching Equipment	87.3%	0%	*	*	110,824	14,020
2212	Digital Switching Equipment	49.6%	3%	5.1	9.3%	655,053	60,920
2220	Operator Systems	64.4%	-3%	5.2	7.4%	6,498	481
2231	Radio Systems	71.1%	-2%	5.9	5.2%	23,571	1,226
2232.1	Circuit DDS	70.9%	3%	3.8	6.9%	5,667	391
2232.2	Circuit Digital	55.0%	2%	5.1	8.4%	752,751	63,231
2232.3	Circuit Analog	59.4%	0%	3.1	13.1%	32,631	4,275
2351	Public Telephone Terminal Eqpt.	45.9%	30%	3.6	6.7%	17,969	1,204
2362	Other Terminal Equipment	45.6%	2%	6.3	8.3%	40,092	3,328
2411	Pole Lines	80.2%	-138%	25.3	6.2%	34,403	2,133
2421.1	Aerial Cable - Metallic	84.1%	-27%	5.1	8.4%	121,417	10,199
2421.2	Aerial Cable - Nonmetallic	30.7%	-27%	10.6	9.1%	4,563	415
2422.1	Underground Cable - Metallic	71.8%	-6%	5.6	6.1%	257,054	15,680
2422.2	Underground Cable - Nonmetallic	49.4%	-6%	6.0	9.4%	64,194	6,034
2423.1	Buried Cable - Metallic	61.1%	-7%	5.6	8.2%	927,241	76,034
2423.2	Buried Cable - Nonmetallic	42.2%	-7%	10.2	6.4%	12,727	815
2424.1	Submarine Cable - Metallic	0.0%	0%	0.5	200.0%	2	4
2424.2	Submarine Cable - Nonmetallic	0.0%	0%	0.0	0.0%	0	0
2426.1	Intrabldg Cable - Metallic	73.7%	0%	7.7	3.4%	30,275	1,029
2426.2	Intrabldg Cable - Nonmetallic	43.4%	0%	6.2	9.1%	429	39
2431	Aerial Wire	55.9%	-30%	5.6	13.2%	6,494	857
2441	Conduit Systems	24.9%	-20%	41.3	2.3%	225,140	5,178
	Total					3,594,290	294,524
	US WEST (Wu Testimony, Exhibit KDW-2, p.1, Col. E)						355,134
	Adjustment						(60,610)

Source: Col. a = Attachment 11, p. 1
Col. b = Wu Testimony, 5/3/00, Exhibit KDW-1, p.5, Cols E & G.
Col. c = Response to WDA 21-151.

* AYFR = Year 2000 (Accruals = Investment - Reserve)

DOD/FEA TEST YEAR ADJUSTMENT 6
DEPRECIATION
($000)

Operating Revenues	0
Operating Expenses	(60,610)
Total Operating Income Taxes	24,365
Net Operating Income	36,245
Rate Base	(254,226)
Revenue Requirements	(108,906)

This adjustment revises U S West's estimate of the end of period depreciation expense and rate base.

DOD/FEA Test Year Adjustment 7
Rate of Return
$(000)

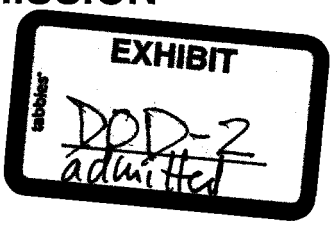
1.	U S WEST Rate of Return (GAR-S1)	10.86%
2.	DOD/FEA Rate of Return (King Testimony)	9.54%
3.	Reduction to Rate of Return (L1 - L2)	1.32%
4.	Adjusted Rate Base (Attachment 5)	$1,138,852
5.	Reduction in Required Earnings (L3 x L4)	$15,033

DOD/FEA Test Year Adjustment 7
Rate of Return
$(000)

Operating Revenue	-
Operating Expenses	-
Total Operating Income Taxes	-
Net Operating Income	15,033
Rate Base	-
Revenue Requirements	(25,640)

This adjustment reflects a 9.54 percent required rate of return.

BEFORE THE ARIZONA CORPORATION COMMISSION



CARL J. KUNASEK
Chairman
JIM IRVIN
Commissioner
WILLIAM A. MUNDELL
Commissioner

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-01051B-99-0150**

DIRECT TESTIMONY
of

CHARLES W. KING

On behalf of

THE UNITED STATES DEPARTMENT OF DEFENSE
And
ALL OTHER FEDERAL EXECUTIVE AGENCIES

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INTRODUCTION

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

A. My name is Charles W. King. I am President of the economic consulting firm of Snavely King Majoros O'Connor & Lee, Inc. ("Snavely King"). My business address is 1220 L Street, N.W. Suite 410, Washington, D.C. 20005.

Q. PLEASE DESCRIBE SNAVELY KING.

A. Snavely King, formerly Snavely, King & Associates, Inc., was founded in 1970 to conduct research on a consulting basis into the rates, revenues, costs, and economic performance of regulated firms and industries. The firm has a professional staff of 12 economists, accountants, engineers and cost analysts. Most of its work involves the development, preparation and presentation of expert witness testimony before Federal and state regulatory agencies. Over the course of its 30-year history, members of the firm have participated in over 500 proceedings before almost all of the state commissions and all Federal commissions that regulate utilities or transportation industries.

Q HAVE YOU ATTACHED A DESCRIPTION OF YOUR BACKGROUND AND EXPERIENCE?

A. Yes. Attachment A to this testimony is a one-page resume of my professional background and experience.

Q. HAVE YOU PREVIOUSLY TESTIFIED IN REGULATORY PROCEEDINGS?

1 A. Yes. I have testified on over 300 separate occasions before 35 state and nine
2 federal regulatory commissions in the United States and Canada. Attachment B is
3 a listing of these appearances.

4 **Q. FOR WHOM ARE YOU APPEARING IN THIS PROCEEDING?**

5 A. I am appearing on behalf of the United States Department of Defense and all other
6 Federal Executive Agencies ("DOD/FEA").

7 **Q. WHAT IS DOD/FEA'S INTEREST IN THIS PROCEEDING?**

8 A. As a user of the telecommunications services provided by US WEST
9 Communications, Inc ("US WEST"), DOD/FEA's interest is in the maintenance of just
10 and reasonable rates.

11 **Q. WAS THIS TESTIMONY PREPARED BY YOU OR UNDER YOU DIRECT**
12 **SUPERVISION?**

13 A. Yes. It was.

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

15 A The purpose of my testimony is to recommend a fair rate of return to be applied to
16 the rate base for US WEST's Arizona intrastate operations. Since US WEST has
17 presented its version of a fair rate of return through the testimony of Peter C.
18 Cummings, much of my testimony responds to the positions stated in Mr. Cummings'
19 testimony.

Q PLEASE SUMMARIZE YOUR FINDINGS.

A. I find that a fair rate of return on the original cost rate base for US WEST's Arizona intrastate operations is 9.54 percent. When applied to the fair value rate base, this return should be adjusted to produce the same dollar amount of return.

I. CAPITAL STRUCTURE AND COST OF DEBT

Q. WHAT CAPITAL STRUCTURE IS APPROPRIATE FOR US WEST'S ARIZONA INTRASTATE OPERATIONS?

A. In his Supplemental Direct Testimony, US WEST witness Peter Cummings has updated US WEST's capital structure to February, 2000. He states that the updated capital structure is 47.6% debt and 52.78% equity.

Q. HOW DOES THE PURCHASE OF US WEST BY QWEST COMMUNICATIONS INTERNATIONAL AFFECT US WEST'S CAPITAL STRUCTURE?

A. In the short term at least, the merger with Qwest does not affect US WEST's capital structure. That is because Qwest is retaining US WEST as a stand-alone subsidiary with its own balance sheet. The capital structure is drawn from the liabilities side of that balance sheet.

Q. WHAT IS THE COST OF US WEST'S DEBT?

A. In his Supplemental Testimony, Mr. Cummings also updated US WEST's embedded debt cost to 7.39%.

II. THE COST OF EQUITY

Q. WHAT IS THE BASIS FOR FINDING A RATE OR RETURN TO THE EQUITY COMPONENT OF THE CAPITAL DEVOTED TO US WEST'S ARIZONA INTRASTATE OPERATIONS

A. In its landmark Hope Natural Gas decision, the United States Supreme Court established the following standards for the return to equity that must be allowed a regulated public utility:

> ...the return to the equity owner should be commensurate with the returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.[1]

It can be seen from this excerpt that there are essentially three standards for determining an appropriate return to equity. The first is the "comparable earnings" standard, that the earnings must be "commensurate with the returns on investments in other enterprises having corresponding risks." The second is that they must be sufficient to assure "the financial integrity of the enterprise," and the third is that they must allow the utility to be able to attract capital.

Q. HOW CAN THE COMPARABLE EARNINGS STANDARD BE APPLIED IN ESTIMATING THE RATE OF RETURN TO EQUITY CAPITAL?

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[1] Federal Power Commission et. al. vs. Hope Natural Gas Company, 320 U.S. 592, at 603.

A. There is a certain circularity to the comparable earnings standard because the competitive nature of the capital markets virtually ensures that the returns to all enterprises having corresponding risks are comparable with each other. Investors establish the price of each traded stock based on that stock's present and prospective earnings in comparison with the present and prospective earnings of all other stocks and other investments available to them. If the earnings of a firm are depressed, then investors will pay only a low price for that firm's stock. As a result, their return on the market value of that stock will be comparable to the return on the market value of the stock of other highly profitable companies which, as a consequence of their profitability, have been bid up to a very high price. Thus, if "return" is defined as the earnings of an equity investment relative to its current market price, then the comparable earnings test becomes a cipher. All returns are comparable with all other returns.

In public utility regulation the conventional procedure for resolving this circularity is to identify the required equity return based on the market value of a utility's stock. That return is combined with the cost of debt, using either the actual or a hypothetical minimum-cost capital structure. The blended return to total capital is then applied to a rate base reflective of the book value of the utility's investment. The book value is the accountant's quantification of the original cost of the utility's assets adjusted for ratepayer contributions such as deposits and deferred taxes. Under this procedure, the market price of a stock is used only to determine the return that investors expect from that stock. That expectation is then applied to the book value of the utility's investment to identify the level of earnings which regulation will allow the utility's common shareholders to recover.

In Arizona, there is a mechanism to adjust the rate base for the growth in value of

the investment due to the effect of dollar inflation. However, since the rates of return for both equity and debt already incorporate an allowance for the risk of inflation, any application of market-based returns to the "fair value" rate base results in a double count of the effect of inflation. This is why the Commission is correct in its practice of adjusting the rate of return applicable to the fair value rate base so that the return allowance is the same as when the unadjusted rate of return is applied to the rate base valued at original cost.

Q. HOW CAN THE FINANCIAL INTEGRITY AND CAPITAL ATTRACTION STANDARDS BE APPLIED IN ESTIMATING THE RATE OF RETURN TO EQUITY CAPITAL?

A. If US WEST can earn a return on its investment comparable to that required by its own shareholders and by shareholders of companies of comparable risk, then it should have no difficulty in attracting capital and maintaining credit. Investors would have no reason to shun US WEST in favor of other investment opportunities. Thus, if the comparable earnings test is met, then the financial integrity and capital attraction standards are also met as well.

Q. WHAT ARE COMPANIES OF COMPARABLE RISK TO US WEST?

A. The companies with business risks most comparable to US WEST are those in the same business as US WEST, that is, local exchange and intraLATA toll telephone service and toll access service. Obviously, these are other telephone companies. Within this category, the companies most comparable are the Regional Bell Holding Companies ("RBHCs"), of which US WEST is one. These are the "Baby Bells" that were spun off from the Bell System when that system was broken up on January 1,

1984.

Originally there were seven Baby Bells, but they have since collapsed into four following the merger of Pacific Telesis and Ameritech into Southwestern Bell and NYNEX into Bell Atlantic. Within the past two months, the identity of even these four has been further blurred by the merger of Bell Atlantic and GTE and by the acquisition of US WEST by Qwest Communications International. Of the original seven Baby Bells, only Bell South remains in its original form, unaffected by merger activity.

Some other companies might also be considered as comparable to the US WEST in terms of investor-perceived risk. GTE might have been a leading candidate except that it has just merged into Bell Atlantic. The new company, Verizon, is therefore a blend of these two predecessor companies. The United and Central telephone companies might be suitable for comparison were they not owned by Sprint, which is best known to the public -- including the investing public -- as a long-distance and wireless carrier. The remaining independents, Frontier, Aliant, Cincinnati Bell, and Citizens, all have long-distance, CLEC[2] and cellular activities that set them apart from US WEST. They are also much smaller than the US WEST, so that their inclusion would require some sort of weighting process to recognize their relative position in the telephone industry.

Beyond the telephone industry, the most comparable companies to US WEST are found in the electric utility industry. They, too, are traditional regulated utilities with geographically defined franchise areas that are now experiencing growing

[2]Competitive Local Exchange Carrier

competition and considerable industry restructuring. Like US WEST, many electric utilities are venturing into related competitive activities, and they are often targets for merger and acquisition.

Q. DID MR. CUMMINGS ALSO USE LISTS OF COMPANIES THAT HE CLAIMS HAVE RISKS COMPARABLE TO US WEST?

A. Yes. Mr. Cummings compared US WEST with the RBHCs, as I propose to do. He also surveyed 9000 firms in Standard & Poor's Computstat data base for two criteria that he claims equate them to US WEST in terms of risk: an S&P bond rating of A+ or greater and cash flow variability similar to US WEST. In his initial testimony, he identified 20 companies, and in his supplemental testimony 30 companies, that he believes to be comparable in risk to US WEST.

Q. DO YOU AGREE THAT THE TWO CRITERIA USED BY MR. CUMMINGS EFFECTIVELY IDENTIFY COMPANIES OF COMPARABLE RISK TO US WEST?

A. No. The first criterion, an S&P A+ rating or better, suggests companies that have comparable debt risk, not comparable equity risk. A company with a high degree of business risk can minimize its debt risk by maintaining a relatively small amount of debt. US WEST maintains over 45 percent of its capitalization in the form of debt, which is higher than most industrial companies with comparable S&P bond ratings, but lower than most electric or gas utilities. The differences in capital structure alone make the "comparable" companies dissimilar to US WEST in terms of equity risk.

The second criterion, variability of cash flow, fails to consider the relation of cash flow to fixed costs. A company with a much lower proportion of fixed costs than US

WEST, but with the same cash flow variability, will enjoy a much lower level of risk. Conversely, a company with a greater fixed cost obligation will experience greater risk.

The greatest difference, however, lies in the nature of the businesses in which most of his comparison companies are engaged. Unlike US WEST, the industrial companies in his comparison group do not produce products or services that are so vested with the public interest that they require governmental price regulation. Nor do any of these industrial enterprises operate in geographically designated markets where they enjoy government-condoned monopoly pricing power. Thus, while these industrial enterprises may retrospectively have experienced earnings variability similar to US WEST, none of them can look forward to continued earnings stability with anything like the confidence of US WEST. Mr. Cummings' selection reflects the variability of cash flow between 1989 through 1997. Investors' perception of risk is prospective, specifically whether cash flow will continue to be stable in the future.

Q. ARE THERE ANY COMPANIES IN MR. CUMMINGS' LISTs THAT ARE COMPARABLE TO US WEST?

A. Yes, as noted, electric utilities are similar in risk to US WEST. In Exhibit PCC-6, Mr. Cummings listed four electric utilities -- Consolidated Edison, DPL Inc., FPL Group, IPALCO Enterprises -- which, according to Mr. Cummings, had an average DCF equity cost of 8.5 percent. In Exhibit PCC-04, Mr. Cummings dropped Consolidated Edison and added Duke Energy, Northern States Power, OGE Energy and Otter Tail Power. As computed by Mr. Cummings, these seven electric utilities showed an average DCF equity return of 12.0 percent, compared with 14.0 percent for the full list of 30 companies. I suspect that the relatively greater confidence in the future

cash flow of utilities relative to industrial enterprises accounts for these lower equity costs.

Q. HOW WILL YOU IDENTIFY THE MARKET-DETERMINED RATE OF RETURN TO THE EQUITY CAPITAL INVESTMENT IN US WEST'S ARIZONA OPERATIONS?

A. I shall first apply the Discounted Cash Flow ("DCF") procedure, which I consider to be the most accurate test of a market return. I shall then consider the Capital Asset Pricing Model, discuss its conceptual and measurement problems, and assess its value in measuring the relative riskiness of different companies. In the course of this discussion, I will comment on the analysis presented by US WEST witness Peter Cummings and explain why his proposed equity return, which is 250 basis points (2.5%) higher than my recommendation, is inappropriate for the equity of US WEST.

A. DISCOUNTED CASE FLOW PROCEDURE

Q. PLEASE DESCRIBE THE DISCOUNTED CASH FLOW PROCEDURE.

A. The basic premise of the Discounted Cash Flow (" DCF") procedure is that the market values each stock at the discounted present value of all future flows of cash that investors expect from purchasing that stock. The discount rate that equates those future cash flows with the market value of the stock is the investors' required rate of return.

The DCF approach is usually represented by the following formula:

$k = {}^{d}/_{P} + g$

where k = required rate of return
d = dividend in the immediate period
P = market price
g = expected growth rate in dividends

While the DCF method is usually presented in mathematical notation format (as above), it can also be described in narrative fashion. The formula says that the return which any investor expects from the purchase of a stock consists of two components. The first is the immediate cash flow in the form of a dividend. The second is the prospect for future growth in dividends. The sum of the rates of these two flows, present and future, equals the return that investors require. Investors adjust the price they are willing to pay for the stock until the sum of the dividend yield and the annual rate of expected future growth in dividends equals the rate of return they expect from other investments of comparable risk. The DCF test thus determines what the investing community requires from the company in terms of present and future dividends relative to the current market price.

Q. IS THERE A CONVENTIONAL PROCEDURE FOR CALCULATING DCF RETURNS?

A. Yes. There is a conventional procedure for calculating equity return under the DCF formula that is often referred to as "classic" DCF calculation. The Federal Communications Commission ("FCC") recently concluded tentatively that this method should be given the greatest weight in determining the rate of return to equity.[3] I

[3] *Notice Initiating a Prescription Proceeding and Notice of Proposed Rulemaking*, CC Docket No. 98-166, October 5, 1998, ¶ 26.

1 agree with that conclusion.

2 **Q. HOW IS THE "g" OR GROWTH FACTOR IN THE DCF FORMULA IDENTIFIED**
3 **UNDER THE CLASSIC DCF CALCULATION?**

4 A According to the DCF theory, the relevant measure of "g" should be the growth in
5 dividends. Dividends, however, are susceptible to management's discretionary
6 control of the dividend payout ratio. In the short run at least, they may not reflect the
7 underlying driver of earnings. For this reason, the classic DCF calculation uses
8 earnings per share growth ("EPS") is the indicator of the "g" factor.

9 The classic DCF calculation also employs predictions of EPS growth, usually in the
10 three to five year time horizon. One leading source of these predictions is survey of
11 institutional investment analysts called the Institutional Brokers Estimate Sytem
12 ("I/B/E/S"). This was the source of Mr. Cummings' growth estimates.

13 **Q. HOW DOES THE CLASSIC DCF CALCULATION DERIVE THE DIVIDEND YIELD**
14 **PORTION OF THE DCF FORMULA?**

15 A. Under the classic calculation, the dividend yield is calculated as the next year's
16 dividend divided by a recent average of the price of the stock. The resultant yield
17 should reasonably match the dividend yields shown by the financial reporting
18 services.

19 There are several ways to predict next year's dividend. Several investors' services
20 provide forecasts of dividends. Another, somewhat more mechanical approach is
21 to compute the next year's dividend as the most recent dividend annualized plus one

1 half the analysts' prediction of the long-term growth rate in earnings per share.

2 **Q. HOW IS THE DENOMINATOR IN THE DIVIDEND YIELD CALCULATION, THE**
3 **RECENT PRICE OF THE STOCKS, IDENTIFIED?**

4 A. Some judgement is required to establish a set of price observations that capture the
5 investing public's current perception of value while at the same time reflecting some
6 stability in the market. Given the fluctuations of the markets, a price observation for
7 a single day, week, or even month runs the risk of becoming obsolete in a very short
8 time. Market fluctuations also mean that the use of monthly highs and lows may
9 exaggerate the effect of some of the sharp drops and rises that the markets have
10 experienced recently. For this reason, I believe it is best to use the average of the
11 prices over a period one to three recent months.

12 **Q. MR. CUMMINGS CLAIMS THAT IT IS APPROPRIATE TO COMPOUND THE**
13 **QUARTERLY DIVIDENDS IN ORDER TO CALCULATE THE ACTUAL DIVIDEND**
14 **YIELD. DO YOU AGREE?**

15 A. No. Mr. Cummings argues that the yield from quarterly dividends is greater than the
16 simple summation of those dividends because investors have the opportunity to earn
17 return during the portion of the year following the receipt of each dividend. Thus, the
18 yield on the first quarter's dividend is supplemented by that dividend's earnings
19 power during the three remaining quarters that the investor holds it. The second
20 quarter's dividend earns additional return during the following two quarters. The third
21 dividend generates a quarter of a year's return.

22 All this is true, but it has nothing to do with the cash dividends that must be

generated by the dividend-issuing company to satisfy investors' requirements. Investors' ability to earn on quarterly dividends is quite outside of the cash flow from the company: it is achieved by taking that cash flow and reinvesting it elsewhere. The cash flow from the company does not need to be supplemented.

Q HAVE YOU CALCULATED THE "CLASSIC" DCF RETURN FOR US WEST?

A. Yes. As Mr. Cummings correctly notes, the US WEST's stock performance has been distorted recently by its impending merger with Qwest. Because of this merger, I/B/E/S provides no earnings growth forecasts for US WEST. However, Zacks Investment Research, Inc. surveyed regional, national and institutional brokers for their expectations as to the earnings that an investor in US WEST might expect if he bought the stock prior to the merger. Zacks reports seven forecasts of the annual percentage growth in US WEST's EPS over the coming five years, analyzed as a stand-alone company. The average of these seven estimates is 7.22 percent.

US WEST's dividend has been $2.14 annually for past six years, and neither Zacks nor Value Line expect that it would have increased.

US WEST's impending merger has heavily influenced the price of its stock, causing it to rise from $66 in mid-April to $85.75 on June 30, the day before the merger was consummated. Since the objective of this exercise is to estimate the cost of the equity in US WEST devoted to Arizona intrastate telephone operations, it is desirable, insofar as possible, to exclude the distorting effect of the expected merger. For this reason, I have excluded the sharp runup in US WEST's price that occurred in June when it appeared that US WEST would receive all of the necessary merger approvals. Instead, I have used the average price during the six-week period from

April 15 through May 26, which was $71.35.

The paradoxical effect of this exclusion is to bias my return estimate upward. By using a lower pre-merger price, I increase the dividend yield, which increases the DCF return. Specifically, the $2.14 dividend divided by $71.35 produces a yield of 3.0 percent. Had I used the closing price of $85.75 just before the merger, the yield would have been only 2.5 percent.

I am probably further exaggerating US WEST's required return when I combine this dividend yield with Zack's forecast of earnings growth. A year ago, I/B/E/S forecast US WEST's long-term growth at only 6.6 percent. The 7.22 percent produced by Zack's probably anticipates the expected merger of US WEST with a dynamic and fast-growing company like Qwest.

The sum of the dividend yield of 3.0 percent and the growth rate of 7.22 percent produces a "classic" DCF calculation for US WEST of 10.22 percent.

Q. HAVE YOU CONDUCTED A CLASSIC DCF ANALYSIS OF THE OTHER THREE BABY BELL COMPANIES?

A. Yes. For this purpose, I have used the I/B/E/S consensus (mean) forecast of earnings growth, the most recent dividends annualized and increased by one half Zack's estimate of annual dividend growth, and the average weekly closing price for the three-month period April 14 through July 14. The results are as follows:

Table 1
DCF Analysis of Bell Companies

		Source	Verizon	BellSouth	SBC
1.	Long Term Growth Consensus	I/B/E/S	11.65%	11.06%	12.87%
2.	Recent Dividend Annualized	Yahoo	$0.19	$0.76	$1.01
3.	Dividend Growth	Zack's	11.65%[4]	2.0%	4.0%
4.	Next year's Dividend	L2* (1+L3/2)	$0.20	$0.77	$1.03
5.	Average Price April 14 - July 14, 2000	CBS MarketWatch	$54.83[5]	$46.00	$44.51
6.	Dividend Yield	L4/L5	0.36%	1.67%	2.31%
7.	DCF Return	L1+L6	**12.01%**	**12.73%**	**15.18%**

Q. HAVE YOU PERFORMED A CLASSIC DCF CALCULATION FOR COMPARABLE ELECTRIC UTILITIES?

A. Yes. Electric utilities are a much more varied group in terms of credit-worthiness than the five RBHCs. To limit the sample to a group with risk approximately equal to that of US WEST, I selected electric utilities rated A3 or better rating by Moody's in its most recent quarterly update.[6] US WEST has a Moody's rating of A2. There are 34 companies in this comparison group. They are listed in Exhibit CWK-1.

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[4]Zack's forecast unavailable; use I/B/E/S EPS growth forecast

[5]Bell Atlantic and GTE blended prior to June.

[6]Moody's Short-Term Market Record: Quarterly Update, April 2000, Moody's Investor Services, Volume XX, No. 2.

Exhibit CWK-1 develops the DCF cost of capital for the comparison electric utilities in a similar manner to that which I used to develop the DCF cost of capital for the telephone companies under the "classic" formulation. In this case, however, I used the dividend yield as it was reported on the current Zacks Investor Research reports for the respective companies. For the "g" factor, I used the Zacks' consensus estimates of the percentage growth in earnings per share over the coming five years. Zacks does not provide a consensus forecast for CILCORP, Madison Gas & Electric and New England Electric System, so they were necessarily excluded from the average.

Exhibit CWK-2 shows that the DCF returns within this comparison group range from 9.06 to 14.83 percent, with an average of 11.53 percent.

Q. ARE THERE ALTERNATIVE FORMULATIONS OF THE DCF PROCEDURE?

A. Yes. There are broadly two alternative formulations to the DCF procedure that have been used in utility rate of return studies, both reflecting different ways of estimating the "g" or growth factor. The first is based on the proposition that growth in earnings and dividends for a regulated public utility is constrained by the growth in book value per share. This is because public utility regulation has traditionally authorized earnings in relation to a "rate base" reflective of the book value of the investment devoted to utility service. The rate of growth in per-share book value is a function of (1) the earnings retention ratio, (2) the authorized rate of return and (3) dilution or accretion from sales of new stock.

The other alternative uses historical trends in growth in earnings and dividends to calculate the "g" factor in the DCF formula.

1 **Q. WHAT IS YOUR ASSESSMENT OF THESE TWO ALTERNATIVE APPROACHES**
2 **FOR THE RBHCs AND US WEST?**

3 A. The book value growth model is altogether unsuited to the Regional Bell Holding
4 Companies ("RBHC") because much of their investment is no longer subject to rate-
5 base/rate-of-return regulation that sets earnings allowances according to the book
6 value of investment. The FCC now regulates interstate access charges under a
7 "price cap" plan that ties these rates to an indices of inflation less productivity offsets,
8 not to the book value of interstate plant.[7] Many states have also reduced or altered
9 their regulation of intrastate rates so that earnings are no longer tied to book
10 investment. As a result, the RBHCs' rates of return on book investment have drifted
11 away from each other and from any calculated estimate of their required rate of
12 return. When this tie is broken, the book value per share model for estimating the
13 "g" factor loses its rationale.

14 Historical trends in dividends and earnings are relevant to an estimation of the"g"
15 factor only to the extent that investors regard them as indicators of their future
16 expectations. Most financial reports display considerable historical data, including
17 past earnings per share and dividends, which suggests that this information is of
18 interest to investors and analysts. The weight that they give to the trends in these
19 indicators is, of course, unknown and unknowable.

20 **Q. CAN YOU IDENTIFY THE HISTORICAL GROWTH TRENDS OF THE RBHCs?**

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[7]Federal Communications Commission, Sixth Report and Order in CC Docket Nos. 96-262 and 94-1, May 31,2000.

A. The RBHCs' earnings have been extraordinarily erratic during the past few years. This is partly owing to mergers (SBC, Bell Atlantic) and partly to special charges (all five RBHCs in 1993, 1994 and 1995). Nevertheless, Zacks Investment Research publishes a figure for the historical percentage growth in earnings during the past five years which presumably corrects for these extraneous factors.

Q. WHAT ARE THE DCF INDICATIONS USING HISTORICAL TRENDS?

A. The following table presents the DCF estimates for the four RBHCs using historical growth rates in earnings per share:

Table 2
DCF Using Earnings per Share Growth, Last 5 Years

	EPS Growth	Dividend Yield	DCF Return
US WEST	4.6%	3.0%	7.6%
Verizon	10.5%	.4%	10.9%
BellSouth	19.3%	1.67%	21.0%
SBC Communications	9.1%	2.3%	11.4%

This table demonstrates the weakness of attempting to use historical trends as the basis for the "g" factor in the DCF formula. Two of the four observations are so out of range as to lack credibility: US WEST's return is too low and BellSouth's is too high. These unreasonable results cast doubt on the validity of the remaining two indications that do seem to be within the range of reasonableness. For this reason, I am inclined to disregard DCF results using historical growth rates.

B. CAPITAL ASSET PRICING MODEL

Q. WHAT IS THE CAPITAL ASSET PRICING MODEL?

A. The Capital Asset Pricing Model ("CAPM") is based on the proposition that investors, through diversification, can eliminate the specific risk of individual stocks, but they cannot avoid the general risk of the stock market as a whole. That market risk is a function of the variability of stock prices over time. Stocks that vary with the market, but less so, are perceived to have a lower risk than the market, while those that display more exaggerated covariance with the market are considered more risky than the market as whole.

The measure of this covariance is a statistic called "beta". The market has a beta of 1.0. Any stock that varies with the market but to a lesser degree has a beta of less than 1.0. Conversely, stocks that fluctuate in a more exaggerated fashion than the market have betas greater than 1.0.

As employed by utility-sponsored analysts such as Mr. Cummings, the CAPM approach attempts to estimate the equity return of any given company by applying that company's beta to the differential between a risk-free return and the average return required from the market as a whole.

Q. WHAT IS YOUR ASSESSMENT OF CAPM AS A METHOD FOR ESTIMATING A COMPANY'S RATE OF RETURN?

A. The CAPM is much more persuasive in theory than in practice. That is because it requires the quantification of highly uncertain and to some extent subjective

measures. There are four such measures:

- The return required from risk-free investments;
- The Beta for the individual company;
- The risk premium between the risk-free return and the return required by the stock market as a whole, and
- The relationship between Beta and the market risk premium.

Because there are selection and measurement problems with all four of these measures, the CAPM can be considered as only a rough indicator of required return.

Q. WHY DO YOU SAY THAT THE RETURN FROM RISK-FREE INVESTMENTS IS UNCERTAIN AND TO SOME EXTENT SUBJECTIVE?

A. The problems associated with this indicator are illustrated by Mr. Cumming's selection of intermediate (3-5 year) and long term (30 year) Treasury bond yields as measure of a risk-free return. The so-called "risk-free rate" is either 6.57 or 6.18 percent [8] depending on whether one uses the intermediate or the long term bond rate. Nor is this differential just a current aberration.

While it is true that there is virtually no risk of default from long-term Treasury bonds, these investments can have a very substantial inflation risk that is not found in shorter term Treasury instruments or in the stock market. The proof of this risk is in the yields themselves. Until quite recently, long-term bond yields were almost always higher than intermediate bond yields, and intermediate bond yields were almost

[8]Cummings Exhibit PCC-05, pages 1 and 2, column A.

always higher than short term bonds, CD's and bills. This relationship was very clear a year ago in June 1999:

Table 3
U.S.Treasury Yields, June 1999[9]

3-Month Bills, auction high	4.60%
6-Month Constant Maturities	4.75%
1-Year Constant Maturity	5.03%
3-Year Bonds	5.62%
5-Year Bonds	5.68%
10-Year Bonds	5.79%
30-Year Bonds	5.98%

This inverse correlation between the term of the instrument and its yield has broken down within the last year. Still, the latest Federal Reserve Release shows that Treasury bills maturing within one year are yielding in the range of 5.74 to 6.00 percent, while long-term Treasury bonds yield, on average 6.23 percent.[10] Clearly, an instrument bearing a yield of 6.23 percent cannot be considered "risk free" if there are alternative instruments which investors are actively buying that yield only 5.74 percent.

The explanation for these differences in yield lies in the inflation risk borne by longer term securities. Any investor knows that once he buys such a bond, he is locked into a fixed monthly or quarterly payment stream that will not change regardless of any

[9]Federal Reserve Bulletin, Domestic Financial Statistics

[10]Federal Reserve Statistical Release, July 5, 2000

future trends in the economy or in the capital markets. If interest rates increase, the value of the bond will decline, and while the bond will ultimately be repaid, the investor is at risk for the reduced value of the bond up to the date of its maturity. The farther away that maturity, the greater the risk. That is why yields on Treasury instruments typically increase the longer the term of the instrument, as demonstrated in Table 3 above.

Q. WHY DO YOU SAY THAT THE ESTIMATION OF COMPANY BETAs IS UNCERTAIN AND TO SOME EXTENT SUBJECTIVE?

A. Mr. Cummings testifies that he calculated his own beta for US WEST based on daily returns on US WEST's stock and on S&P's 500 companies during the period November 1, 1995 through August 31, 1998. He derived a beta for US WEST of .6266, but this was later corrected to .6419. He then adjusted the beta using both Merrill Lynch and Value Line adjustment procedures, to .76.[11]

It is obvious that other methods and other periods would yield different betas, and indeed they do, as shown in the following table.

[11]US WEST Response to APA03, No. 15, p.2.

Table 4
Investment Analysts' Estimates of Beta, 1999

Company	Thompson	S&P	Yahoo	Zacks	Market Guide	Value Line
Ameritech	.66	.70	.66	.66	.70	.85
Bell Atlantic	.68	.74	.68	.72	.74	.85
Bell South	.45	.48	.45	.47	.48	.85
SBC Com.	.81	.84	.82	.78	.84	.80
US WEST	.51	.47	.41	.53	.47	.75

The only beta estimate for US WEST that even remotely approaches that of Mr. Cummings is the Value Line estimate. This is probably because both Mr. Cummings and Value Line adjust the "raw" beta upward, in Mr. Cummings' case from .6266 to .76.

Mr. Cummings provides no explanation for this adjustment. However, I inquired of Value Line as to the source of its adjustment and was directed to an article by Marshall Blume, "On the Assessment of Risk," in the March 1971 *Journal of Finance*. Dr. Blume performed time series analyses of beta measurements of different portfolios of stocks, comparing six different periods between 1926 and 1961. Dr. Blume's principal finding was that the beta measured in one period was a very good predictor of future betas for portfolios of stocks. However, for individual stocks, he found that a beta derived in the earlier period typically explained only 36 percent of the beta in the future period, leaving 64 percent unexplained, Dr. Blume noted that, "The large magnitude of unexplained variation may make the beta coefficient an inadequate measure of risk for analyzing the cost of equity for an individual firm, although it may be adequate for cross-section analyses of cost of equity."

In order to reflect this poor predictability of beta as a measure of future risk, Dr. Blume adjusted the current measure of beta by its standard error. The effect of this adjustment is to increase the beta. The objective of this adjustment is to discount the value of the beta as a measure of risk, not to imply the stock becomes significantly less risky as time progresses.

The data in Table 4 indicate that only Value Line adjusts its beta. According to Mr. Cummings, Merrill Lynch does also. The other analysts apparently use the "raw" beta.

Accepting the propriety of using beta at all for a single company -- which Dr. Blume questions — there is obviously no consensus on the value of beta at any given point in time, nor is there any consensus on whether raw or adjusted betas should be used. The selection of beta is therefore uncertain and somewhat subjective.

Q. WHY DO YOU SAY THAT THE ESTIMATION OF THE PREMIUM BETWEEN THE RISK-FREE RETURN AND THE OVERALL STOCK MARKET RETURN REQUIREMENT IS UNCERTAIN AND TO SOME EXTENT SUBJECTIVE?

A. Obviously, if it is difficult to estimate the return requirement for a single company, it is also difficult to measure that requirement for the overall market. The procedures used by Mr. Cummings illustrate this difficulty. Mr. Cummings employed two approaches to this measurement. The first is the historical risk premium approach, which Mr. Cummings refers to as "ex post", and the other is the "ex ante" which is a DCF measurement for the entire market.

Q. PLEASE DESCRIBE THE HISTORICAL RISK PREMIUM APPROACH.

A. The historical risk premium is predicated on the proposition that the expected risk premium over debt financing is the difference in average realized returns for stocks and bonds over large number of years. The theory holds that expectations and realized returns converge given a long enough period of time. Mr. Cummings employs the conventional measure, which is the Ibbotson Associates' calculations of differences between returns to common stocks and to bonds over a period beginning in 1926 and running up to the present.

Q. WHAT IS YOUR ASSESSMENT OF THE HISTORICAL RISK PREMIUM APPROACH?

A. The historical risk premium model is both conceptually and statistically so flawed as to be without value.

Q. WHY DO YOU SAY THE HISTORICAL RISK PREMIUM APPROACH IS CONCEPTUALLY FLAWED?

A. This historical risk premium approach relies on two erroneous assumptions: first, that the risk premium for equity investment is fixed for extended periods of time, and second, that the risk premium can be derived from observations of realized returns in the past.

Q. WHY IS IT ERRONEOUS TO ASSUME THAT THE RISK PREMIUM FOR EQUITY INVESTMENT IS FIXED FOR EXTENDED PERIODS OF TIME?

A. First, I should note that this assumption of an unchanging equity risk premium is

implicit to this methodology, not explicit. Nowhere in their exposition of this approach do its authors, Roger G. Ibbotson and Rex A. Sinquefield, assert that the risk premium never changes over time. However, this assumption is the undeniable corollary of adopting an average of the return differentials over 72 years as the measure of the current difference between the required returns on equity and debt.

The assumption is flatly incorrect. The risks of stocks and bonds are inversely related. During periods of slow economic growth or recession, bonds are a safe haven from the threat of declining earnings. Inflation, which is the principal risk of fixed income securities, tends to be quite low during recessions. The equity risk premium relative to debt is quite high.

In the past (although happily not at present), periods of high growth tended to be accompanied by the potential — and sometimes the reality — of high inflation. In that environment, stocks become the haven. Not only do stocks receive the benefit of expanded markets and increased earnings, but their value rises with inflation, often ahead of it. Bonds, which have a fixed nominal return, decline in value in the face of threatened inflation, and their yields increase. The risk premium for stocks declines. Indeed, it was argued during the oil crises of the 1970s that the risk premium of stocks relative to bonds had become negative.

Q. WHY IS IT ERRONEOUS TO ASSUME THAT REALIZED RETURNS CONVERGE ON EXPECTED RETURNS, GIVEN ENOUGH TIME?

A. The basis for this assumption is that realized returns have a "random walk" such that although no one investor necessarily realizes his required return, the whole body of

investors over time realize their requirements on average.[12] The advocates of this theory readily acknowledge that expectations and realization do not converge in the short run. No one would have invested a dollar during 1929 had he known the returns that were actually realized in 1930 through 1933. Conversely, the realized returns from stock investments during the past eight years have far exceeded even the most optimistic expectations of investors at the beginning of that period.

It is thus assumed that over a long enough time, the variations in earned returns even out, with the negatives offsetting the positives, so that the long-term experienced returns have conformed to the long-term expected returns. This is a statement of faith, not of fact, and it flies in the face of common sense. If short-term returns consistently fail to reflect investor expectations, what possible logic supports the proposition that the sum of these failed expectations equals the actual expectation? If the actual return differentials match expected return differentials, it would be the result of pure chance, not of any reasoned or rational explanation.

Q WHY DO YOU SAY THAT THE HISTORICAL RISK PREMIUM APPROACH IS STATISTICALLY FLAWED?

A. Mr. Cummings did not provide the data from which his historical risk premiums were developed, but I have been able to obtain a 1982 version of the Ibbotson-Sinquefield publication that contains return and "risk premia" data for the period 1926 through 1981. Exhibit CWK-2 presents the returns on stocks, bonds and the risk premiums for each year. At the bottom of the page is found the averages. It is these averages

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[12]R.G. Ibbotson and R.A. Sinquefield, *Stocks, Bonds, Bills, and Inflation: the Past and the Future,* Financial Analysts Research Foundation, 1982 Edition, Monograph #15.

that are assumed to be representative of the risk premium that investors required for stocks relative to bonds.

The exhibit also shows the standard deviation, or average error, of each series. In each case, the average error exceeds the mean, and in the case of the risk premiums it is 2.66 times the mean. When the variance around the mean is this great, the mean has no statistical significance. That is, it cannot be used as a predictor of future values of the statistic measured. The average of past risk premiums has no statistical value as an indication of future risk premiums.

Q. HOW DID MR. CUMMINGS DEVELOP HIS EX ANTE ESTIMATE OF THE MARKET'S REQUIRED RETURN?

A. Mr. Cummings simply summed the dividend yield and the I/B/E/S five-year growth forecasts for each of Standard & Poor's 500 companies to arrive at a composite DCF return of 14.8 percent, subsequently revised to 15.8 percent.

Q. WHAT IS YOUR ASSESSMENT OF MR. CUMMINGS' EX ANTE ESTIMATE OF THE MARKET'S REQUIRED RETURN?

A. This is certainly a much more reasonable way to estimate the market's required return than using the experienced historical difference between stock and bond returns, but it suffers from the problem of redundancy. If the DCF procedure is employed to implement the CAPM, why bother with the CAPM in the first place? Why not use the DCF model as the basic measure of equity return for the company or the industry under study?

Beyond that conceptual problem, I question Mr. Cummings' 15.8%. It is the simple average of the growth and yield expectations of all 500 companies in the S&P list. This simple average is not a valid measure of the total market's earnings requirements. The market does not invest equally in all companies. Rather, it has substantially larger investments in larger companies and smaller investments in smaller companies. Intuitively, one would expect large companies to have less risk, on average, than small companies. If so, then a simple average of the DCF returns for S&Ps 500 companies would be higher than a dollar weighted average that reflects the actual mix of investments in the market.

Q. ARE THERE ANY OTHER PROBLEMS WITH THE CAPM PROCEDURE?

A. Yes. The CAPM calls for the beta, whatever it is, to be applied to the risk premium between risk-free securities, whatever they are, and the market's required rate of return, whatever it is. It is presumed that beta is linearly related to this risk premium. A beta of 0.0 would yield a return requirement equivalent to the risk-free rate, so a beta of .5 should translate into the risk free rate, plus one-half of the market's risk premium.

To my knowledge, no one has established this linear relationship empirically. Recall that beta measures only systematic risk. Unsystematic risk, that is, variation in price unrelated to the market, is assumed away. I question whether the market totally discounts unsystematic risk. If it does not, then the CAPM is invalid as a procedure for measuring return requirements.

This issue might be resolved by regressing the DCF returns of individual companies against their betas. This test, however, would again raise the question of

redundancy. If the DCF model is to be used to assess the CAPM, why bother with the CAPM in the first place?

Q. WHAT IS YOUR ASSESSMENT OF THE CAPM AS A PROCEDURE FOR FINDING THE COST OF EQUITY OF A COMPANY LIKE US WEST?

A. Given all of the measurement problems that I have discussed, I question the value of the CAPM as a predictor of the absolute level of the cost of equity for any one company. As noted by Dr. Blume, its greatest value is to test the riskiness, and possibly the required return, of portfolios of stocks.

Q. DO YOU THEREFORE CONCLUDE THAT CAPM CONCEPTS HAVE NO VALUE WHATEVER IN EVALUATING US WEST'S REQUIRED RETURN?

A. No. I believe that the concepts of the CAPM have considerable value in assessing the relative risk of different companies.

Although the specific measures differ depending on the period covered and on the adjustment methodology, the beta does appear to reflect fairly consistent differences in risk among seemingly like companies. Table 4 shows that in 1999 there was a clear consensus among the various investment analysts as to the general risk relationships among the five RBHCs. All six of the investor services surveyed agreed that SBC Communications is the most risky RBHC. Second was Bell Atlantic, which is only slightly more risky than Ameritech. Bell South and US WEST were found considerably less risky than Bell Atlantic. Three of the five services found US WEST to have to least risk of the five.

The value of these beta measurements is not so much in their ability to identify the required rate of return as it is explain the differences in rates of return among the RBHCs.

Q. CAN THESE BETA DIFFERENCES BE USED TO EXPLAIN THE DIFFERENCES AMONG THE DCF INDICATIONS THAT YOU HAVE CALCULATED?

A. Yes. Because Verizon has only recently been formed, I do not have the array of beta observations that I was able to accumulate last year. However, Zack's beta estimates for the four RBHCs reveals the following relationship to my DCF indications:

Table 5
Comparison of DCF Returns and Betas

Company	DCF Return	Zack's Beta[13]
US WEST	10.22%	.49
Verizon	12.01%	.82
Bell South	12.73%	.54
SBC Communications	15.18%	.89

Certainly the betas help explain the extremes of the DCF returns. The highest beta, that for SBC Communications, corresponds with the highest return requirement, as one would expect. The lowest beta, that for US WEST, corresponds with the lowest DCF return, again as one would expect. The observations in between are more obscure. Verizon's beta cannot have much predictive value because it is actually a

[13]Zack's Investment Research Inc. Company Reports, July 2000. http://my.zacks.com/reports

combination of the betas of the two predecessor companies, Bell Atlantic and GTE, neither of which exist any longer. The merger of these two companies has to have clouded investor perception of Verizon's beta as a predictor of risk.

Most inexplicable is the result for Bell South. This company has an average beta only slightly higher than that of US WEST, yet its DCF return is 251 basis points higher. Possibly this relationship has to do with the mix of current dividend yield and growth. Table 1 shows that Bell South's dividend yield is only 1.67%, the second lowest among the RBHCs, while that of US WEST is 3.00%, the highest of the four companies. It may be that investors place relatively greater value on the higher immediate return of US WEST than on the promise of high growth offered by Bell South. This would justify a lower required return from US WEST.

One thing is clearly demonstrated by these beta comparisons: that Mr. Cummings was incorrect in his rejection of US WEST as "clearly out of range compared to the other estimates."[14] Mr. Cummings' findings regarding US WEST were indeed out of range, but that is because US WEST is demonstratively less risky than his comparison groups. Since this inquiry relates to US WEST, that finding cannot be ignored.

C. EQUITY RETURN - CONCLUSION

Q. WHAT IS YOUR NET CONCLUSION AS REGARDS THE REQUIRED RETURN TO US WEST'S EQUITY CAPITAL?

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[14]Cummings Testimony, page 47.

A The relationships shown in Table 5 indicate the general range of US WEST's required rate of return to equity. SBC and Verizon are riskier companies than US WEST. Only Bell South has a beta close to that of US WEST, and for this reason, its DCF return of 12.73 percent can be taken as the top of the range for US WEST. This is a generous treatment of US WEST because there are undoubtedly other influences that increase the perceived risk of Bell South that do not apply to US WEST. I also generously accept that the indicated DCF return of 10.22% for US WEST is the bottom of the range. Normally, one would assume that the DCF return for a specific company is the middle of its true rate-of-return range. Using these standards, I conclude that the required return for US WEST's equity capital lies within a range of 10.22 to 12.73 percent.

The reasonableness of this range is demonstrated by the return requirements of the electric utilities. Their composite DCF return of 11.53 percent is only slightly above the mid-point of this range (11.48%).

Q. WHERE WITHIN THIS RANGE DO YOU RECOMMEND THE RETURN BE SET FOR US WEST'S REGULATED INTRASTATE TELEPHONE OPERATIONS?

A. The range of 10.22 to 12.73 percent covers the gamut of US WEST's business activities These include not only local exchange and short-haul toll telephone service — the services subject the Commission's regulation — but also US WEST's ventures into Internet access, wireless, directories, and video. While the regulated services are facing some increased competition, US WEST is still overwhelmingly dominant in these markets. With the possible exception of directories, US WEST enjoys no comparable market dominance for the remaining, unregulated services. Since these unregulated services are clearly more risky than US WEST's regulated

service, it is appropriate to set the equity return for the Company's regulated intrastate services no higher than the mid-point of the rate-of-return range.

Q. WHAT EQUITY RATE OF RETURN DO YOU RECOMMEND FOR US WEST'S REGULATED INTRASTATE SERVICES?

A. I recommend a rate of return on the equity capital devoted to US WEST's regulated intrastate services of **11.5**, which is the approximate mid-point of the rate of return range. Since this rate of return is 128 basis point above the DCF return indicated for US WEST, it allows sufficient margin to ensure that US WEST's investors recover their return requirements even if there is a modest increase in the cost of capital.

D. FLOTATION COSTS

Q. WHAT ARE FLOTATION COST?

A. Flotation costs are the expenses associated with the issuing new stock. They include such costs as underwriters' commissions, legal fees, and the preparation and publication of prospectuses.

Q. WHY ARE FLOTATION COSTS AN ISSUE IN THIS CASE?

A. Mr. Cummings claims that it is necessary to increase the return to equity to account for flotation costs. This is because the actual proceeds that the Company receives are less than the amount of the stock issued when new public stock sales are conducted. Since the paid-in capital is less than the capital outstanding, it is necessary, argues Mr. Cummings, to adjust upward the rate or return on the invested

capital to ensure that outstanding stock receives its full return.

Q. PLEASE DESCRIBE MR. CUMMINGS' STOCK FLOTATION ADJUSTMENT.

A. Using historical US WEST and Bell System data, Mr. Cummings estimates that flotation costs account for 2.0 percent of the cost of each new stock issue. He then weights the amount of US WEST's capital raised from public offerings with the non-public equity capital to arrive at an adjustment of 1.7 percent. He increases his recommended rate of return by this amount.

Q. IS IT APPROPRIATE TO ADJUST THE RATE OF RETURN FOR FLOTATION COSTS?

A. No. Mr. Cumming's rate of return adjustment would generate far more revenue than the actual flotation costs the Company has incurred. As applied to his recommended rate of return of 14 percent, the effect of the flotation cost adjustment is approximately 0.20 percent, that is, 20 basis points. The effect on the overall rate or return is 10 basis points. Applied to US WEST's year-end 1999 capitalization of $23,216 million, this 0.10% would generate $23.2 million annually. Mr. Cummings' Exhibit PCC-10 indicates that between 1984 and 1994, the Company spent a total of $55 million on stock issuance costs. If amortized over the 15 years since 1984, the annual cost recognition would come to $3.7 million per year. Mr. Cummings' adjustment would generate over six times this amount each year indefinitely into the future.

Q. WHAT IS YOUR RECOMMENDATION WITH RESPECT TO FLOTATION COST?

A. An adjustment to the rate of return is a very expensive way to recognize flotation costs. If the Company actually incurs flotation costs, then the Commission might consider amortizing them in the revenue requirement. This treatment would parallel that applied to debt flotation costs.

Q. NOTWITHSTANDING THIS RECOMMENDATION, DOES YOUR RECOMMENDED RETURN TO EQUITY ALLOW THE RECOVERY OF FLOTATION COSTS?

A. Yes. Although I do not believe it appropriate to make an explicit adjustment of flotation costs, I have recommended a rate of return to equity that is above the return indicated by my DCF analysis of US WEST's stock. The premium I have proposed over the DCF return is more than enough to compensate for the flotation costs that US WEST has incurred or may incur in the future.

III. RETURN TO TOTAL CAPITAL

Q. WHAT IS YOUR RECOMMENDED RETURN TO TOTAL CAPITAL?

A. Using the capital structure and cost rates developed in this testimony, I find compute the weighted cost of US WEST's total capital as follows:

Table 6
US WEST Cost of Total Capital

	Proportion	Cost	Weighted Cost
Debt	.476	7.39	3.52%
Equity	.524	11.50%	6.02%
Total Capital	1.000		**9.54%**

I recommend **9.54%** as the allowed return on US WEST's Arizona original cost intrastate rate base. The return should be adjusted so that it yields the same dollar value of total return when applied to the Company's fair value rate base.

Q DOES THIS COMPLETE YOUR TESTIMONY?

A. Yes. It does.

Attachment A

Resume of Charles W. King

Charles W. King

Experience

Snavely King Majoros O'Connor & Lee, Inc.
Washington, DC

President (1989 to Present)
Vice President (1970 - 1989)

Mr. King, a founder of the firm and acknowledged authority on regulatory economics, brings over thirty years of experience in economic consulting to his direction of the firm's work in transportation, utility and telecommunications economics.

Mr. King has appeared as an expert witness on over 300 separate occasions before more than thirty state and nine U.S. Canadian federal regulatory agencies, presenting testimony on rate base calculations, rate of return, rate design, costing methodology, depreciation market forecasting, and ratemaking principles. Mr. King has also testified before House and Senate Committees on energy and telecommunications legislation pending before the U.S. Congress.

In telecommunications, Mr. King has testified before the Federal Communications Commission on a number of policy issues, service authorization, competitive impacts, video dialtone, and prescription of interstate depreciation rates. Before state regulatory bodies, he has presented testimony in proceedings on intrastate rates, earnings and depreciation. Mr. King recently directed analyses of the prices of services under Federal Government's FTS2000 long distance system.

In addition to his appearances as a witness in judicial and administrative proceedings, Mr. King has negotiated settlements among private parties and between private parties and regulatory offices. Mr. King also has directed depreciation studies, investment cost benefit analyses, demand forecasts, cost allocation studies and antitrust damage calculations.

In Canada, Mr. King designed and directed an extended inquiry into the principles and procedures for regulating the telecommunication carriers subject to the jurisdiction of the Canadian Transport Commission. He also was the principal investigator in the Canadian Transport Commission's comprehensive review of rail costing procedures.

EBS Management Consultants, Inc.
Washington, DC

Director, Economic Development Department (1968-1970)

Mr. King organized and directed a five-person staff of economists performing research, evaluation, and planning relating to economic development of depressed areas and communities within the U.S. Most of this work was on behalf of federal, state, and municipal agencies responsible for community or regional economic development.

Principal Consultant (1966-1968)

Mr. King conducted research on a broad range of economic topics, including transportation, regional economic development, communications, and physical distribution.

W.B. Saunders & Company, Inc.,
Washington, DC

Staff Economist (1962-1966)

For this economic consulting firm, which later merged with EBS Management Consultants, Inc., Mr. King engaged in numerous research efforts relating primarily to economic development and transportation.

U.S. Bureau of the Budget, Office of Statistical Standards

Analytical Statistician (1961-1962)

Mr. King was responsible for the review of all federal statistical and data-gathering programs relating to transportation.

Education

Washington & Lee University, B.A. in Economics

The George Washington University, M.A. in Government Economic Policy

Attachment B

Expert Witness Appearances of Charles W. King

CHARLES W. KING
Snavely King Majoros O'Connor & Lee, Inc.
1220 L Street, N.W.
Suite 410
Washington, D.C. 20005
(202) 371-1111

Appearances before State Regulatory Agencies

State	Electric, Gas, Water Utility Cases			Date of Cross-Examination
	Client	Case		
		Case Number	Utility	
AK	Exxon USA	P-89-1,2	Trans Alaska Pipeline System	October 18, 1990
AZ	Arizona Corporation Commission	U-1345-I	Arizona Public Service Co.	December 16, 1980
	Arizona Retailers Association	U-1345-II	Arizona Public Service Co.	January 15, 1981
CA	California Retailers Association	57666	Pacific Gas & Electric Co.	March 6, 1978
	California Retailers Association	57602	Southern California Edison	April 25, 1978
	California Retailers Association	59351	Pacific Gas & Electric Co.	June 12, 1981
	California Retailers & California Manufacturers	59351	Southern California Edison	May 20, 1982
	California Retailers Association	61138	Southern California Edison	May 28, 1982
CO	U. S. Department of Defense	I&S 1100	Colorado Springs (Elec)	June 14, 1977
	J.C. Penny Company	5693	All Electric Utilities	March 8, 1978
	U.S. Department of Defense	I&S 1339	Colorado Springs DPU (Gas)	October 18, 1979
	U. S. Department of Defense	I&S 1540	Colorado Springs DPU (Gas)	February 9, 1982
	U.S. Department of Defense	C. Council	Colorado Springs DPU (Gas)	September 30, 1984
	U.S. Department of Defense	C. Council	Colorado Springs DPU (Elec)	June 6, 1985
	U.S. Department of Defense	C. Council	Colorado Springs DPU (Elec)	May 19, 1986
	U.S. Department of Defense	C. Council	Colorado Springs DPU (Elec)	June 30, 1987
CT	Retailers Merchants Association	72-0204	Various Electric Utilities	July 22, 1976
	Division of Consumer Counsel	76-0604,5	CL&P and HELCO	November 10, 1977
	Public Utilities Control Auto	78-0303	Bridgeport Hydraulic Co.	(none)
	Division of Consumer Counsel	80-0403,4	CL&P and HELCO	August 11, 1980
	Division of Consumer Counsel	81-0413	United Illuminating Company	July 20, 1981
	Division of Consumer Counsel	81-0602,4	CL&P and HELCO	October 5, 1981
	Division of Consumer Counsel	82-0701	CL&P	September 28, 1982
	Coalition of Hotels, Alloys & Retailers	85-10-22	CL&P	(none)
	Coalition of Hotels, Alloys & Retailers	87-07-01	CL&P	April 25, 1988

CHARLES W. KING
Appearances before State Regulatory Agencies

State	Electric, Gas, Water Utility Cases			Date of Cross-Examination
	Client	Case		
		Case Number	Utility	
DC	D.C. People's Counsel	685	Potomac Electric Power Company	March 6, 1978
	D.C. People's Counsel	715	Potomac Electric Power Company	(none)
	D.C. People's Counsel	725	Potomac Electric Power Company	April 4, 1980
	D.C. People's Counsel	737	Potomac Electric Power Company	January 1, 1981
	Washington Metro Area Transit Authority	748	Potomac Electric Power Company	June 26, 1981
	Washington Metro Area Transit Authority	758	Potomac Electric Power Company	December 15, 1981
	D.C. People's Counsel	785	Potomac Electric Power Company	September 21, 1982
	Washington Metro Area Transit Authority	759	Potomac Electric Power Company	March 29, 1984
	D.C. People's Counsel	685 Remand	Potomac Electric Power Company	June 10, 1985
	D.C. People's Counsel	905	Potomac Electric Power Company	August 20, 1991
	D.C. People's Counsel	912	Potomac Electric Power Company	May 7, 1992
	D.C. People's Counsel	834, III	Potomac Electric Power Company	May 22, 1992
	D.C. People's Counsel	917	Potomac Electric Power Company	September 24, 1992
	D.C. People's Counsel	922	Washington Gas Light Company	June 15, 1993
	D.C. People's Counsel	929	Potomac Electric Power Company	December 16, 1993
	D.C. People's Counsel	934	Washington Gas Light Company	Filed April 22, 1994
	D.C. People's Counsel	939	Potomac Electric Power Company	March 16, 1995
	D.C. People's Counsel	917	Potomac Electric Power Company	April 16, 1995
	D.C. People's Counsel	951	Potomac Electric Power Company	February 20, 1957
	D.C. People's Counsel	945	Potomac Electric Power Company	September 29, 1999
DE	DPSC Staff	94-164	Artesian Water Company	(none)
	DPSC Staff	94-149	Wilmington Surburban Water Company	March 10, 1995
FL	Florida Retail Federation	790593-EU	All Electric Utilities	March 5, 1981
	Florida Retail Federation	810002-EU	Florida Power and Light Company	July 23, 1981
	Florida Retail Federation	820097-EU	Florida Power and Light Company	September 22, 1982
	Florida Retail Federation	820097-EU	Florida Power and Light Company	April 11, 1983
	Florida Retail Federation	830012-EU	Tampa Electric Company	August 19, 1983
	Florida Retail Federation	830465-EI	Florida Power and Light Company	April 19, 1984
	Florida Retail Federation	830465-EI	Tampa Electric Company	(none)
GA	Georgia Retail Federation	3270-U	Georgia Power Company	September 3, 1981
	Georgia Public Service Commission	4007-U	Georgia Power Company	August 21, 1991
	Georgia Public Service Commission	4384-U	All Electric Utilities	August 1, 1993
	Georgia Public Service Commission	4755-U	Georgia Power Company	January 25, 1994
	Georgia Public Service Commission	4697-U	All Utilities	May 10, 1994
	Georgia Public Service Commission	9355-U	Georgia Power Company	November 4, 1998
HI	Public Utilities Department	2793	All Electric Utilities	February 14, 1978
	Hawaii Consumer Advocate	4536	Hawaiian Electric Company	February 1, 1983

CHARLES W. KING
Appearances before State Regulatory Agencies

State	Electric, Gas, Water Utility Cases			Date of Cross-Examination
	Client	Case		
		Case Number	Utility	
IL	Illinois Retail Merchants Association/ Chicago Bldg. Mgrs. Association	76-0698	Commonwealth Edison	June 22, 1977
	Illinois Retail Merchants Association/ Chicago Bldg. Mgrs. Association	76-0568	All Eletric Utilities	(none)
	Illinois Retail Merchants Association/ Chicago Bldg. Mgrs. Association	80-0546	Commonwealth Edison	March 5, 1981
	Illinois Retail Merchants Association/ Chicago Bldg. Mgrs. Association	82-0026	Commonwealth Edison	July 22, 1982
	Illinois Retail Merchants Association/ Chicago Bldg. Mgrs. Association	83-0537	Commonwealth Edison	March 19, 1984
	Illinois Retail Merchants Association/ Chicago Bldg. Mgrs. Association	87-0427	Commonwealth Edison	March/April 22, 1988
	Illinois Retail Merchants Association/	90-0169	Commonwealth Edison	October 29, 1990
IN	Indiana Retail Council	35780-S2	N. Ind. Public Service co.	June 1, 1980
	Indiana Retail Council	35780-S1	Public Service of Indiana	October 15, 1980
	Indiana Retail Council	36318	Public Service of Indiana	May 4, 1982
KS	J.C. Penny Company	115,379-U	All Kansas Utilities	January 22, 1981
KY	Seven Kentucky Retailers	7310	Louisville Gas & Electric Co.	April 25, 1979
MA	Coalition of Municipalities	20279	Western Massachusetts Electric	March 19, 1980
	Coalition of Municipalities	557/558	Western Massachusetts Electric	May 14, 1981
	Coalition of Municipalities	957	Western Massachusetts Electric	March 9, 1982
	Coalition of Municipalities	1300	Western Massachusetts Electric	January 1, 1983
	Coalition of Municipalities	85-270	Western Massachusetts Electric	March 26, 1986
MD	Maryland People's Counsel	6977	Washington Gas & Light Company	September 17, 1976
	Maryland People's Counsel	6814	Potomac Electric Power Company	
	Maryland People's Counsel	6807	All Electric Utilities	September 1, 1977

CHARLES W. KING
Appearances before State Regulatory Agencies

State	Electric, Gas, Water Utility Cases			Date of Cross-Examination
	Client	Case		
		Case Number	Utility	
MD	Maryland People's Counsel	6882	Baltimore Gas & Electric Company	(none)
	Maryland People's Counsel	6985	Baltimore Gas & Electric Company	September 28, 1976
	Maryland People's Counsel	7070	Baltimore Gas & Electric Company	December 20, 1976
	Maryland People's Counsel	7149	Potomac Electric Power Company	April 18, 1978
	Maryland People's Counsel	7163	All Electric Utilities	January 17, 1979
	Maryland People's Counsel	7236	Delmarva Power & Light Company	October 23, 1978
	Retail Merchants of Baltimore	7397	Baltimore Gas & Electric Company	June 20, 1980
	Maryland People's Counsel	7427	Delmarva Power & Light Company	September 8, 1980
	Maryland People's Counsel	7574	Baltimore Gas & Electric Company	December 2, 1981
	Maryland People's Counsel	7597	Potomac Electric Power Company	February 18, 1982
	Organization of Consumer Justice	7604	Potomac Electric Power Company	April 20, 1982
	Maryland People's Counsel	7588	Baltimore Gas & Electric Company	October 19, 1982
	Maryland People's Counsel	7663	Potomac Electric Power Company	November 22, 1982
	Retail Merchants of Baltimore	7685	Baltimore Gas & Electric Company	April 12, 1983
	Genstar Stone Products, et al.	7878	Potomac Electric Power Company	December 9, 1985
	Industrial Intervenors	7878	Potomac Electric Power Company	June 28/July 1986
	Maryland People's Counsel	7983	Baltimore Gas & Electric Company	March 4, 1987
MI	General Services Administration	U-10102	Detroit Edison Company	March 22, 1993
	Michigan Attorney General	U-11772	Consumers Energy/Detroit Edison	November 16, 1998
MN	Minnesota Retail Federation	EOO2/6R-77-611	Northern States Power	1979
MO	Missouri Retailers Association	EO-78-161	Kansas City Power & Light Company	February 19, 1981
NC	North Carolina Merchants Association	E-100	All Electric Utilities	December 18, 1975
NH	Business & Industry Association of N.H.	79-187-II	Public Service of N.H.	February 6, 1981
	Business & Industry Association of N.H.	80-260	Public Service of N.H.	February 5, 1981
	Business & Industry Association of N.H.	82-333	Public Service of N.H.	November 2, 1983

CHARLES W. KING
Appearances before State Regulatory Agencies

State	Electric, Gas, Water Utility Cases			Date of Cross-Examination
	Client	Case		
		Case Number	Utility	
NJ	Dept. of Public Advocate	761-8	Public Service Electric & Gas	January 18, 1977
	Dept. of Public Advocate	7911-951	Atlantic City Electric Co.	April 21, 1980
	N.J. Retail Merchants Association	803-151	All New Jersey Utilities	March 31, 1981
	Department of Public Advocate	815-459	N.J. Natural Gas Company	(none)
	Resorts International Hotel, Inc.	8011-827	Atlantic City Sewerage Co.	(none)
	Dept. of Public Advocate	822-116	Atlantic City Electric Co.	August 11, 1982
	Dept. of Public Advocate	355-87	Elizabethtown Gas	June 9, 1987
	Dover Township Fire Chiefs	88-080967	Tom's River Water Company	February 22, 1989
NY	N.Y. Council of Retail Merchants	26806	All Electric Utilities	February 3, 1976
	Metropolitan N.Y. Retail Council	27029	Consolidated Edison Company	(none)
	Metropolitan N.Y. Retail Council	27136	Long Island Lighting Company	July 1, 1977
	N.Y. Metro. Transit Authority	27353	Consolidated Edison Company	September 5, 1980
OH	Ohio Council of Retail Association	88-170-EL	Cleveland Elec. Illuminating	(none)
	Ohio Council of Retail Association	83-1529-EL	Cincinnati Gas & Electric	February 15, 1992
PA	Pennsylvania Retail Association	76-PRMD-7	All Electric Utilities	September 7, 1977
	Southeastern Pa. Transp. Authority	R-811626	Philadelphia Electric Company	December 11, 1981
	Eastern Penn Energy Users Group	R-822169	Penn. Power & Light Company	March/April 1983
	Eastern Penn Energy Association	R-842651	Penn. Power & Light Company	December 3, 1984
	Penn Business Utility User Group	R-850152	Philadelphia Electric Company	February 19, 1986
TX	Houston Retailers Association	5779	Houston Lighting Company	October 19, 1984
	Houston Retailers Association	6765	Houston Lighting Company	September 25, 1986
	Cities for Fair Utility Rates	8425/8431	Houston Lighting Company	April 25, 1989

CHARLES W. KING
Appearances before State Regulatory Agencies

State	Electric, Gas, Water Utility Cases			Date of Cross-Examination
	Client	Case		
		Case Number	Utility	
VA	Consumer Congress of Virginia Consumer Congress of Virginia Va. Business Committee on Energy Virginia Pipe Trades Council	19426 19960 PUE 7900012 PUE 8900051	Virginia Electric Power Company Virginia Electric Power Company Virginia Electric Power Company Old Dominion Electric Corp. &	July 1, 1975 September 19, 1978 February 25, 1981 October 31, 1989
WI	Wisconsin Merchants Federation	6630-ER-2	Wisconsin Electric Power Company	May 15, 1978

CHARLES W. KING
Appearances before State Regulatory Agencies

State	Telecommunications Cases			Date of Cross-Examination
	Client	Case		
		Case Number	Utility	
AL	U.S. Department of Defense	24472	All Telephone Companies	June 14, 1995
AZ	Arizona Burglar & Fire Alarm Association	9981-E-1051-80-64	Mountain State Telephone	(none)
	Federal Executive Agencies	E-1051-88-146	Mountain State Telephone	(none)
CA	Western Burglar & Fire Alarm Association	59849	Pacific Telephone & Telegraph	March 25, 1981
	Western Burglar & Fire Alarm Association	5984cont.	Pacific Telephone & Telegraph	June 23, 1982
	Western Burglar & Fire Alarm Association	A83-01-22	Pacific Telephone & Telegraph	June 29, 1983
	Western Burglar & Fire Alarm Association	A83-02-02	General Telephone of California	January 17, 1984
	Western Burglar & Fire Alarm Association	A82-11-07	Pacific Telephone & Telegraph	Jan. 18, Oct. 31 November 28, 1984
	Western Burglar & Fire Alarm Association	A85-01-034	Pacific Telephone & Telegraph	June 4, 1985 October 2, 1986
	Western Burglar & Fire Alarm Association	A87-01-02	General Telephone of California	October 22, 1987
	Western Burglar & Fire Alarm Association	A88-07-17019	Pac. Bell Tel. & GTE of CA.	January 23, 1989
	California Cellular Resellers	A.88-11-1040	All Cellular Carriers	August 11, 1989
	Federal Executive Agencies	1.87-11-033	All Telephone Companies	March 6-7, 1991
	California Cellular Resellers	1.88-11-040	All Cellular Carriers	August 19, 1991
	Cellular Services, Inc.	1.88-11-040	All Cellular Carriers	October 3, 1991
	Federal Executive Agencies	A92-05-004	Pacific Telephone & Telegraph	June 9, 1993
CO	U.S. Department of Defense	I&S 717	Mountain Bell Telephone Company	1972
	U.S. Department of Defense	I&S 1700	Mountain Bell Telephone Company	(none)
	U.S. Department of Defense	Appl.	Mountain Bell Telephone Company	September 18, 1986
	U.S. Department of Defense	I&S 1766	Mountain Bell Telephone Company	November 28, 1988
	Colorado Municipal League	Appl 36883	Mountain Bell Telephone Company	December 13, 1988
	U.S. Department of Defense	I&S 891-O82T	U.S. West Communications	February 21, 1990
	U.S. Department of Defense	905-544T	U.S. West Communications	July 17, 1991
	U.S. Department of Defense	90A-665T	U.S. West Communications	October 23, 1991
	U.S. Department of Defense	92M-039T	U.S. West Communications	February 24-24, 1992
	U.S. Department of Defense	92S-229T	U.S. West Communications	July 30-31, 1992
	U.S. Department of Defense	90A-665T	U.S. West Communications	November 6, 1996
	AT&T	96S-331T	U.S. West Communications	April 17, 1997

CHARLES W. KING
Appearances before State Regulatory Agencies

State	Telecommunications Cases			Date of Cross-Examination
	Client	Case		
		Case Number	Utility	
CT	Connecticut Consumer Counsel	770526	Southern New England Telephone Co.	November 10, 1977
	CT Cellular Resellers Assn.	89-12-05	Southern New England Telephone Co.	(none)
	CT Cellular Resellers Coalition	94-03-27	Springwich Cellular/Bell Atlantic	May 16, June, 1994
	AT&T	AT&T/SNET Arbitration	Southern New England Telephone Co.	Filed October 28, 1996
DC	D.C. People's Counsel	729	Chesapeake & Potomac Tel. Co.	May 13, 1980
	D.C. People's Counsel	798	Chesapeake & Potomac Tel. Co.	July 18, 1983
	General Services Administration	827	Chesapeake & Potomac Tel. Co.	May 7, 1985
	General Services Administration	854	Chesapeake & Potomac Tel. Co.	April 16, 1987
	General Services Administration	850	Chesapeake & Potomac Tel. Co.	October 7, 1991
	General Services Administration	926	Chesapeake & Potomac Tel. Co.	October 7, 1993
DE	Public Service Commission	Depr.Repre	Diamond State Telephone Co.	April 1, 1985
	Federal Executive Agencies	86-20	Diamond State Telephone Co.	July 31, 1987
	Public Service Commission	Depr.Repre	Diamond State Telephone Co.	March 8, 1988
FL	GTE Sprint Communications Company	720536-TP	All Telephone Companies	September 12, 1983
	Office of Public Counsel	Depr.Repre	Southern Bell	July 30, 1986
	Federal Executive Agencies	880069-TL	Southern Bell	July 21, 1988
	Federal Executive Agencies	880069-TL	Southern Bell	November 30, 1990
	Federal Executive Agencies	880069-TL	Southern Bell	February 11, 1992
GA	Georgia Attorney General	3893-U	Southern Bell Telephone Co.	January 8, 1990
	Federal Executive Agencies	3905-U	Southern Bell Telephone Co.	June 12, 1990
	Federal Executive Agencies	3987-U	Southern Bell Telephone Co.	February 13, 1992
	Georgia Public Service Commission	4018-U	Southern Bell Telephone Co.	Jan 14, Feb 10, 1993
HI	Hawaii Public Utility Commission	1871	Hawaiian Telephone Company	July 8, 1971
	Four Hawaii Counties	4588	Hawaiian Telephone Company	December 15, 1983
	Department of Defense	7579	Hawaiian Telephone Company	April 26, 1994
	Department of Defense	94-0093	Oceanic Communications	March 13, 1995
	Department of Defense	7702	All Communications Carriers	June 2, 1995
	Department of Defense	94-0298	GTE Hawaiian Telephone Company	May 7, 1996

State	Telecommunications Cases			Date of Cross-Examination
	Client	Case		
		Case Number	Utility	
ID	U.S. Department of Energy U.S. Department of Energy	U-1000-63 U-1000-70	Mountain Bell Telephone Co. Mountain Bell Telephone Co.	May 16, 1983 March 6, 1984
IL	Illinois Aalarm Companies Attorney Generaal of Illinois GTE Sprint Communications Co. Federal Executive Agencies	79-0143 81-0478 83-0142 89-0033	Illinois Bell Telephone Illinois Bell Telephone All Telephone Companies Illinois Bell Telephone	September 26, 1979 December 28, 1981 August 4, 1983 June 12, 1989
KS	State Corporation Commission Federal Executive Agencies Federal Executive Agencies	Depr. Repr. 166.856-U 190, 492	Southwestern Bell Southwestern Bell All Telephone Companies	May 12-14, 1986 November 7, 1989 November 4, 1994
MD	Maryland People's Counsel Maryland People's Counsel Maryland People's Counsel Maryland People's Counsel Federal Executive Agencies Federal Executive Agencies Federal Executive Agencies	6813 6881 7025 7467 7851 8106 8274	C&P Telephone Company C&P Telephone Company C&P Telephone Company C&P Telephone Company C&P Telephone Company C&P Telephone Company C&P Telephone Company	1975 December 17, 1975 March 15, 1975 October 20, 1981 March 20, 1985 May 9, 1988 August 2, 1990
MI	Michigan Attorney General Michigan Attorney General	U-8911 U-9553	Michigan Bell Telephone Co. AT&T Communications/MCI	November 7, 1988 December 4, 1990
MN	GTE Sprint Communications Co. U.S. Department of Defense	83-102-HC 87-021-BC	All Telephone Companies Northwest Bell Telephone Co.	August 5, 1983 (none)
MO	GTE Sprint Communications Co. Federal Executive Agencies Federal Executive Agencies	TR83-253 TC-89-14 TO-89-56	Southwestern Bell Tel. Co. Southwestern Bell Tel. Co. Southwestern Bell Tel. Co.	September 5, 1983 (none) November 7, 1990
MS	Federal Executive Agencies	U-5453	South Central Bell Tel. Co.	May 15, 1990

CHARLES W. KING
Appearances before State Regulatory Agencies

State	Telecommunications Cases			Date of Cross-Examination
	Client	Case		
		Case Number	Utility	
NJ	Department of Public Advocate Department of Public Advocate Department of Public Advocate Department of Public Advocate Department of Public Advocate	Depr.Repr. 815-458 Depr.Repr. Depr.Repr. T092030358	N.J. Bell Telephone Company N.J. Bell Telephone Company N.J. Bell Telephone Company N.J. Bell Telephone Company N.J. Bell Telephone Company	Mar-79 October 15, 1981 March 1, 1982 February 1, 1985 September 30, 1992
NM	New Mexico Corporation Commission New Mexico Corporation Commission	1032 86-151-TC	Mountain Bell Telephone Co. General Telephone of Southwest	November 14, 1983 February 5, 1987
NV	Prime Cable of Las Vegas Prime Cable of Las Vegas	95-8034/8035 96-9035	Central Telephone - NV Sprint/Centel, Nevada Bell	Filed November 22, 1995 June 2, 1997
NY	Holmes Protection, Inc. Holmes Protection, Inc. 5 Alarm Companies GTE Sprint Communications Co.	27350 27469 27710 28425	New York Telephone Company New York Telephone Company New York Telephone Company All Telephone Companies	October 17, 1978 May 17, 1979 July 24, 1980 July 8, 1983
PA	City of Philadelphia	R-832316	Pennsylvania Bell Telephone	September 20, 1983
SC	Office of Consumer Advocate Office of Consumer Advocate Office of Consumer Advocate Office of Consumer Advocate Office of Consumer Advocate	Depr.Repr. 86-511-C 86-541-C Depr.Repr. 89-180-C	Southern Bell Southern Bell General Telephone of South Southern Bell ALLTEL of South Carolina	July 1, 1986 December 11, 1986 April 8, 1987 July 10, 1989 September 26, 1989
TX	U.S. Department of Defense	8585/8218	Southwestern Bell Telephone Co.	(none)
VA	U.S. Dept. Of Defense, GSA, et Federal Executive Agencies	19696 PUC 890014	C&P Telephone Company All Telephone Companies	October 6, 1976 February 13, 1989

CHARLES W. KING
Appearances before State Regulatory Agencies

State	Telecommunications Cases			Date of Cross-Examination
	Client	Case		
		Case Number	Utility	
VI	V.I. Department of Commerce V.I. Public Service Commission	205 341	Virgin Islands Telephone Co. Virgin Islands Telephone Co.	April 29, 1980 March 20, 1991
WA	U.S. Department of Defense U.S. Department of Defense U.S. Department of Defense U.S. Department of Defense WA Attorney General/TRACER U.S. Department of Defense U.S. Department of Defense WA Attorney General/TRACER WA Attorney General/TRACER	U-72-39 U-87-796-T U-88-20524 U-89-2698-F UT-940641 UT-941464 UT-951425 UT-961632	Pacific Northwest Bell Pacific Northwest Bell Pacific Northwest Bell US West Communications US West Communications US West Communications US West Communications US West Communications GTE Northwest, Inc	1973 December 20, 1983 November 8, 1988 November 28, 1989 Filed October 14, 1994 June 22, 1995 January 22, 1996 Filed June 23, 1997 July 29, 1997
WI	GTE Sprint	6720-TR-38	All Telephone Companies	October 20, 1983

Client	Docket	Subject	Date of Cross-Examination
Federal Communications Commission			
Department of Defense	16020	Consat Rate of Return	1973
Airline Parties	16258	Bell System Rates	July 22, 1968
Airline Parties	18128	TELPAK	3/22, 10/15 1971, Feb. 22, 1972
National Data Corporation	19989	WATS	(none)
Press Wire Services	19919	Private Line Rates	(none)
Aeronautical Radio	20814	Private Line Rates	October 5, 1978
Department of Defense	20690	1,544 Mbps Service	January 30, 1979
State of Hawaii	21263	Interstate Separation	February 7, 1979
International Record Carriers	CC78-97	Telex/TWX Rates	March 6, 1980
ITT World Communications	CC84-633	Rate of Return	(none)
Aeornautical Radio	CC78-72	Access Line Charges	(none)
MCI	CC84-800	Rate of Return	(none)
Ind. Data Com. Mfg. Assn.	CC85-26	AT&T Accounting Plan	(none)
Tymnet, Inc.	ENF84-22	Packet Switching Costs	(none)
Adelphia Jones Intercable, et. al.	Bell Atlantic	Video Dialtone	Filed 7/29/94
Adelphia Jones Intercable, et. al.	Bell Atlantic	Video Dialtone	Filed 8/23/94
Adelphia Jones Intercable, et. al.	Bell Atlantic	Video Dialtone	Filed 2/21/95
Nuclear Regulatory Commission			
Fauquier League for Environment Protection	50-328 50-329	Va. Electric Power Co.	1976
Postal Rate Commission			
Association of Third Class Mail Users	R71-1	Rates	1970
Dow Jones & Company	R72-1	Rates	1972
Dow Jones & Company	R74-1	Rates	September 13, 1974
Dow Jones & Company	MC76-2	Rate Structure	January 6, 1979
Dow Jones & Company	MC79-3	Rate Structure	September 12, 1979
Dow Jones & Company	R80-1	Rates	November 25, 1980
Warshawsky & Company	C82-1	Rate Structure	(none)
Dow Jones & Company	R84-1	Postal Costs	June 14, 1984
Dow Jones & Company	R87-1	Rate Structure Costs	November 2, 1987
Dow Jones & Company	R90-1	Rate Structure Costs	Sept 12, Oct 10, 1990
Dow Jones & Company	MC91-1	Pre-barcoding Discounts	November 19, 1991
Dow Jones & Company	MC91-3	Palletization Discounts	March 2, 1992

CHARLES W. KING
Appearances before Federal Regulatory Agencies

U.S. Congress			
Client	**Docket**	**Subject**	**Date of Cross-Examination**
National Retail Merchants Association National Wireless Resellers Association	House/Senate Hearings House Commerce Committee	Electric Rate Reform Legislation Interconnection & Resale of Wireless Services	1976, 1977 & 1979 October 12, 1995
Federal Maritime Commission			
State of Hawaii Foss Alaska Line Palmetto Shipping and Stevadoring	71-18 79-54 85-20	Ocean Shipping Rates Barge Rate Increase Vessel Charge Liability	October-71 Jul-79 October 27, 1986
Interstate Commerce Commission			
Western Coal Traffic League Western Coal Traffic League Western Coal Traffic League Arkansas Power & Light Co. Central Illinois Light Co. Western Coal Traffic League	Ex Parte 349 Ex Parte 357 Ex Parte 375 (Sub1) 37276 37450 Ex Parte 347	R.R. Rate Increase R.R. Rate Increase R.R. Rate Increase Cost of Capital Cost of Capital Costing Methods	May-76 Oct-78 June 1, 1980 (none) March 10, 1981 (none)
Thomas Cook, Inc.	36595	Air Fare Deregulation	(none)
Copyright Royalty Tribunal			
Public Broadcasting Service	88-2-86CD	Television Valuation	(none)
Federal Energy Regulatory Commission			
Exxon USA	OR89-2-000	Pipeline Quality Bank	October 18, 1990
Canadian Transport Commission			
Rail Costing Inquiry, 1967-1969 Telecommunications Costing Inquiry, 1972-1975			

DCF Cost Of Capital

Electric Utilties Rated A3 or Higher by Moody's

April 2000

as of July 3, 2000

Company (Utility Subsidiary)	Stock Symbol	Moody's Long-term Debt Rating	Next 5-year growth (Percent)	Yield (Percent)	DCF Return (Percent)
Allegheny	AYE	A1	4.58	6.10	10.68
Alliant Energy Corp	LNT	A2	4.00	7.50	11.50
Ameren Corp.	AEE	Aa2	3.33	7.50	10.83
Cleco Corp.	CNL	A2	9.00	4.90	13.90
Constellation (Baltimore Gas & Electric)	CEG	A1	6.60	5.20	11.80
Carolina Power & Light	CPL	A2	4.92	6.39	11.31
CILCORP (Central Illinois Light Co.))	CER	A2	N/A	N/A	N/A
Consolidated Edison	ED	A1	3.33	7.40	10.73
DTE Energy	DTE	A3	4.83	6.50	11.33
Dominion Resources (VEPCO)	D	A2	7.82	6.00	13.82
Duke Energy	DUK	Aa3	8.81	3.90	12.71
Edison International	EIX	A2	7.78	5.50	13.28
EnergyEast (NYSEG)	NEG	A3	7.57	4.50	12.07
Florida Power & Light	FPL	A2	6.09	4.40	10.49
Florida Progress Co.	FPC	A1	4.95	4.70	9.65
Hawaiian Electric Industries	HE	A3	3.14	7.10	10.24
Kansas City Power & Light	KLT	A1	3.60	7.40	11.00
LG & E Energy	LGE	A3	3.89	5.30	9.19
Madison Gas & Electric	MDSN	Aa2	N/A	N/A	N/A
New England Electric System	NES	A1	N/A	N/A	N/A
New Century Energies	NCE	A3	4.69	7.20	11.89
Northern States Power	NSP	Aa3	5.63	7.20	12.83
OGE Energy (Oklahoma G & E)	OGE	A1	4.00	7.20	11.20
Otter Tail Power	OTTR	Aa3	5.00	4.90	9.90
PG & E Corp (Pacific Gas & Electric)	PCG	A1	6.83	4.90	11.73
Potomac Electric Power Corp. (PEPCO)	POM	A1	3.81	6.40	10.21
PP & L Resources	PPL	A3	5.33	4.80	10.13
Reliant Energy (HL & P)	REI	A3	9.34	5.10	14.44
Sempra Energy	SRE	A2	6.75	7.10	13.85
SCANA Corp.	SCG	A!	4.46	4.60	9.06
TECO Energy (Tampa Electric)	TE	Aa3	6.41	6.70	13.11
Western Resources	WR	A3	4.60	7.70	12.30
Wisconsin Energy (WEPCO)	WEC	Aa2	4.50	7.90	12.40
WPS Resources (Wisconsin Pub. Serv.)	WPS	Aa2	3.00	6.70	9.70
Mean			**5.44**	**6.09**	**11.53**

ANALYSIS OF STOCK RETURNS, BOND RETURNS AND RISK PREMIA
1926-1981

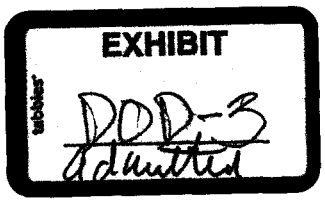
YEAR	STOCKS	BONDS	RISK PREMIA
1926	0.1162	0.0737	0.0811
1927	0.3749	0.0744	0.3342
1928	0.4361	0.0284	0.3924
1929	-0.0842	0.0327	-0.1264
1930	-0.2490	0.0798	-0.2671
1931	-0.4334	-0.0185	-0.4397
1932	-0.0819	0.1082	-0.0911
1933	0.5339	0.1038	0.5360
1934	-0.0144	0.1384	-0.0160
1935	0.4767	0.0961	0.4743
1936	0.3392	0.0674	0.3369
1937	-0.3503	0.0275	-0.3523
1938	0.3112	0.0613	0.3115
1939	-0.0041	0.0397	-0.0043
1940	-0.0978	0.0339	-0.0978
1941	-0.1159	0.0273	-0.1164
1942	0.2034	0.0260	0.2003
1943	0.2590	0.0283	0.2547
1944	0.1975	0.0473	0.1936
1945	0.3644	0.0408	0.3600
1946	-0.0807	0.0172	-0.0840
1947	0.0571	-0.0234	0.0518
1948	0.0550	0.0414	0.0466
1949	0.1879	0.0331	0.1751
1950	0.3171	0.0212	0.3019
1951	0.2402	-0.0269	0.2222
1952	0.1837	0.0352	0.1646
1953	-0.0099	0.0341	-0.0277
1954	0.5262	0.0539	0.5136
1955	0.3156	0.0048	0.2956
1956	0.0656	-0.0681	0.0400
1957	-0.1078	0.0871	-0.1353
1958	0.4336	-0.0222	0.4126
1959	0.1195	-0.0097	0.0876
1960	0.0047	0.0907	-0.0215
1961	0.2689	0.0482	0.2429
1962	-0.0873	0.0795	-0.1118
1963	0.2280	0.0219	0.1914
1964	0.1648	0.0477	0.1254
1965	0.1245	-0.0046	0.0822
1966	0.1006	0.0020	-0.1420
1967	0.2398	-0.0495	0.1904
1968	0.1106	0.0257	0.0559
1969	0.0850	-0.0809	-0.1423
1970	0.0401	0.1837	-0.0240
1971	0.1431	0.1101	0.0954
1972	0.1898	0.0726	0.1462
1973	-0.1466	0.0114	-0.2029
1974	-0.2647	-0.0306	-0.3213
1975	0.3720	0.1464	0.2983
1976	0.2384	0.1865	0.1794
1977	-0.0718	0.0171	-0.1175
1978	0.0656	-0.0007	-0.0059
1979	0.1844	-0.0418	0.0736
1980	0.3242	-0.0262	0.1911
1981	-0.0491	-0.0096	-0.1729
1. Mean	0.1205	0.0374	0.0828
2. Standard Deviation	0.2148	0.0562	0.2204
3. T-value (1. / 2.)	0.56	0.67	0.38
4. Relative Error (2. / 1.)	178.2%	150.2%	266.1%

Source: Stocks, Bonds, Bills and Inflation, The Past and the Future, Roger Ibbotson and Rex A Sinquefield
Roger Ibbotson and Rex A Sinquefield, The Financial Analysis Research Foundation, 1982 Edition

Mean = Average or expected value of series
Standard Deviation = Average error of Series
T-value = Significance of Average Value - For 95% Confidence that Mean is representative of series t-value must be > 1.96
Relative Error = Average Error as a Percent of Average Value

None of these averages can be used as representatative of a typical value for stocks, bonds, or risk premia.

BEFORE THE ARIZONA CORPORATION COMMISSION



CARL J. KUNASEK
Chairman
JIM IRVIN
Commissioner
WILLIAM A. MUNDELL
Commissioner

IN THE MATTER OF THE APPLICATION OF U S WEST COMMMUNICATIONS, 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-01051B-99-0105**

SURREBUTTAL TESTIMONY
of

RICHARD B. LEE

on behalf of

THE UNITED STATES DEPARTMENT OF DEFENSE
And
ALL OTHER FEDERAL EXECUTIVE AGENCIES

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September 8, 2000

Surrebuttal Testimony of Richard B. Lee

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1 **INTRODUCTION**

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

3 A. My name is Richard B. Lee. I am Vice President of the economic consulting firm
4 of Snavely King Majoros O'Connor & Lee, Inc. ("Snavely King"). My business
5 address is 1220 L Street, N.W., Suite 410, Washington, D.C. 20005.

6 **Q. ON WHOSE BEHALF ARE YOU APPEARING IN THIS DOCKET?**

7 A. I am appearing on behalf of the Department of Defense and all other Federal
8 Executive Agencies ("DOD/FEA").

9 **Q. ARE YOU THE SAME RICHARD B. LEE WHO SUBMITTED DIRECT**
10 **TESTIMONY IN THIS PROCEEDING ON JULY 25, 2000?**

11 A. Yes, I am.

12 **Q. DID YOUR DIRECT TESTIMONY CONTAIN A DESCRIPTION OF YOUR**
13 **BACKGROUND AND EXPERIENCE?**

14 A. Yes, it did.

15 **Q. WAS THIS TESTIMONY PREPARED BY YOU OR UNDER YOUR DIRECT**
16 **SUPERVISION?**

17 A. Yes, it was.

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

19 A. In this surrebuttal testimony, I will respond to the rebuttal testimony of QWEST
20 witnesses George Redding, Kerry Dennis Wu and Ann Koehler-Christensen.

1 **Q. PLEASE SUMMARIZE YOUR FINDINGS.**

2 A. Most of the criticisms of my Direct Testimony are without merit. In my Direct
3 Testimony I proposed seven adjustments which had the effect of changing
4 Qwest's revenue requirement deficiency of $201.2 million to an excess of $46.9
5 million.[1] My review of the Rebuttal Testimonies filed by Qwest and the Direct
6 Testimonies of other parties has led me to revise certain adjustments and add an
7 eighth adjustment. I now calculate Qwest's revenue excess to be $52 million.

8

9 **TEST PERIOD THEORY**

10

11 **Q. WHAT IS A TEST PERIOD?**

12 A. A "test period" is a snapshot of a regulated company's financial performance for
13 use in determining the company's revenue requirement.

14 **Q. WHAT TYPE OF TEST PERIODS HAVE REGULATORS USED IN**
15 **DEVELOPING REVENUE REQUIREMENTS?**

16 A. Regulators have generally used either "historic", "fully forecast", or "partially
17 forecast" test periods.

18 **Q. PLEASE DESCRIBE AN HISTORIC TEST PERIOD.**

19 A. An historic test period is one for which all financial data is available. Its
20 advantage lies in the reviewable nature of this data. It requires adjustment,

[1] Lee Direct, p. 4.

however, for use in ratemaking. First, it must be adjusted to accurately reflect only the revenues and expenses relevant to the period in question. Mr. Redding refers to such adjustments as "accounting" adjustments.[2] Second, it may need to be adjusted to reflect conditions expected during the first year of new rates. In general, the use of an historic test period assumes that revenues and costs will change over time in a consistent manner such that the company's rate of return will remain constant. If there are specific conditions which can be expected to be upset this consistency, they can be accommodated by adjustments to the historic test period. Mr. Redding refers to such adjustments as "pro forma" adjustments.[3]

This proceeding is based upon an historic test period of December 31, 1999.

Q. PLEASE DESCRIBE A FULLY FORECAST TEST PERIOD.

A. A fully forecast test period is for a future period for which no financial data is available. Its advantage lies in that it requires no accounting adjustments and, if the period chosen is the first year of new rates, no pro forma adjustments. It can be just as contentious as an historic test period, however, since it is based entirely upon future estimates.

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[2] Redding Rebuttal, p. 6.

[3] Id., p. 7.

Q. PLEASE DESCRIBE A PARTIALLY FORECAST TEST PERIOD.

A. As the name implies, a partially forecast test period consists of some months for which financial data is available, and some months which are fully forecast. It shares the strengths and weakness of both the historic and fully forecast test periods.

Q. WHAT ARE "COMMISSION" ADJUSTMENTS?

A. Commission adjustments is the term Mr. Redding uses to refer to adjustments made by the Commission in prior rate cases.[4] Such adjustments can be made to any type of test period, and reflect decisions made by a Commission to impute or disallow revenues, expenses or investment in determining revenue requirements. I will use the term "policy" adjustments in this testimony to include both past Commission adjustments and proposed imputations or disallowances.

Q. DO YOU AGREE WITH MR. REDDING'S DEFINITION OF THE PURPOSE OF THE TEST PERIOD?

A. Mr. Redding describes the purpose of the test period twice. On Page 4 he states:

> The purpose of the test period is to estimate, to the best extent possible, the conditions that will exist when rates from this proceeding will go into effect.

This definition is appropriate only for fully estimated test periods. It is likely that all financial data (revenues, expenses and investment) will differ greatly from an

[4] Id., p. 6.

historical test period by the time rates go into effect.

Mr. Redding's other description of the purpose of the test period is almost correct. On page i of his Summary he states:

> The purpose of any properly adjusted test period is to produce a revenue requirement that will allow the Company the opportunity to achieve the requested rate of return in the future when rates from the proceeding will be in effect.

I take issue with only the use of word "requested' instead of "allowed" when referring to the rate of return. The appropriate target rate of return is a contentious issue in this proceeding, as in most rate cases.

Q. IS MR. REDDING'S COMPARISON OF ADJUSTED RATES OF RETURN ON PAGE 9 OF HIS REBUTTAL TESTIMONY RELEVANT TO THIS PROCEEDING?

A. No. Mr. Redding annualizes booked financial data for the first five months of 2000 and adjusts this data by the net operating income value of the revenue requirement he calculates to determine an adjusted rate of return. He performs that same calculation based upon the proposed revenue requirements of the Commission Staff ("Staff") and the Residential Utility Consumer Office ("RUCO"). He then compares this data to the rate of return proposed by each party.

In effect, Mr. Redding is introducing a new partially forecast test period (5 months actual, 7 months estimated). For it to be relevant at all, this period would require accounting adjustments to normalize the first 5 months and various pro

1 forma adjustments. It is entirely too late in this proceeding to start all over again
2 with a new test period.
3 Furthermore, Mr. Redding's analysis is grossly misleading on its face
4 because it ignores policy adjustments proposed by the parties. For example,
5 both Staff and RUCO propose a continuation of the $43 million directory
6 advertising revenue imputation which has been in effect for the past sixteen
7 years. To be relevant to this proceeding, any comparison to booked data would
8 have to reflect such policy imputations and disallowances.
9 But even if Mr. Redding's calculations were somehow revised to reflect
10 accounting, pro forma and policy adjustments, it would still not be relevant to the
11 question of which revenue requirement calculation is correct as of the historical
12 test period ended December 31, 1999. This is because a properly adjusted test
13 period provides the Company with only the opportunity to earn the allowed rate
14 of return, not a guarantee.
15 Financial bookings beyond the test period reflect actual input price
16 changes, achieved productivity levels and a myriad of management decisions
17 affecting expenses and investments. Absent significant exogenous factors,
18 achieved returns can be described as the result of the relative growth in input
19 prices and productivity. If input price increases exceed productivity gains,
20 returns go down. If productivity gains exceed input price increases, returns go
21 up. A comparison of financial bookings beyond a test period to test period
22 calculations sheds little light on the appropriateness of test period adjustments.

Ironically, Qwest itself disavowed such calculations nearly a year ago. On December 13, 1999, DOD/FEA requested revenue data for months beyond the then test period of June 30, 1998.[5] Qwest objected to this request on December 21, 1999. Qwest stated:

> US WEST objects to Information Request DOD/FEA 3-1 on the grounds that it is not reasonably calculated to lead to the discovery of admissible evidence and that it calls for information significantly outside of the test-year established in this matter.[6]

DOD/FEA did not pursue its request for all of the reasons discussed above. Financial bookings beyond the test period simply are not relevant to the determination of a Company's test period revenue requirement.

ADJUSTMENT 1 – CUSTOMER OPERATIONS EXPENSE

ADJUSTMENT 2 – CORPORATE OPERATIONS EXPENSE

Q. DOES QWEST ACCEPT YOUR FIRST TWO ADJUSTMENTS?

A. No. In my Direct Testimony I proposed test period revenue requirement reductions of $20.5 million for customer operations expense and $11.7 million for corporate operations expense.[7] Mr. Redding had based his revenue

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[5] DOD/FEA Information Request 3-1(See Attachment 7).

[6] Qwest, Objections to Department of Defense's Third Set of Information Requests to U S WEST Communications, Inc., p. 1 (See Attachment 8).

[7] Lee Direct, pp. 5-7.

requirement calculation on a five month trend of expenses from October 1999 to February 2000. I based my calculation on the trend of customer and corporate operations expenses from January 1997 through December 1999.[8] Mr. Redding contends that my adjustment relies on "old history".

Ironically (again), Mr. Redding attempts to discredit my calculation by reference to a trend chart he prepared of Expenses Other than Depreciation from January 1997 through May 2000. His reliance on "old history" is, of course, as appropriate as mine. Thirty-six months of history provides a sound basis for trending expenses. His conclusion, however, that my specific adjustments to customer and corporate expenses are somehow invalidated by his charting of total expenses is incorrect. As discussed above, and as Qwest contended last year, financial bookings beyond the test period are irrelevant to the determination of appropriate historical test period adjustments. My calculation accurately shows the going-basis level of customer and corporate operations expenses as of the test period, December 31, 1999.

ADJUSTMENT 3 – SERVICES DEREGULATED BY FCC

Q. DOES QWEST ACCEPT YOUR THIRD ADJUSTMENT?

A. Not exactly. In my Direct Testimony, I proposed a test period revenue

[8] My specific adjustments were calculated as of the end of December 1999 to coincide with the historical test period in this proceeding.

requirement reduction of $13 million which I believed was half of the test period loss on services deregulated by the Federal Communications Commission ("FCC"). This is the treatment afforded such services by the Commission in the last rate case.

Mr. Redding believes such services should be specifically deregulated by the Commission and removed completely from the test period.[9] If the Commission deregulates these services, I agree that their impact should be completely removed from the test period. If the Commission does not deregulate these services, I believe half of any gains or losses should be removed from the test period.

I find, however, that my calculation as submitted is in error. In an information request, DOD/FEA asked for a break-out of all revenue, expense and rate base amounts included in the test year, but considered nonregulated by the FCC.[10] U S WEST's response provided me with the data for all services considered nonregulated by the FCC, including those <u>not</u> included in the test year. On Attachment 1 to this Surrebuttal Testimony I have revised my third adjustment to reflect the removal of half of the losses for <u>only</u> those services included in the test period. The revised revenue requirement reduction is $2.4 million as shown on Page 2 of Attachment 1.

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[9] Redding Rebuttal, pp. 45-46.

[10] Information Request DOD/FEA 4-7.

1 **ADJUSTMENT 4 – DIRECTORY ADVERTISING**

2

3 **Q. DOES QWEST ACCEPT YOUR FOURTH ADJUSTMENT?**

4 A. No. In my Direct Testimony, I proposed a test period revenue requirement
5 reduction of $42.7 million to reflect the long-standing imputation of directory
6 advertising revenues in the determination of intrastate revenue requirements.[11]
7 This policy adjustment is based upon the decision of the court to transfer the
8 directory function to the Bell Operating Companies in 1984 so that the significant
9 profits of this operation would continue to be used to reduce local telephone
10 rates.

11 Ms. Koehler-Christensen contends that a 1988 settlement agreement
12 between Mountain Bell and the Commission dictate that the fees and value of
13 services received by Qwest from DEX are to be the basis for any directory
14 imputation.[12] She relies upon the following part of the settlement agreement:

15 [T]he Commission, in arriving at the test year
16 operating income of Mountain Bell, will consider
17 the fees and the value of services received by
18 Mountain Bell from USWD under publishing
19 agreements with USWD; that Mountain Bell and
20 the Commission Staff may present evidence in
21 support of or in contradiction to those fees and
22 the value of those services.[13]

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[11] Lee Direct, pp. 8-10.

[12] Koehler-Christensen Rebuttal, p. 18.

[13] Id., Page i (emphasis added).

She than proceeds to detail the fees and the value of service received by Qwest from DEX, and concludes that no additional revenue imputation is appropriate.[14]

There is a fatal flaw in Ms. Koehler-Christensen's logic. While the Commission must consider the fees and value of services received by Qwest from DEX, the basis for imputation is the value of the directory function transferred to DEX. For over a decade, this value has been $43 million. For example, if a publishing fee of $20 million were to be received by Qwest from DEX, the Commission would be obligated to consider this fee and reduce the $43 million imputation accordingly. Absent such publishing fee, the imputation must continue.

Ms. Koehler-Christensen does, however, correctly note that I failed to remove $1.7 million in fees that were actually received by Qwest from DEX from the $43 million imputation. Attachment 2 to this Surrebuttal Testimony revises my calculation of Adjustment 4 to correct this omission, and shows a revised revenue requirement reduction of $41.3 million.

ADJUSTMENT 5 – PRODUCTIVITY

Q. DOES QWEST ACCEPT YOUR FIFTH ADJUSTMENT?

A. Mr. Redding appears to accept the concept of a productivity adjustment, but he

[14] Id., p. 11.

contends that I am applying it in a "mechanical manner."[15] He once again supports his opposition to my adjustment by reference to financial bookings beyond the test period. He states:

> As shown on Rebuttal Exhibit GAR-R2, Expenses Other Than Depreciation, the pro forma level of these expenses proposed by the Company exactly matches the levels of actual expenses as of May 2000. This pro forma level of expenses includes the full value of the out of period wage increases with no productivity offset. Had the Company's pro forma level been higher than actual May 2000, expenses, then a reevaluation of that pro forma level might have been appropriate.[16]

Mr. Redding's argument should be rejected.

As discussed at length above, actual financial bookings beyond the test period can be affected by many factors and are irrelevant to the appropriateness of test period adjustments. My productivity adjustment of 3.5 percent was based upon Qwest's average productivity for the five year period ending 1998.[17] My adjustment is based upon the concept that, if the Commission allows adjustment for input price increases beyond the test period, as proposed by Mr. Redding, it must also allow an adjustment for expected productivity improvement beyond the

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[15] Redding Rebuttal, p. 57.

[16] Id. (emphasis added).

[17] Lee Direct, p. 11.

test period. To do otherwise would be to bias the revenue requirement calculation improperly.

Conceptually, if Qwest continues to achieve average productivity gains beyond the test period, it will achieve the rate of return targeted in this proceeding. If its productivity is above average, its achieved return will be above the target. If its productivity is below average, its achieved return will be below the target.

Even if we assume that Mr. Redding's calculations demonstrate that Qwest's actual productivity for the first five months of 2000 has dropped to zero, my test period adjustment remains appropriate. The Commission should expect no less than average productivity from Qwest. The rejection of my productivity adjustment would effectively reward Qwest for a decrease in its productivity.

Mr. Redding has updated his productivity calculation to include 1999 data.[18] The average productivity for the five year period ending 1999 remains 3.5 percent, so there is no need for a revision to my originally filed productivity adjustment.

[18] 1999 productivity was 3.6 percent. Qwest Response to UTI 60-15.

1 **ADJUSTMENT 6 – DEPRECIATION**

2

3 **Q. DOES QWEST ACCEPT YOUR SIXTH ADJUSTMENT?**

4 A. No. Mr. Wu contends that my adjustment is inconsistent with the Commission's
5 depreciation orders.[19] He states that the effect of my adjustment is a write-off of
6 investment and a denial of capital recovery on that investment. He states that
7 such a writeoff proposal was rejected by the Commission in Decision No. 62507.

8 My sixth adjustment proposed a revenue requirement reduction of $109
9 million based upon the use of depreciation rates incorporating the depreciation
10 lives adopted by the Commission in Docket No. 62507.[20] Mr. Wu does not
11 dispute this fact. He does, however, protest my calculations, which assume that
12 rates based upon these lives would be effective as of the study date used by Mr.
13 Wu to develop rates (1/1/97). While conceding that the FCC requires that
14 depreciation rates be calculated effective as of the study date, he contends that
15 such an assumption should not be adopted in this proceeding since (1) the
16 depreciation order was dated three and a half years after the study date, and (2)
17 the Commission can legally ignore the FCC's policy.[21]

---

[19] Wu Rebuttal, p. 4.

[20] Attachment 3 to this Surrebuttal Testimony revises Adjustment 6 to incorporate technical corrections in accordance with Qwest's response to WDA 34-9. This revision results in a revised revenue requirement reduction of $110 million.

[21] Id., p. 5.

1 Mr. Wu is correct in noting that the FCC leaves it to the states to decide when
2 intrastate depreciation rates will become effective for state ratemaking purposes.
3 The Commission should use this discretion to assume that the lives it adopted
4 were effective as of the study date in this proceeding.

5 The depreciation lives adopted by the Commission in Docket No. 62507
6 are very short. The depreciation rates calculated by Mr. Wu as of 1/1/97 are
7 very high, because depreciation reserve levels as of 1/1/97 were relatively low.
8 Unless these rates are assumed to be effective (for ratemaking purposes) as of
9 1/1/97, Qwest's revenue requirement as of December 31, 1999, test period will
10 combine high depreciation rates with high net book costs. As I noted in my
11 Direct Testimony, this is precisely the result that the FCC found would
12 disadvantage consumers and competitors.[22]

13 The FCC requires carriers to write-down its investment before it will
14 prescribe depreciation lives as short as this Commission has approved. The
15 Commission need not require Qwest to write-off its investment to ensure just and
16 reasonable rates. The Commission need only adopt the ratemaking adjustment I
17 have proposed. If it accepts my adjustment, Qwest's revenue requirement will
18 reflect an appropriate level of depreciation accruals.

19 If my adjustment is not adopted, the level of depreciation accruals in

[22] Lee Direct, p. 14.

1 Qwest's revenue requirement will be excessive. The Supreme Court has found
2 that excessive depreciation represents, in effect, capital contributions paid by
3 subscribers.[23] The Commission is not empowered to require telephone
4 subscribers to contribute capital to finance Qwest's operations.

5 **Q. HAVE YOU REVIEWED STAFF'S POSITION ON DEPRECIATION?**

6 A. Yes, I have. William Dunkel's Direct Testimony provides an alternative to my
7 proposal which should be adopted if my proposal is rejected.

8 First, Mr. Dunkel ameliorates the problem of very short depreciation lives
9 in combination with high net book costs by calculating rates as of the test period
10 (December 31, 1999) using the lives adopted by the Commission and the
11 depreciation reserve level as of December 31, 1999.[24] If this adjustment is
12 adopted, Qwest should be required to revise its regulatory books to reflect these
13 rates.[25]

14 Second, Mr. Dunkel proposes a rate credit if Qwest's plant retirements do
15 not materialize as implied by the very short lives adopted by the Commission. In
16 effect, I view this mechanism as giving Qwest the "benefit of a doubt" in

---

[23] Lindheimer v. Illinois Bell Telephone Co., 292 U.S. 151, 78 L. ed 1182, 54 S. Ct. 658 (1934).

[24] For the Analog Switching account, Mr. Dunkel used the rate calculated by Mr. Wu as of 1/1/97. In effect, this implies a 3.4 year life, which would be appropriate for a "dying" account amortization pursuant to established FCC practices.

[25] The Analog Switching account should reflect a 3.4 percent year amortization.

establishing its revenue requirement. If Qwest does indeed experience an "avalanche" of retirements in the next few years, its short depreciation lives will be justified. In this case, the higher rates paid by subscribers will not included a capital contribution. If these retirements do not materialize, the high depreciation rates will represent a capital contribution, and Qwest should be required to return its excess recoveries to ratepayers in the form of a billing credit.

ADJUSTMENT 7 – RATE OF RETURN

Q. DOES QWEST ACCEPT YOUR SEVENTH ADJUSTMENT?

A. No. In his Surrebuttal Testimony, DOD/FEA witness Charles W. King addresses Qwest's rebuttal testimony on the subject of rate of return.

Q. DO YOU HAVE A REVISION TO ADJUSTMENT 7?

A. Yes, I do. My revisions to Adjustments 3 and 6 require a conforming revision to Adjustment 7. I have shown this revision on Attachment 4 to this Surrebuttal Testimony.

ADJUSTMENT 8 – REVENUES

Q. HAS MR. REDDING'S REBUTTAL TESTIMONY LED YOU TO PROPOSE AN EIGHTH REVENUE REQUIREMENT ADJUSTMENT?

1 A. Yes. Mr. Redding presents a chart trending intrastate revenues since January
2 1997. On Page 1 of Attachment 5 to this Surrebuttal Testimony I have
3 determined the revenue level as of the test period, December 31, 1999, based
4 upon the trend of intrastate revenues from January 1997 through December
5 1999. This is the same trending methodology I used to develop Adjustments 1
6 and 2 as discussed above.
7 On Page 3 of Attachment 5, I compare this revenue level to that proposed
8 by Mr. Redding for the test period and determine that Mr. Redding has
9 overstated test period revenues by $15 million. On Page 4 of Attachment 5, I
10 calculate a revenue requirement reduction of $15 million as Adjustment 8.
11
12 **CONCLUSION**
13
14 **Q. HAVE YOU PREPARED A SUMMARY OF YOUR PROPOSED REVENUE**
15 **REQUIREMENT ADJUSTMENTS?**
16 A. Yes. Attachment 6 to this Surrebuttal Testimony provides a summary of my
17 proposed adjustments, including the revisions discussed above. As shown in
18 Column j, I calculate a Qwest test period revenue excess of $52 million.
19 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**
20 A. Yes, it does.

DOD/FEA Test Year Adjustment 3
Services Deregulated By FCC
$(000)

		FCC Deregulated Services (a)	1/2 FCC Deregulated Services (b = a / 2)
1.	Revenues	85,479	42,739
2.	Expenses	86,748	43,374
3.	Rate Base	18,914	9,457

Source: Col. a = Staff Direct, Schedule C-17

DOD/FEA Test Year Adjustment 3
Services Deregulated By FCC
$(000)

Operating Revenue	(42,739)
Operating Expenses	(43,374)
Total Operating Income Taxes	255
Net Operating Income	380
Rate Base	(9,457)
Revenue Requirements	(2,398)

This adjustment reflects half of the impact of services deregulated by the FCC on the test year.

DOD/FEA Test Year Adjustment 4
Directory Advertising
$(000)

Operating Revenue	41,340
Operating Expenses	808
Total Operating Income Taxes	16,294
Net Operating Income	24,238
Rate Base	-
Revenue Requirements	(41,340)

This adjustment imputes directory advertising revenue to the test year.

DOD/FEA TEST YEAR ADJUSTMENT 6
DEPRECIATION
($000)

Account Number	Account Name or Subclass of Plant	Intrastate Investment 12/31/99 (a)	Change In Accruals Annual (b)	Change In Accruals 3 Year (c=3*b)	12/31/99 Reserve (d)	Adjusted Reserve (e=c+d)	Reserve Percent (f=e/a)
2112	Motor Vehicles	47,502	(2,308)	(6,924)	34,912	27,988	58.9%
2114	Spec Purpose Vehicles	18	1	3	0	3	16.7%
2115	Garage Work Equipment	961	90	270	(684)	(414)	-43.1%
2116	Other Work Equipment	15,891	1,851	5,553	2,269	7,822	49.2%
2121	Buildings	115,383	(476)	(1,428)	39,573	38,145	33.1%
2122	Furniture	1,208	174	522	(20)	502	41.6%
2123.1	Ofc. Support Eqpt	3,883	610	1,830	1,649	3,479	89.6%
2123.2	Company Communications Eqpt	1,040	(728)	(2,184)	1,594	(590)	-56.7%
2124	Gen. Purpose Computers	79,409	(10,237)	(30,711)	67,857	37,146	46.8%
2211	Analog Switching Equipment	110,824	16,400	49,200	47,604	96,804	87.3%
2212	Digital Switching Equipment	655,053	15,529	46,587	278,255	324,842	49.6%
2220	Operator Systems	6,498	0 *	0	4,187	4,187	64.4%
2231	Radio Systems	23,571	(895)	(2,685)	19,450	16,765	71.1%
2232.1	Circuit DDS	5,667	(663)	(1,989)	6,006	4,017	70.9%
2232.2	Circuit Digital	752,751	6,040	18,120	395,804	413,924	55.0%
2232.3	Circuit Analog	32,631	(3,906)	(11,718)	31,098	19,380	59.4%
2362	Other Terminal Equipment	40,092	(1,000)	(3,000)	21,273	18,273	45.6%
2411	Pole Lines	34,403	125	375	27,203	27,578	80.2%
2421.1	Aerial Cable - Metallic	121,417	2,419	7,257	94,889	102,146	84.1%
2421.2	Aerial Cable - Nonmetallic	4,563	33	99	1,303	1,402	30.7%
2422.1	Underground Cable - Metallic	257,054	7,936	23,808	160,771	184,579	71.8%
2422.2	Underground Cable - Nonmetallic	64,194	2,310	6,930	24,788	31,718	49.4%
2423.1	Buried Cable - Metallic	927,241	50,736	152,208	414,376	566,584	61.1%
2423.2	Buried Cable - Nonmetallic	12,727	171	513	4,860	5,373	42.2%
2424.1	Submarine Cable - Metallic	2	2	0	0	0	-
2424.2	Submarine Cable - Nonmetallic	0	0	0	0	0	-
2426.1	Intrabldg Cable - Metallic	30,275	(197)	(591)	22,912	22,321	73.7%
2426.2	Intrabldg Cable - Nonmetallic	429	3	9	177	186	43.4%
2431	Aerial Wire	6,494	504	1,512	2,117	3,629	55.9%
2441	Conduit Systems	225,140	401	1,203	54,795	55,998	24.9%
	Total	3,576,321	84,925	254,769	1,759,018	2,013,787	56.3%

Source: Col. a = Wu Testimony, 5/3/00, Exhibit KDW-2, p.1, Col A.
Col. b = Wu Testimony, 5/3/00, Exhibit KDW-1, p.4, Col P.
Col. d = Response to WDA 21-001, Attachment D.

* Assumes no accruals since 1/1/97.

DOD/FEA TEST YEAR ADJUSTMENT 6
DEPRECIATION
($000)

Account Number	Account Name or Subclass of Plan	Reserve Percent (a)	Future Net Salvage Percent (b)	Average Remaining Life (c)	Remaining Life Rate (d= (100-a-b)/c)	Intrastate Investment 12/31/99 (e)	Test Period Accruals (f=d*e)
2112	Motor Vehicles	58.9%	16%	3.9	6.4%	47,502	3,040
2114	Spec Purpose Vehicles	16.7%	0%	7.3	11.4%	18	2
2115	Garage Work Equipment	-43.1%	-4%	9.7	15.2%	961	146
2116	Other Work Equipment	49.2%	7%	5.7	7.7%	15,891	1,224
2121	Buildings	33.1%	-6%	25.0	2.9%	115,383	3,346
2122	Furniture	41.6%	0%	4.8	12.2%	1,208	147
2123.1	Ofc. Support Eqpt	89.6%	0%	3.0	3.5%	3,883	136
2123.2	Company Communications Eqpt	-56.7%	0%	3.7	42.4%	1,040	441
2124	Gen. Purpose Computers	46.8%	5%	2.1	23.0%	79,409	18,264
2211	Analog Switching Equipment	87.3%	0%	*	*	110,824	14,020
2212	Digital Switching Equipment	49.6%	3%	5.1	9.3%	655,053	60,920
2220	Operator Systems	64.4%	-3%	5.2	7.4%	6,498	481
2231	Radio Systems	71.1%	-2%	5.9	5.2%	23,571	1,226
2232.1	Circuit DDS	70.9%	3%	3.8	6.9%	5,667	391
2232.2	Circuit Digital	55.0%	2%	5.1	8.4%	752,751	63,231
2232.3	Circuit Analog	59.4%	0%	3.1	13.1%	32,631	4,275
2362	Other Terminal Equipment	45.6%	2%	6.3	8.3%	40,092	3,328
2411	Pole Lines	80.2%	-138%	25.0	6.3%	34,403	2,167
2421.1	Aerial Cable - Metallic	84.1%	-27%	5.1	8.4%	121,417	10,199
2421.2	Aerial Cable - Nonmetallic	30.7%	-27%	10.6	9.1%	4,563	415
2422.1	Underground Cable - Metallic	71.8%	-6%	5.6	6.1%	257,054	15,680
2422.2	Underground Cable - Nonmetallic	49.4%	-6%	6.0	9.4%	64,194	6,034
2423.1	Buried Cable - Metallic	61.1%	-7%	5.6	8.2%	927,241	76,034
2423.2	Buried Cable - Nonmetallic	42.2%	-7%	10.2	6.4%	12,727	815
2424.1	Submarine Cable - Metallic	0.0%	0%	0.5	200.0%	2	4
2424.2	Submarine Cable - Nonmetallic	0.0%	0%	0.0	0.0%	0	0
2426.1	Intrabldg Cable - Metallic	73.7%	0%	7.7	3.4%	30,275	1,029
2426.2	Intrabldg Cable - Nonmetallic	43.4%	0%	6.2	9.1%	429	39
2431	Aerial Wire	55.9%	-30%	5.6	13.2%	6,494	857
2441	Conduit Systems	24.9%	-20%	41.0	2.3%	225,140	5,178
	Total					3,576,321	293,069
	US WEST (Wu Testimony, Exhibit KDW-2, p.1, Col. E)						355,134
	Adjustment						(62,065)

Source: Col. a = Attachment 3, p. 1.
Col. b = Wu Testimony, 5/3/00, Exhibit KDW-1, p.5, Cols E & G.
Col. c = Responses to WDA 21-151 and WDA 34-9.

* AYFR = Year 2000 (Accruals = Investment - Reserve)

DOD/FEA TEST YEAR ADJUSTMENT 6
DEPRECIATION
($000)

Operating Revenues	0
Operating Expenses	(62,065)
Total Operating Income Taxes	24,950
Net Operating Income	37,115
Rate Base	(254,769)
Revenue Requirements	(110,491)

This adjustment revises U S West's estimate of the end of period depreciation expense and rate base.

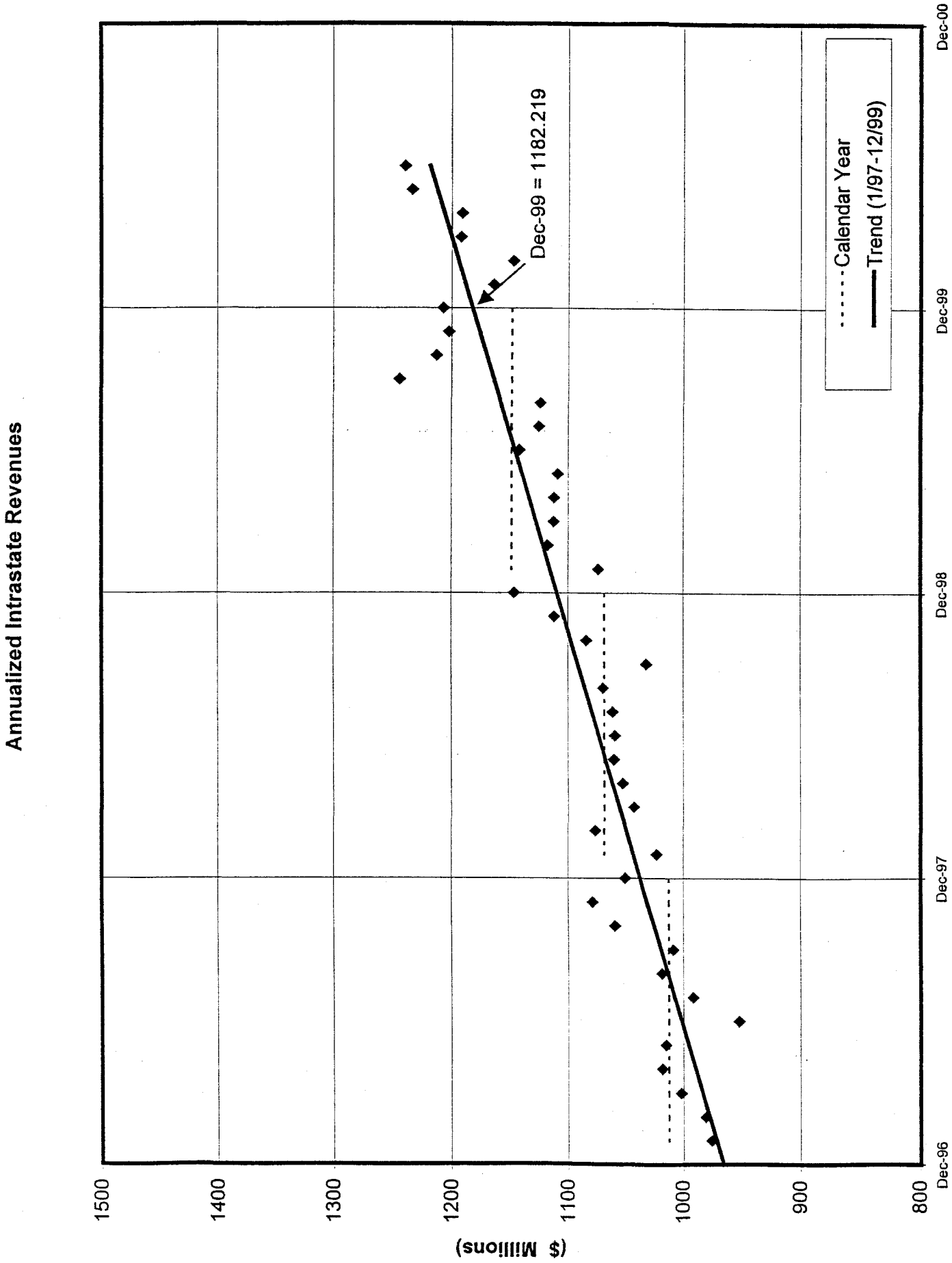
DOD/FEA Test Year Adjustment 7
Rate of Return
$(000)

1.	U S WEST Rate of Return (GAR-S1)	10.86%
2.	DOD/FEA Rate of Return (King Testimony)	9.54%
3.	Reduction to Rate of Return (L1 - L2)	1.32%
4.	Adjusted Rate Base (Attachment 6)	$1,157,873
5.	Reduction in Required Earnings (L3 x L4)	$15,284

DOD/FEA Test Year Adjustment 7
Rate of Return
$(000)

Operating Revenue	-
Operating Expenses	-
Total Operating Income Taxes	-
Net Operating Income	15,284
Rate Base	-
Revenue Requirements	(26,068)

This adjustment reflects a 9.54 percent required rate of return.


Annualized Intrastate Revenues
($ Millions)
1500
1400
1300
1200
1100
1000
900
800
Dec-96
Dec-97
Dec-98
Dec-99
Dec-00
Dec-99 = 1182.219
Calendar Year
Trend (1/97-12/99)

Intrastate Revenue Trend Data

YR / MO	Gross Revenue a	Directory Surcharge b	Adjusted Month c = a - b	Annualized d = 12c	Annualized (for graph)	Annualized 2000 (for graph)
Jan-97	81,316,314	-	81,316,314	975,795,768	976	
Feb-97	81,745,162	-	81,745,162	980,941,944	981	
Mar-97	83,531,574	-	83,531,574	1,002,378,888	1,002	
Apr-97	84,900,707	-	84,900,707	1,018,808,484	1,019	
May-97	84,629,780	-	84,629,780	1,015,557,360	1,016	
Jun-97	79,342,313	-	79,342,313	952,107,756	952	
Jul-97	82,677,190	-	82,677,190	992,126,280	992	
Aug-97	84,927,610	-	84,927,610	1,019,131,320	1,019	
Sep-97	84,078,843	-	84,078,843	1,008,946,116	1,009	
Oct-97	89,927,786	1,598,225	88,329,561	1,059,954,732	1,060	
Nov-97	91,564,060	1,598,225	89,965,835	1,079,590,020	1,080	
Dec-97	89,184,545	1,598,225	87,586,320	1,051,035,840	1,051	
Jan-98	86,903,075	1,598,225	85,304,850	1,023,658,200	1,024	
Feb-98	91,346,481	1,598,225	89,748,256	1,076,979,072	1,077	
Mar-98	88,543,754	1,598,225	86,945,529	1,043,346,348	1,043	
Apr-98	89,367,062	1,598,225	87,768,837	1,053,226,044	1,053	
May-98	89,978,983	1,598,225	88,380,758	1,060,569,096	1,061	
Jun-98	89,928,370	1,598,225	88,330,145	1,059,961,740	1,060	
Jul-98	90,083,599	1,598,225	88,485,374	1,061,824,488	1,062	
Aug-98	90,775,917	1,598,225	89,177,692	1,070,132,304	1,070	
Sep-98	87,633,301	1,598,225	86,035,076	1,032,420,912	1,032	
Oct-98	92,004,659	1,598,225	90,406,434	1,084,877,208	1,085	
Nov-98	94,306,705	1,598,225	92,708,480	1,112,501,760	1,113	
Dec-98	97,161,319	1,598,225	95,563,094	1,146,757,128	1,147	
Jan-99	91,138,000	1,598,225	89,539,775	1,074,477,300	1,074	
Feb-99	94,764,000	1,598,225	93,165,775	1,117,989,300	1,118	
Mar-99	94,349,000	1,598,225	92,750,775	1,113,009,300	1,113	
Apr-99	94,320,000	1,598,225	92,721,775	1,112,661,300	1,113	
May-99	94,053,000	1,598,225	92,454,775	1,109,457,300	1,109	
Jun-99	96,803,000	1,598,225	95,204,775	1,142,457,300	1,142	
Jul-99	95,402,000	1,598,225	93,803,775	1,125,645,300	1,126	
Aug-99	95,295,000	1,598,225	93,696,775	1,124,361,300	1,124	
Sep-99	105,289,000	1,598,225	103,690,775	1,244,289,300	1,244	
Oct-99	101,073,000	-	101,073,000	1,212,876,000	1,213	
Nov-99	100,204,000	-	100,204,000	1,202,448,000	1,202	
Dec-99	100,600,000	-	100,600,000	1,207,200,000	1,207	
Jan-00	97,034,000	-	97,034,000	1,164,408,000		1,164
Feb-00	95,650,000	-	95,650,000	1,147,800,000		1,148
Mar-00	99,349,000	-	99,349,000	1,192,188,000		1,192
Apr-00	99,271,000	-	99,271,000	1,191,252,000		1,191
May-00	102,775,000	-	102,775,000	1,233,300,000		1,233
Jun-00	103,281,000	-	103,281,000	1,239,372,000		1,239
1997	1,017,825,884	4,794,675	1,013,031,209			
1998	1,088,033,225	19,178,700	1,068,854,525			
1999	1,163,290,000	14,384,025	1,148,905,975			

Source: Col. a = DOD/FEA 1-6, UTI 42-2, UTI 42-2S
Col. b = UTI 10-9

DOD/FEA Test Year Adjustment 8
Test Year Revenues
$(000)

1.	Actual 1999 Intrastate Revenues (Azty1999.xls, Interface-1990 Financials)	$1,163,288
2.	QWEST EOP Adjustment (GAR-S7, Col a)	3,929
3.	QWEST Intrastate Revenues (L3=L1+L2)	1,167,217
4.	Proposed Intrastate Revenues (Attachment 4, p. 1)	1,182,219
5.	Revenue Adjustment (L5=L4-L3)	15,002

DOD/FEA Test Year Adjustment 8
Test Year Revenues
$(000)

Operating Revenue	15,002
Operating Expenses	293
Total Operating Income Taxes	5,913
Net Operating Income	8,796
Rate Base	-
Revenue Requirements	(15,002)

Attachment 6
Summary

DOD/FEA Test Year Adjustment Summary
$(000)

		U S WEST Test Year (a)	Adj. 1 Customer Operations (b)	Adj. 2 Corporate Operations (c)	Adj. 3 FCC Deregulated Services (d)	Adj. 4 Directory Advertising (e)	Adj. 5 Productivity Adjustment (f)	Adj. 6 Depreciation Adjustment (g)	Adj. 7 Rate of Return Adjustment (h)	Adj. 8 Revenue Adjustment (i)	Adjusted Test Year (j=Sum(a..i))
1.	Adjusted Rate Base	1,422,099	_	_	(9,457)	-	-	(254,769)	-	-	1,157,873
2.	Adjusted Net Operating Income	43,822	12,038	6,870	380	24,238	15,036	37,115	-	8,796	148,295
3.	Current Rate of Return	3.08%	-	-	-	-	-	-	-	-	12.81%
4.	Required Operating Income	154,430	-	-	(1,027)	-	-	(27,666)	(15,284)	-	110,453
5.	Required Rate of Return	10.86%	-	-	-	-	-	-	-1.32%	-	9.54%
6.	Operating Income Deficiency	110,608	(12,038)	(6,870)	(1,407)	(24,238)	(15,036)	(64,781)	(15,284)	(8,796)	(37,842)
7.	Gross Revenue Conversion Factor	1.7056	1.7056	1.7056	1.7056	1.7056	1.7056	1.7056	1.7056	1.7056	15
8.	Increase in Gross Revenue Requirements	188,654	(20,531)	(11,716)	(2,398)	(41,340)	(25,646)	(110,491)	(26,068)	(15,002)	(64,538)
9.	Three Year Revenue Requirement	(686)	-	-	-	-	-	-	-	-	(686)
10.	Adjustment to Revenue Requirements	13,252	-	-	-	-	-	-	-	-	13,252
11.	Total Increase in Revenue Requirement	201,220	(20,531)	(11,716)	(2,398)	(41,340)	(25,646)	(110,491)	(26,068)	(15,002)	(51,972)
	Source	GAR-S1	Direct Att 6	Direct Att 7	Surrebuttal **Att 1**	Surrebuttal **Att 2**	Direct Att 10	Surrebuttal **Att 3**	Surrebuttal **Att 4**	Surrebuttal **Att 5**	

DEPARTMENT OF THE ARMY
UNITED STATES ARMY LEGAL SERVICES AGENCY
901 NORTH STUART STREET
ARLINGTON, VA 22203-1837

REPLY TO
ATTENTION OF

December 13, 1999

Regulatory Law Office
U 4016

Subject: 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-01051B-99-0105, Before The Arizona Corporation Commission

Timothy Berg
Fennemore Craig
3003 N Central Ave Suite 2600
Phoenix, Arizona 85012

Dear Mr. Berg:

Enclosed are the 3rd Set of Information Requests to U S West Communications by the United States Department of Defense and All Other Federal Executive Agencies, in the above-referenced proceeding. Please provide a copy of the Responses to Mr. Richard Lee.

Copies have been served on all known parties in accordance with the enclosed Service List.

Sincerely,

Peter Q. Nyce, Jr.
General Attorney
Regulatory Law
Phone: (703) 696-1644
Fax: (703) 696-2960

Printed on Recycled Paper

Before the Arizona Corporation Commission
Docket No. T-01051B-99-0150 Information Requests
Of the Department of Defense
And All Other Federal Executive Agencies
To U S WEST

DOD/FEA 3-1: Please provide gross revenues by month for the year 1999 as they become available in the same format as used in response to DOD 2-1.

CERTIFICATE OF SERVICE

I, Peter Q. Nyce, Jr., certify that I have this day caused this 3rd Set of Information Requests to U S West Communications, on behalf of the Department of Defense and All Other Federal Executive Agencies, to be served on all known parties by sending a copy by either Federal Express or by regular U.S. Mail delivery to those on the "Service List" attached hereto.

Executed December 13, 1999, at Arlington Virginia.

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BEFORE THE ARIZONA CORPORATION COMMISSION

CARL J. KUNASEK
Chairman
JAMES M. IRVIN
Commissioner
WILLIAM MUNDELL
Commissioner

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-01051B-99-0105 **OBJECTIONS TO DEPARTMENT OF DEFENSE'S THIRD SET OF INFORMATION REQUESTS TO U S WEST COMMUNICATION, INC.**

Pursuant to the Procedural Order issued in this docket on March 4, 1999, U S WEST Communications, Inc. ("U S WEST") objects to the Department of Defense's ("DOD") Third Set of Information Requests to U S WEST as follows:

<u>Objections to DOD's Third Set</u>

1. U S WEST objects to Information Request DOD/FEA 3-1 on the grounds that it is not reasonably calculated to lead to the discovery of admissible evidence and that it calls for information significantly outside of the test-year established in this matter.

. . . .

. . . .

. . . .

DATED this 21st day of December, 1999.

U S WEST COMMUNICATIONS, INC.
Law Department
Thomas Dethlefs

and

FENNEMORE CRAIG

By Jennifer Prendiville
Timothy Berg
Jennifer Prendiville
3003 N. Central Avenue, Suite 2600
Phoenix, Arizona 85012-2913
Attorneys for U S West Communications, Inc.

ORIGINAL faxed/mailed this 21st day of December, 1999, to:

Peter Q. Nyce, Jr.
Regulatory Law Office
Department of the Army
United States Army Lergal Services Agency
901 North Stuart Street
Arlington, VA 22203-1837

COPY faxed/mailed this 21st day of December, 1999, to:

Constance J. Fitzsimmons
Legal Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Maureen Scott
Legal Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Dana Poole

BEFORE THE ARIZONA CORPORATION COMMISSION

EXHIBIT
DOD-4
admitted

CARL J. KUNASEK
Chairman
JIM IRVIN
Commissioner
WILLIAM A. MUNDELL
Commissioner

IN THE MATTER OF THE APPLICATION OF U S WEST COMMMUNICATIONS, 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-01051B-99-0105

SURREBUTTAL TESTIMONY
of
CHARLES W. KING

on behalf of

THE UNITED STATES DEPARTMENT OF DEFENSE
And
ALL OTHER FEDERAL EXECUTIVE AGENCIES

ROBERT N. KITTEL, CHIEF
Regulatory Law Office
Office of The Judge Advocate General
U.S. Army Litigation Center
901 N. Stuart Street, Suite 713
Arlington, Virginia 22203-1837

by

Peter Q. Nyce, Jr.
General Attorney

September 8, 2000

CONTENTS

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Introduction 1

1. Comparability of Market Returns 2

2. Comparable Companies 3

3. Verizon Dividend Yield 7

4. Inclusion of US WEST in DCF Analysis 8

5. Historical Risk Premium Model 10

6. Flotation Costs 11

Exhibits:

CWK-01 . . . . . Beta vs. Equity Cost, USW "Comparable Risk" Indices

CWK-02 . . . . . Exerpt from C.W. King Draft Testimony of October 25, 1999

CWK-03 . . . . . Verizon Communications, Consolidated 1999 Revenues

INTRODUCTION

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

A. My name is Charles W. King. I am President of the economic consulting firm of Snavely King Majoros O'Connor & Lee, Inc. ("Snavely King"). My business address is 1220 L Street, N.W. Suite 410, Washington, D.C. 20005.

Q. ON WHOSE BEHALF ARE YOU APPEARING IN THIS DOCKET?

A. I am appearing on behalf of the Department of Defense and all other Federal Executive Agencies ("DOD/FEA").

Q. ARE YOU THE SAME CHARLES W. KING WHO SUBMITTED DIRECT TESTIMONY ON BEHALF OF DOD/FEA IN THIS DOCKET ON JULY 26, 2000?

A. Yes. I am.

Q. DID THAT DIRECT TESTIMONY CONTAIN A SUMMARY OF YOUR EXPERIENCE AND QUALIFICATIONS?

A. Yes. It did.

Q. WHAT IS THE OBJECTIVE OF THIS SURREBUTTAL TESTIMONY?

A. The objective of this surrebuttal testimony is to respond to the challenges to my initial testimony presented by Qwest Witness Peter Cummings on August 21, 2000.

Q. WHAT CHALLENGES DOES MR. CUMMINGS MAKE TO YOUR INITIAL TESTIMONY?

A. Mr. Cummings offers the following challenges to my initial testimony:

1. That my statement that all market returns are comparable to all other market returns is incorrect (page 4),

2. That electric utilities are not comparable in terms of risk to Qwest Corporation (pages 5 and 14),

3. That I underestimated the dividend yield for Verison (page 7),

4. That I inappropriately included a DCF return analysis for the pre-merger US WEST (page 8),

5. That I inappropriately dismissed the historical risk premium model as flawed (page 9), and

6. That I failed to provide adequate allowance for stock issuance expense (page 12).

1. <u>COMPARABILITY OF MARKET RETURNS</u>

Q. WHAT IS MR. CUMMINGS' CRITICISM WITH RESPECT TO YOUR STATEMENT THAT ALL MARKET RETURNS ARE COMPARABLE WITH ALL OTHER MARKET RETURNS?

A. Mr. Cummings states that the obvious variation in earnings-price ratios proves that all market returns are not comparable with all other market returns.

Q. WHAT IS YOUR RESPONSE TO THIS CHALLENGE?

A. Mr. Cummings either does not, or chooses not to understand my statement at the top of page 5 of my direct testimony. There, I argue that investors assess the likely returns from each stock and adjust the price they are willing to pay according to that assessment. That assessment considers three things: the dividend yield, the likely growth in earnings, and the assurance of that earnings growth. Earnings-price ratios differ because some companies have higher dividend yields than others. Earnings price ratios also differ because some companies' earnings are predicted to increase at a faster rate than others. Finally, earnings-price ratios differ because there is greater confidence in the rate of earnings growth for some companies than for others. The fact remains, however, that the market price of all stocks reflects the consensus of the investing community as to the comparability of yield, earnings growth and earnings certainty. That is my simple point.

2. COMPARABLE COMPANIES

Q. WHAT IS MR. CUMMINGS' CHALLENGE WITH RESPECT TO COMPARABLE COMPANIES?

Q. Mr. Cummings accuses me of biasing the results of my analysis by using electric

utilities as comparable companies to US WEST.[1] He argues that his selection of 30 companies from a variety of industries is more comparable to US WEST in terms of risk. He supports this position by comparing the betas of the electric companies with those of the three surviving non-US WEST Bell holding companies.

Q. WHAT IS YOUR RESPONSE TO THIS CRITICISM?

A. The issue of comparable companies is always a contentious one in rate-of-return analyses. It is clarified by focusing on the specific business activities for which we are attempting to find comparable risk. In the present case, the business activities under study are the intrastate landline telephone services of US WEST in Arizona. Those services display a number of salient characteristics that are not shared by other activities of US WEST or the other Regional Bell Holding Companies ("RBHCs"). First, there is a high degree of market power, which if unchecked by regulation, would permit US WEST to earn monopoly profits. Second, there is regulation, which in Arizona continues to be closely cost-based. In this regard, Arizona intrastate regulation differs from interstate access charge regulation, where prices have been decoupled from costs and the carriers are able to earn high profits without fear of consequent forced rate reductions. Arizona intrastate services also differ from the wireless operations of the respective telephone companies, which are not regulated with respect to price and which face considerable competition from other suppliers.

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[1]Throughout this surrebuttal, I refer to US WEST, even though the company has changed its name to Qwest, in order to distinguish the pre-merger company from the consolidated post-merger company. Qwest Communications, Inc., the post-merger company, is a far riskier enterprise than was US WEST, and more specifically, US WEST's Arizona intrastate operations.

While Mr. Cummings may have a point that electric utility companies are less risky than telephone companies (US WEST possibly excluded), the activities of electric utilities are quite similar to the activities subject to this rate-of-return analysis. As I point out in my direct testimony, electric utilities have geographically defined franchise areas, are subject to regulation, and are currently experiencing growing competition and considerable industry restructuring. This is a good description of US WEST's Arizona intrastate operations. I should point out further that electric utilities continue to be subject to rate base/rate-of-return regulation similar to that applied to US WEST's Arizona operations and unlike that applied to interstate access services and the intrastate services of many of the other RBHCs. For this reason, I again assert that electric utilities are similar in their risk characteristics to US WEST's Arizona intrastate operations.

Mr. Cummings purports to rebut my use of electric utilities by comparing their composite beta of .49 with a beta for his telephone industry group of .84. Notably, Mr. Cummings fails to mention that US WEST's pre-merger beta was also .49, as reported on page 32 of my direct testimony.

Q. **IS MR. CUMMINGS' COMPOSITE INDUSTRY GROUP COMPARABLE IN RISK TO US WEST'S ARIZONA INTRASTATE OPERATONS?**

A. No, at least as measured by betas. Exhibit CWK-01 compares Zack's betas with the rates of return calculated by Mr. Cummings for the 17 of the 20 "Comparable Risk Companies" in exhibits PCC-6 in his original testimony and 29 of the 30 PCC-04 in his supplemental testimony.[2]

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[2]Two companies are dropped from page 1 because of mergers; Brown Foreman is dropped from both exhibits because no beta reports are available from Zack's.

Page 1 of my exhibit shows that the companies presented in Mr. Cummings' initial testimony cluster into two quite distinct groups. The four electric utilities have, quite unsurprisingly, low betas and low rates of return. All of the unregulated service and manufacturing companies have high return requirements, even though their betas stretch from .45 to almost 1.20.

Page 2 of Exhibit CWK-01 shows the same information for the companies presented in Mr. Cummings' supplemental testimony. Again, the utilities cluster at the low end of the scales for both beta and equity cost. The non-utilities display higher betas but no clear relationship between beta and equity cost.

This last observation is the most relevant. Page 3 replicates the data in page 2 just for the non-utility companies. It also presents the results of my effort to establish a correlation between beta and rate of return. There is none: the R^2 is .00001. This result is in direct contradiction to the basic precept of the Capital Asset Pricing Model ("CAPM") that beta, the measure of undiversifiable risk, determines the return requirements of each company relative to the overall market. It suggests that the CAPM, as applied to individual companies, represents the triumph of theory over evidence.

As applied to portfolios of companies, however, beta appears to have some value. The portfolio of electric companies clearly has less risk than that of industrial enterprises. As I noted earlier, the general riskiness of electric utilities resembles that of US WEST's Arizona intrastate operations, and for that reason the earnings requirements of those companies represent the better indicator of US WEST's equity cost than an average for a broad mix of utilities and industrial companies.

3. VERIZON DIVIDEND YIELD

Q. WHAT IS MR. CUMMINGS' CHALLENGE WITH REGARD TO VERIZON'S DIVIDEND YIELD?

A Mr. Cummings states that I committed an error in my calculation of Verizon's dividend yield. I indicated that the dividend would be $.20 for a yield of 0.36 percent. Mr. Cummings states that Verizon's going-forward dividend is $1.54, for a yield of 2.81 percent.

Q. WHERE DID YOU GET YOUR $.20 DIVIDEND ESTIMATE?

A. The actual number was derived from an estimate of $.047 per quarter as reported on July 18, 2000 by Yahoo. As of July 11, 2000, Zack's Investment Research reported no dividend whatever for Verizon.

Q. ARE THESE THE DIVIDEND ESTIMATES CURRENTLY BEING REPORTED?

A. No. All of the investment services are currently reporting $1.54 as the annual dividend. Apparently, my sources proceded the establishment of a dividend policy by Verizon. Mr. Cummings' revision is therefore appropriate.

4. INCLUSION OF US WEST IN DCF ANALYSIS

Q. WHAT IS MR. CUMMINGS' OBJECTION TO YOUR INCLUSION OF US WEST IN YOUR DCF ANALYSIS?

A. Mr. Cummings argues that prior to the merger with Qwest, US WEST was trading as a derivative of Qwest, was significantly influenced by arbitrage trading relative to pricing of the merger and was influenced by speculation about further business combinations affecting both US WEST and Qwest. For these reasons, Mr. Cummings believes it is not appropriate to include US WEST in the DCF analysis.

Q. WHAT IS YOUR RESPONSE TO THESE COMMENTS BY MR. CUMMINGS?

A. I suspect that the cause of Mr. Cummings' dislike of US WEST as a subject of DCF analysis is the low value of the results, not the impropriety of the inclusion. The DCF analysis that I provided was derived from data that predated June 30, 2000, which was the date on which the regulatory approvals for the merger with Qwest were finally received. During those earlier periods, the merger could not be assumed. The Zack's consensus earnings forecasts that I used were for US WEST, the pre-merger company, and not for the merged Qwest. It is these very low earnings forecasts that account for the low DCF results for US WEST.

Further demonstration that the impending merger is not responsible for the low US WEST results is provided in exhibit CWK-02, which is a portion of testimony I drafted

for filing on October 25, 1999 in this case.[3] This draft testimony presents my development of the "classic" DCF formulation based on data that predated or closely followed the July 18, 1999 announcement date of the merger with Qwest. These results would have been even less influenced by the pending merger than those in my current testimony. Nevertheless, the same pattern appears: US WEST's equity return is much lower than that of the other RBHCs, principally due to the lower earnings growth expectations.

Q. WHY WOULD US WEST HAVE A LOWER EARNINGS REQUIREMENT THAN THE OTHER RBHCs?

A. A likely explanation is provided by Mr. Cummings himself. In his rebuttal to Staff witness Stephen Hill, Mr. Cummings provides the following proportions of revenue provided by local service:

RBHC Service Makeup[4]

Company	% Local Service
Bell Atlantic	55%
BellSouth	43%
SBC	39%
US WEST	59%

[3]The filing was postponed due to the pendency of findings with regard to depreciation rates.

[4]Rebuttal Testimony of Peter C. Cummings, pages 19, 20, cited to Value Line Investment Survey, July 7, 2000.

On Exhibit CWK-03, I have calculated the 1999 local service proportion of Verizon's revenue as 36 percent, based on consolidated historical information distributed by the newly merged company in August 2000.

US WEST has much the highest proportion of local service revenue of any of the RBHCs. Local Service is the most secure, least risky, but also the slowest growing segment of the telephone market. US WEST's heavy concentration in local service would account for the low growth expectations of investment analysts and for the generally lower return requirements demanded by investors.

5 HISTORICAL RISK PREMIUM MODEL

Q. WHAT IS MR. CUMMINGS' CHALLENGE WITH RESPECT TO YOUR STATEMENTS REGARDING THE HISTORICAL RISK PREMIUM MODEL?

A. Mr. Cummings states that finance theorists and finance practitioners have consistently advocated the use of historical data to estimate the expected market risk premium over the risk free rate obtained from investment in government securities. He then quotes from two textbooks that say that securities analysts extrapolate past risk premiums to future periods.

Q. WHAT IS YOUR RESPONSE TO THESE COMMENTS?

A. It is one thing to say that there is a premium for equity risk over government debt and that historical differences in returns are an indicator of that premium. It is quite

another matter to take the 72-year average difference in achieved monthly returns to stocks and government bonds, add it to the current Treasury bond yield, and claim to have estimated the currently required return to equity. Mr. Cummings overlays a specious mathematical calculation on rather simple principle of finance, which is that there is (usually) a greater risk associated with equity investment relative to government debt.

Mr. Cummings does not address, let alone rebut, the conceptual challenges I have raised against his historical risk premium calculation, nor does he attempt to refute my demonstration that the historical risk premium calculation he uses is statistically worthless as a predictor of future risk premiums.

6. FLOTATION COSTS

Q. WHAT IS MR. CUMMINGS' CHALLENGE TO YOUR COMMENTS ON FLOTATION COSTS?

A. Mr. Cummings quarrels with my calculation of flotation costs and the amount of recovery that would be allocated to Arizona ratepayers. First, he states that $55 million is not the appropriate amount of flotation costs; rather, the figure is $166.7 million. Then, he states that stock issuance costs are applicable only to the equity financing of US WEST Communications, apparently in contradiction to my application of the return differential to the parent company's capitalization. Finally, he claims that his flotation cost adjustment would generate an Arizona allowance of about $2 million annually.

Mr. Cummings goes on to comment on my proposal that any stock issuance costs be amortized directly to rates, rather than included as an additive to the rate of return. He concludes that it would be inappropriate to burden ratepayers in any one period of time for the issuance of stock that is perpetual.

Q. WHAT IS YOU RESPONSE TO MR. CUMMINGS COMMENTS REGARDING YOUR CALCULATION?

A. First, the $55 million I identified in my initial testimony is correctly labeled as the stock issuance cost since 1984 as reported by Mr. Cummings in his PCC-10.[5] The $166.7 million referred to by Mr. Cummings includes $112.7 million in pre-1984 issuance costs. This would have been flotation cost for selling the stock of AT&T prior to the breakup of the Bell System. While that cost has been allocated to UC WEST, I believe it inappropriate to burden present-day ratepayers with the issuance costs of stock in an extinct company that was found to be in violation of the anti-trust laws.

It is not true that stock issuance costs pertain only to the subsidiary company, US WEST Communications, Inc. Stock issuance costs are not incurred by wholly-owned subsidiaries; they are incurred by the parent, which is the entity that sells stock to the public.

Finally, Mr. Cummings' calculation of $2 million in Arizona-related flotation cost collections annually does not refute my statement that this allowance grossly overcompensates the Company for its experienced flotation costs. If US WEST's

[5]The actual number from Mr. Cummings' exhibit is $55.5 million, but a small amount of that number must be allocated to the USW Media Group.

1 Arizona equity capitalization is slightly over $1 billion,[6] and if the Company's
2 December 31, 1995 paid in equity capital was $8.228 billion,[7] then Arizona accounts
3 for no more than 12 percent of the total --- probably much less. Twelve percent of
4 $55 million is $660,000. Amortized over 15 years, the annual revenue requirement
5 for this cost would be $44,000, or 2 percent of the $2 million allowance Mr.
6 Cummings proposes to collect annually through an upward adjustment in the rate
7 of return.

8 Q. WHAT IS YOUR RESPONSE TO MR. CUMMINGS COMMENTS ON THE
9 RELATIVE DESIRABILITY OF AMORTIZING FLOTATION COSTS

10 A. As I have just demonstrated, the costs of stock flotation are negligible when
11 converted into an annual amortization, even using a relatively short 15-year period.
12 However, the Company is entitled to recover these costs if it incurs them, and an
13 amortization would ensure that recovery. A properly quantified adder to the rate of
14 return would be so small as to be lost in the rounding. For this reason, I recommend
15 that flotation costs, if they are incurred, be amortized as an explicit item in the
16 revenue requirement calculation.

17 Q DOES THIS COMPLETE YOUR REBUTTAL TESTIMONY?

18 A. Yes. It does.

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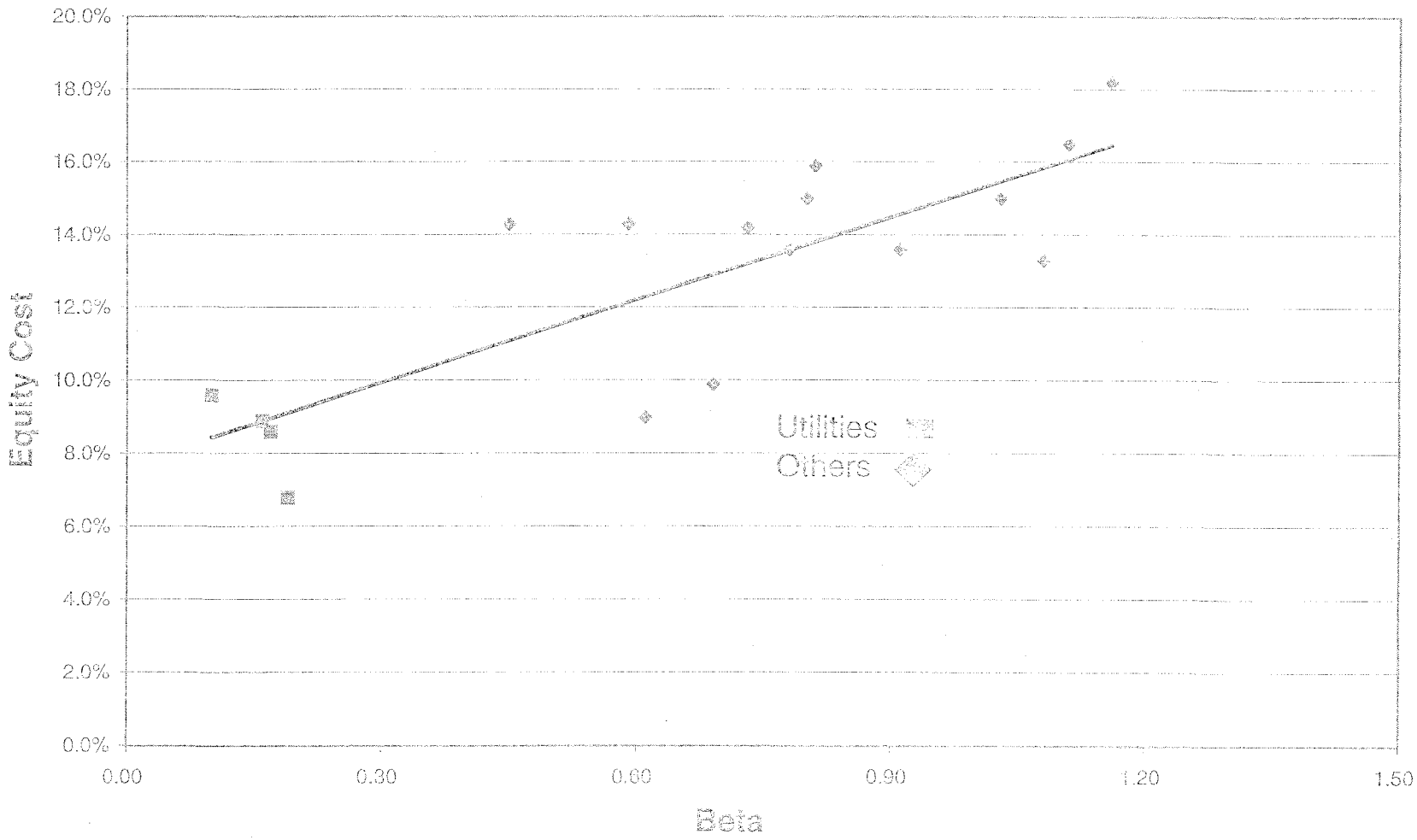
[6]Cummings Rebuttal Testimony at page 12. Mr. Cummings refers to an Exhibit PCC -02 as the source of this number, but it is not to be found in the exhibit with that label.

[7]Exhibit PCC-10

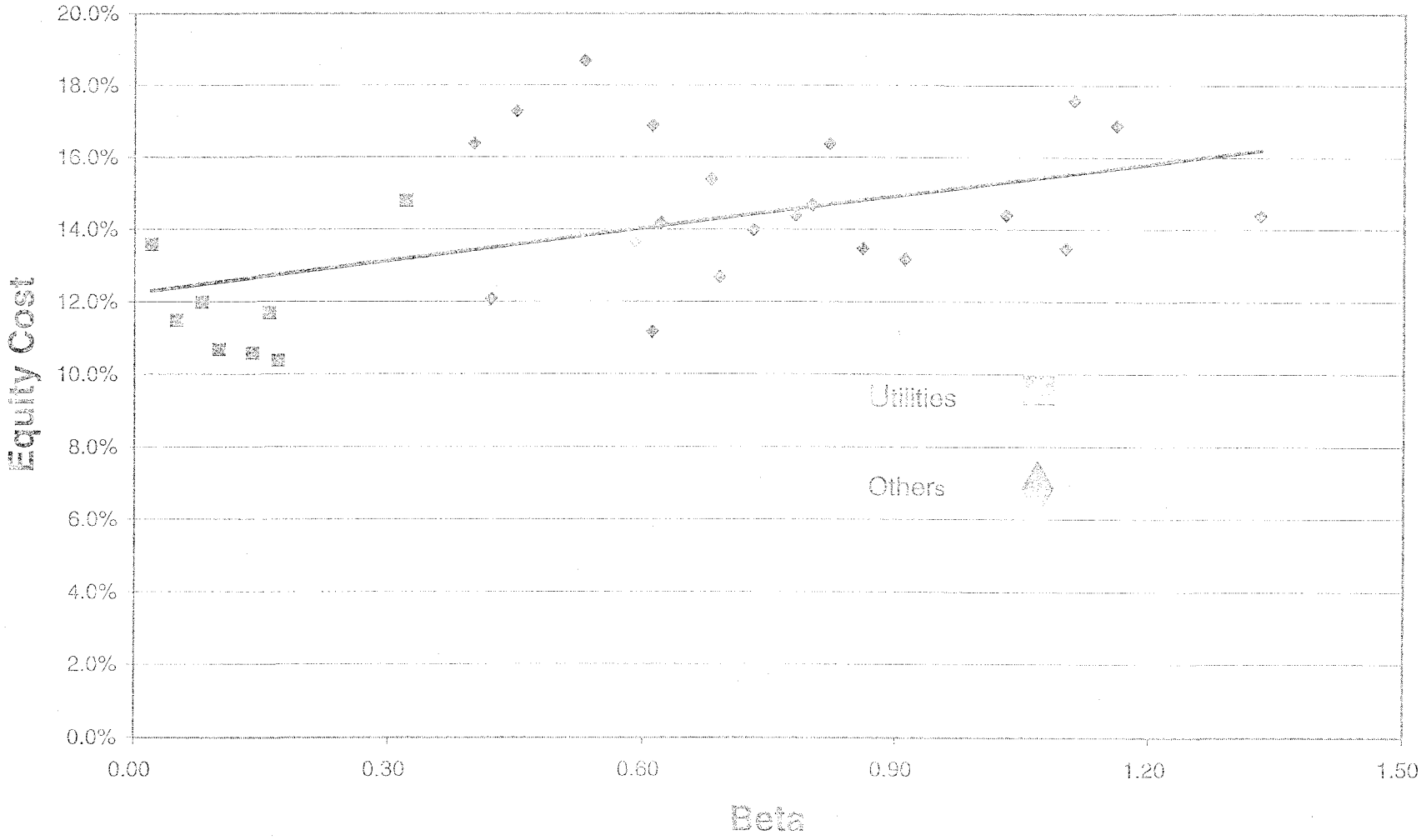
Beta vs Equity Cost
USW "Comparable Risk" Index 1/8/99



Sources: Betas from Zacks Research 8/28/00
Equity Cost from Exhibit PCC-06

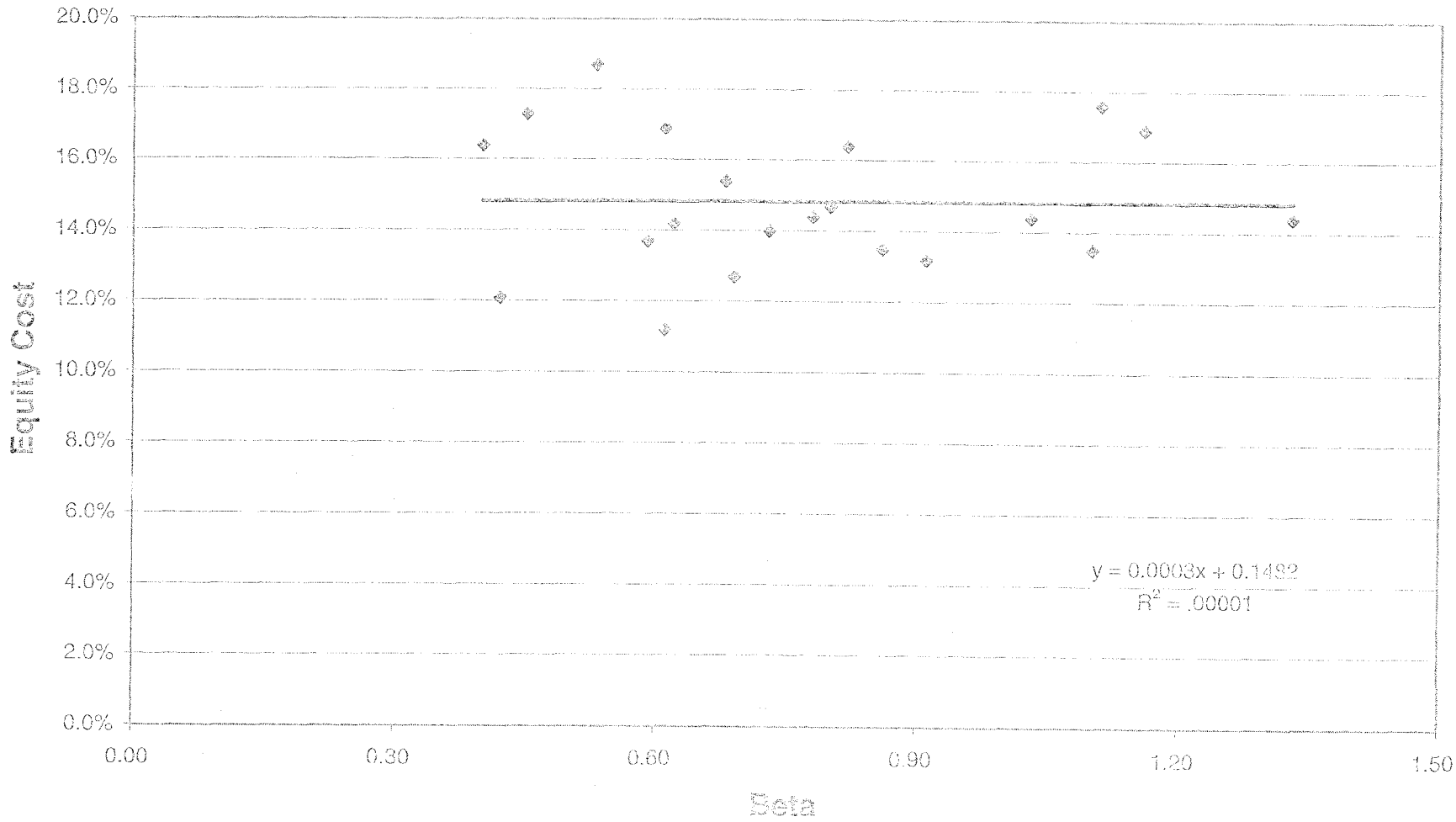
Beta vs Equity Cost

USW "Comparable Risk" Index 5/3/00



Sources: Betas from Zacks Research 8/28/00
Equity Cost from Exhibit PCC-04

Beta vs Equity Cost
USW "Comparable Risk" Index 5/3/00
Excluding Utilities



Sources: Betas from Zacks Research 8/28/00
Equity Cost from Exhibit PCC-04

Q. HOW WILL YOU IDENTIFY THE MARKET-DETERMINED RATE OF RETURN TO THE EQUITY CAPITAL INVESTMENT IN US WEST'S ARIZONA OPERATIONS?

A I shall first apply the Discounted Cash Flow ("DCF") procedure, which I consider to be the most accurate test of a market return. I shall then consider the Capital Asset Pricing Model, discuss its conceptual and measurement problems, and assess its value in measuring the relative riskiness of different companies. In the course of this discussion, I will comment on the analysis presented by US witness Peter Cummings and explain why his proposed equity return, which is 200 basis points (2.0%) higher than my recommendation, is inappropriate for the equity of US WEST.

A. DISCOUNTED CASH FLOW PROCEDURE

Q. PLEASE DESCRIBE THE DISCOUNTED CASH FLOW PROCEDURE.

A. The basic premise of the Discounted Cash Flow (" DCF") procedure is that the market establishes the price of each stock at the discounted present value of all future flows of cash that investors expect from purchasing that stock. The discount rate that equates those future cash flows with the market value of the stock is the investors' required rate of return.

The DCF approach is usually represented by the following formula:

$$k = {}^{d}/_{p} + g$$

where k = required rate of return
d = dividend in the immediate period
P = market price
g = expected growth rate in dividends

While the DCF method is usually presented in mathematical notation format (as above), it can also be described in narrative fashion. The formula says that the return which any investor expects from the purchase of a stock consists of two components. The first is the immediate cash flow in the form of a dividend. The second is the prospect for future growth in dividends. The sum of the rates of these two flows, present and future, equals the return that investors require. Investors adjust the price they are willing to pay for the stock until the sum of the dividend yield and the annual rate of expected future growth in dividends equals the rate of return they expect from other investments of comparable risk. The DCF test thus determines what the investing community requires from the company in terms of present and future dividends relative to the current market price.

1. GROWTH RATE

Q. HOW CAN THE "g" OR GROWTH FACTOR IN THE DCF FORMULA BE IDENTIFIED?

A According to the DCF theory, the relevant measure of "g" should be the growth in dividends. Dividends, however, are largely a function of management discretion, and they do not necessarily reflect the underlying driver of earnings. Simply by

changing the dividend payout ratio, a company's management can create a rate of dividend growth that is unsustainable. For this reason, I believe that earnings per share ("EPS") is the most reliable indicator of the "g" factor.

I agree with Mr. Cummings that the expectations of investment analysts are probably the most reliable basis upon which to estimate the "g" factor in the DCF formula. Mr. Cummings uses the Institutional Brokers Estimate System ("I/B/E/S"). I have added the somewhat broader survey of investment analysts by Zacks Investment Research, Inc., which includes retail as well as institutional brokers.

Q. WHAT ARE THE "g" ESTIMATES BASED ON INVESTMENT ANALYSTS' FORECASTS?

A. The two sets of forecasts and their averages are as follows:

Table 1
Forecast 5-Year RBHC Earnings Per Share Growth Rates

Company	I/B/E/S	Zacks	Average
Ameritech	8.95%	8.56%	8.76%
Bell Atlantic	10.20%	9.34%	9.77%
BellSouth	10.24%	10.08%	10.16%
SBC	12.00%	11.74%	11.87%
US WEST	6.90%	6.30%	6.60%

2. DIVIDEND YIELD

Q. HOW DO YOU DERIVE THE DIVIDEND YIELD PORTION OF THE DCF FORMULA?

A. The dividend yield can be calculated as the next year's dividend divided by a recent average of the price of the stock. The resultant yield should reasonably match the dividend yields shown in the financial reporting services.

Q. HOW DO YOU FORECAST THE NEXT YEAR'S DIVIDEND?

A. Conventional procedure is to compute the next year's dividend as the most recent dividend annualized plus one half the analysts' prediction of the long-term growth rate in earnings per share, as shown in Table 1 above. This formulation yields the following estimates dividend forecasts:

Table 2
RBOC Dividends, Forecast for 1999

Company	Dividend	1/2 Growth	Forecast
Ameritech	$1.27	4.38%	$1.33
Bell Atlantic	1.54	4.88%	1.62
BellSouth	0.76	5.08%	0.80
SBC Communications	0.98	5.94%	1.38
US WEST	2.14	3.30%	2.21

The use of these forecasts in the dividend yield calculation is conservative, that

is, it likely overstates the dividend in the coming year. As I will demonstrate shortly, all five RBHCs have been reducing their dividend payout ratios in recent years. That is, they have been increasing their dividends at a much slower rate than their experienced increase in earnings. If this trend continues into the coming year, then the use of predicted growth in earnings per share overstates the likely growth in dividend.

Q. HOW DO YOU IDENTIFY THE DENOMINATOR IN THE DIVIDEND YIELD CALCULATION, THE RECENT PRICE OF THE STOCKS?

A. Some judgement is required to establish a set of price observations that capture the investing public's current perception of value while at the same time reflecting some stability in the market. Given the fluctuations of the markets, a price observation for a single day, week, or even month runs the risk of becoming obsolete in a very short time. Market fluctuations also mean that the use of monthly highs and lows may exaggerate the effect of some of the sharp drops and rises that the markets have experienced recently.

I therefore recommend an average of the closing prices for all trading days during the most recent three months. On this basis, the dividend yield for the five RBHCs can be calculated as follows:

Table 3
RBOC Dividend Yield

Company	Dividend	Price[1]	Yield
Ameritech	$1.33	$68.57	1.94%
Bell Atlantic	1.62	63.03	2.57%
BellSouth	0.80	46.01	1.74%
SBC Communications	1.38	52.96	2.61%
US WEST	2.21	55.54	3.98%

Q. MR. CUMMINGS CLAIMS THAT IT IS APPROPRIATE TO COMPOUND THE QUARTERLY DIVIDENDS IN ORDER TO CALCULATE THE ACTUAL DIVIDEND YIELD. DO YOU AGREE?

A. No. Mr. Cummings argues that the yield from quarterly dividends is greater than the simple summation of those dividends because investors have the opportunity to earn return during the portion of the year following the receipt of each dividend. Thus, the yield on the first quarter's dividend is supplemented by that dividend's earnings power during the three remaining quarters that the investor

[1]Average of closing prices July 7, 1999 - October 7, 1999 as reported by Yahoo Financial Data.

holds it. The second quarter's dividend earns additional return during the following two quarters. The third dividend generates a quarter of a year's return.

All this is true, but it has nothing to do with the cash dividends that must be generated by the dividend-issuing company to satisfy investors' requirements. Investors' ability to earn on quarterly dividends is quite outside of the cash flow from the company: it is achieved by taking that cash flow and reinvesting it elsewhere. The cash flow from the company does not need to be supplemented.

3. CLASSIC DCF CALCULATION

Q. WHAT ARE THE RESULTS OF YOUR DCF ANALYSIS?

A. The indicated rates of equity return using this calculation are as follows:

Table 4
RBOC Equity Return "Classic" DCF Calculation

Company	Dividend Yield	Growth	Return
Ameritech	1.94%	8.76%	10.70%
Bell Atlantic	2.57%	9.77%	12.34%
BellSouth	1.74%	10.16%	11.90%
SBC Communications	2.61%	11.87%	14.48%
US WEST	3.98%	6.60%	10.58%
Average, All RBOCs			12.00%

Q. HOW WOULD YOU CHARACTERIZE THESE RESULTS?

A. The sum of the dividend yield and the growth rate as I have developed them is often referred to as "classic" DCF calculation. The Federal Communications Commission ("FCC") recently concluded tentatively that this method should be given the greatest weight in determining the rate of return to equity.[2] I agree with that conclusion.

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[2] *Notice Initiating a Prescription Proceeding and Notice of Proposed Rulemaking*, CC Docket No. 98-166, October 5, 1998, ¶ 26.

Exhibit CWK-03

Verizon Communications
Consolidated 1999 Revenues

Local Services	$21,145	36.34%
Network Access	13,381	
Long Distance	3,253	
Other Domestic Teleco	5,204	
Domestic Wireless	7,658	
International	1,957	
Information Services	4,086	
Other	1,510	
Total	$58,194	

Source: Verizon Communications:
Pro Forma Historical Financial Information
August, 2000

BEFORE THE ARIZONA CORPORATION COMMISSION

CARL J. KUNASEK
Chairman
JIM IRVIN
Commissioner
WILLIAM A. MUNDELL
Commissioner

IN THE MATTER OF THE APPLICATION OF U S WEST COMMMUNICATIONS, 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-01051B-99-0105**

TESTIMONY ON THE AGREEMENT BETWEEN
THE COMMISSION STAFF AND QWEST
of

RICHARD B. LEE

on behalf of

THE UNITED STATES DEPARTMENT OF DEFENSE
And
ALL OTHER FEDERAL EXECUTIVE AGENCIES

ROBERT N. KITTEL, CHIEF
Regulatory Law Office
Office of The Judge Advocate General
U.S. Army Litigation Center
901 N. Stuart Street, Suite 713
Arlington, Virginia 22203-1837

By

Peter Q. Nyce, Jr.
General Attorney

November 13, 2000

EXHIBIT
DOD-5
Admitted

Testimony of Richard B. Lee

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1 **INTRODUCTION**

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

3 A. My name is Richard B. Lee. I am Vice President of the economic consulting firm
4 of Snavely King Majoros O'Connor & Lee, Inc. ("Snavely King"). My business
5 address is 1220 L Street, N.W., Suite 410, Washington, D.C. 20005.

6 **Q. ON WHOSE BEHALF ARE YOU APPEARING IN THIS DOCKET?**

7 A. I am appearing on behalf of the Department of Defense and all other Federal
8 Executive Agencies ("DOD/FEA").

9 **Q. ARE YOU THE SAME RICHARD B. LEE WHO SUBMITTED DIRECT**
10 **TESTIMONY IN THIS PROCEEDING ON JULY 25, 2000, AND SURREBUTTAL**
11 **TESTIMONY ON SEPTEMBER 8, 2000?**

12 A. Yes, I am.

13 **Q. DID YOUR DIRECT TESTIMONY CONTAIN A DESCRIPTION OF YOUR**
14 **BACKGROUND AND EXPERIENCE?**

15 A. Yes, it did.

16 **Q. WAS THIS TESTIMONY PREPARED BY YOU OR UNDER YOUR DIRECT**
17 **SUPERVISION?**

18 A. Yes, it was.

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

20 A. The purpose of my testimony is to present DOD/FEA's position on the
21 Settlement Agreement between the Commission Staff and Qwest dated October

20, 2000.

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. DOD/FEA finds the Settlement Agreement to be in the public interest. DOD/FEA remains open, however, to the possibility that the Settlement Agreement may be enhanced by modifications proposed by other parties.

THE SETTELEMENT AGREEMENT IS IN THE PUBLIC INTEREST

Q. PLEASE SUMMARIZE THE SETTLEMENT AGREEMENT

A. The Settlement Agreement has two principal components. First, the Settlement Agreement resolves the many contested issues in this rate case by authorizing a $42.9 million increase in Qwest's net intrastate revenues, of which approximately $17.6 million would be implemented immediately. Second, the Settlement Agreement establishes a three-year Price Cap Plan during which neither Qwest nor Staff will initiate a general rate case.

Q. PLEASE SUMMARIZE THE PROPOSED PRICE CAP PLAN.

A. The Price Cap Plan establishes three baskets of service. Each basket is subject to specific pricing rules.

Basket One consists of Basic/Essential Noncompetitive Services. The price cap for this basket will decrease each year to the extent that inflation is less than an assumed productivity increase of 4.2 percent.

Basket Two consists of Essential Wholesale Services. Intrastate Switched Access service rates will be decreased by $5 million each year, with the eventual objective of parity with interstate switched access rates. All other services in this basket are either frozen or subject to other specific pricing rules.

Basket Three consists of Flexibly-Priced Competitive Services that have already been accorded pricing flexibility. The price cap for this basket will begin at 110 percent of current rates, reflecting the $25.3 million of higher authorized net intrastate revenues not implemented immediately. This cap will be increased by $5 million each year to offset the reductions in intrastate access rates.

The Price Cap Plan also increases the Service Quality Plan penalties applicable if Qwest fails to meet existing performance standards in Arizona.

Q. IS THE RESOLUTION OF THE ISSUES IN THE RATE CASE IN THE PUBLIC INTEREST?

A. Yes, it is. In its January 8, 1999, filing, Qwest proposed an increase of $225.9 million in authorized net revenues, with $70.9 million to be implemented immediately. DOD/FEA, Staff, the Residential Utility Consumer Office ("RUCO") and AT&T all found Qwest's revenue requirement proposal to be vastly excessive. The Settlement Agreement represents a reasonable compromise given the many contentious issues raised by the parties and the inherent uncertainty of revenue requirement projections.

The Settlement Agreement strikes an appropriate balance between the

interests of Qwest and its ratepayers. Indeed, under the Settlement Agreement, all of the revenue increases allowed are applied to competitive services, while all of the revenue decreases required are related to noncompetitive or wholesale services. This rate design feature appropriately places the burden on Qwest to realize the net revenue increase authorized under the Settlement Agreement.

Q. IS THE PROPOSED PRICE CAP PLAN IN THE PUBLIC INTEREST?

A. Yes, it is. This aspect of the Settlement Agreement also appropriately balances the interests of Qwest and its ratepayers.

The productivity factor of 4.2 percent represents a realistic, but challenging, target for Qwest over the next three years. If it exceeds this target, Qwest will be rewarded with higher earnings. If it falls short, Qwest, and not its ratepayers, will suffer the consequences.

The proposed reductions in intrastate access charges are most appropriate. The offsetting increase to the competitive service cap provides Qwest with an opportunity to recoup these lost access revenues in the marketplace.

The strengthening of the penalties associated with service quality failures is an important part of the Price Cap Plan. It should serve to discourage the achievement of higher earnings at the expense of service quality.

Finally, the three-year period of the Price Cap Plan seems appropriate for all concerned. Three years represent a long enough period to provide Qwest

with a real incentive to reap the earnings rewards which would come with outstanding productivity improvements. At the same time, three years is a short enough period to prevent Qwest from reaping a windfall at the expense of ratepayers if the productivity factor is found to be too low.

Q. IS THE PROPOSED PRICE CAP PLAN PERFECT?

A. I doubt it. Although I have no specific recommendations to make concerning the details of the plan, it is possible that other parties may propose worthwhile modifications. I recommend that Qwest, the Staff and the Commission remain open to such enhancements to the Price Cap Plan as may be proposed during this proceeding.

CONCLUSION

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

CERTIFICATE OF SERVICE

I, Peter Q. Nyce, Jr., certify that I have this day caused the Surrebuttal Testimony of Richard B. Lee, and Surrebuttal Testimony of Charles W. King, on behalf of the Department of Defense and All Other Federal Executive Agencies, to be served on all known parties by sending a copy by either Federal Express or by regular U.S. Mail delivery to those on the "Service List" attached hereto.

Executed September 7, 2000, at Arlington Virginia.

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