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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 STAFF'S NOTICE OF FILING DIRECT TESTIMONY

The Arizona Corporation Commission Staff ("Staff"), hereby files the Direct Testimony of Michael C. Brosch, Steven C. Carver, Stephen G. Hill, William Dunkel, Tom Regan and Harry M. Shooshan III. Unredacted copies of Mr. Broschs', Mr. Carvers' and Mr. Dunkels' testimony are being provided in a separate, sealed envelope to the Hearing Officer and Applicant U S WEST Communications, Inc., now known as Qwest Corporation.

RESPECTFULLY SUBMITTED this 9th day of August, 2000

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BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF U S WEST COMMUNICATIONS, INC., A COLORADO CORPORATION, FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY, THE FAIR VALUE OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN	)	DOCKET NO. T-1051B-99-105

TESTIMONY OF HARRY M. SHOOSHAN III STRATEGIC POLICY RESEARCH, INC.

August 9, 2000

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DIRECT TESTIMONY OF
HARRY M. SHOOSHAN III

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Attachment 1: Proposed Basket Structure

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DIRECT TESTIMONY OF HARRY M. SHOOSHAN III

1. INTRODUCTION

Q. WHAT IS YOUR NAME AND OCCUPATION?

A. My name is Harry M. Shooshan III. I am a principal in, and co-founder of, Strategic Policy Research, Inc. ("SPR"), an economics and public policy consulting firm located at 7979 Old Georgetown Road, Suite 700, Bethesda, Maryland.

Q. WILL YOU BRIEFLY DESCRIBE YOUR RELEVANT BACKGROUND AND EXPERIENCE?

A. Prior to founding SPR, I worked for eleven years on Capitol Hill and, for six years, was Chief Counsel and Staff Director of the Communications Subcommittee in the U.S. House of Representatives. I had responsibility for developing policy options for the Subcommittee, assisting in the drafting of legislation and coordinating the Subcommittee's oversight of the Federal Communications Commission ("FCC"). I was especially active in early efforts to rewrite the Communications Act of 1934. From 1976 to 1991, I was an adjunct professor at Georgetown University Law Center. I taught courses in communications law and regulation. These courses examined the role of administrative agencies in interpreting their statutory mandates, including their exercise of discretion in rule-makings and other proceedings. In my twenty years as a consultant, I have advised a wide range of clients in the private sector as well as several regulatory bodies in the United States and around the world. I have published numerous works on a variety of topics including alternative regulation, rate rebalancing, universal service, and asymmetric regulation. For nearly a decade, I have served as an advisor to the Iowa Utilities Board on a variety of

telecommunications matters, including the evaluation of incentive regulation plans and the implementation of the federal Telecommunications Act of 1996 ("the 1996 Act"). In addition, I have testified before numerous public utility commissions on issues relating to competition, customer perspectives on telecommunications markets, price caps and other forms of incentive regulation. My complete curriculum vitae is attached as Attachment 2 to this testimony.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS CASE?

A. SPR was hired by the Arizona Corporation Commission (the "Commission") to work with the staff to develop an alternative regulation plan for U S WEST Communications, Inc. ("U S WEST"). We worked with the staff and its other consultants to develop the plan that I am presenting in this testimony. This alternative regulation plan can be considered by the Commission if it decides to reject the approach taken by U S WEST.

2. EVALUATION OF U S WEST'S COMPETITIVE ZONE PROPOSAL AND AN ALTERNATIVE PROPOSAL

Q. PLEASE DESCRIBE U S WEST'S PLAN, AS YOU UNDERSTAND IT.

A. U S WEST's plan seeks competitive classification for its various services based on "zones" that relate to exchanges or wire centers. Once U S WEST has demonstrated that a service is competitive in a particular zone, that service would be subject to the competitive service pricing rules of the Commission (ACCR 14-2-1109, 14-2-1110). However, U S WEST would remain under traditional rate-of-return ("ROR") regulation for both competitive and non-competitive services.

Q. WILL YOU PLEASE BRIEFLY DESCRIBE THE ALTERNATIVE REGULATION PLAN YOU ARE RECOMMENDING?

A. Yes. The plan I recommend, in essence, moves away from traditional ROR regulation towards price regulation and, ultimately, to reliance on competitive

markets to determine prices and service offerings. It is structured to be forward-looking and to provide U S WEST with important incentives to increase its investments in Arizona and to improve its service quality both now and in the future. The plan also protects consumers who will continue to rely on the basic services provided by U S WEST during the transition to fully competitive markets mandated by federal law. The plan establishes three categories or "baskets" of services, each with its own price controls. The term of the plan is five years, which, in my opinion, is long enough for the new incentives to have an impact, but short enough to enable the Commission to review the company's performance under the plan to ascertain that it is actually providing the expected benefits to consumers.

Q. CAN YOU EXPLAIN HOW YOUR PLAN DIFFERS FROM THE FILING MADE BY U S WEST?

A. Yes. Contrary to the plan I propose, U S WEST has filed a plan that is consistent with traditional regulation in Arizona. It retains rate-base ROR regulation, but seeks expanded pricing flexibility of its services where the company faces competition. After updating the test year in its direct case to reflect a January 1999 to December 1999 test year, U S WEST proposes that the Commission grant rate increases totalling $88 million for its basic services and seeks only minor reductions in the access charges paid by long-distance providers.[1]

Q. IN YOUR OPINION, WHAT ARE THE MOST PROBLEMATIC ASPECTS OF THE APPROACH TAKEN BY U S WEST AND HOW WOULD YOUR PROPOSAL ALLEVIATE THEM?

A. In general, I see three problems with the U S WEST filing. First, I am concerned that U S WEST's approach leaves most of the risk associated with increasing

[1] Supplemental testimony of David L. Teitzel (May 19, 2000) at 51-52. In its original filing, U S WEST sought a $70.9 million rate increase. *See also* Wayne Alcott Direct Testimony at 14.

competition on basic ratepayers. For example, U S WEST is asking the Commission to grant it pricing flexibility, including for basic services, where it faces competition but would not assign any costs directly to competitive services. As a result, if U S WEST suffers competitive losses, as I expect it will, it can come back to the Commission to ask that basic service rates be increased in areas where there is little or no competition. Similarly, U S WEST may have the incentive and opportunity to cross-subsidize lower rates in competitive services and/or areas with higher basic rates in non-competitive services and/or areas. Finally, extending pricing flexibility on a service-by-service, exchange-by-exchange basis, while retaining elements of ROR, can be confusing to consumers and needlessly complex for the Commission to oversee and administer, especially as competition intensifies. More specifically, I am concerned that U S WEST wants the Commission to approve significant increases in basic service rates while proposing only minor reductions in its intrastate access charges. While I believe that rates should be rebalanced, I am concerned about the approach taken by U S WEST and believe that an alternative approach should be considered.

Q. IN SUPPLEMENTAL TESTIMONY, U S WEST RECOMMENDS THAT "FINISHED WHOLESALE SERVICES" SUCH AS SWITCHED ACCESS, PRIVATE LINE AND PUBLIC PAYPHONE ACCESS LINES BE CLASSIFIED AS COMPETITIVE IN THIS PROCEEDING.[2] HOW WOULD THE PLAN YOU ARE PROPOSING TREAT SUCH SERVICES?

A. As I describe in greater detail subsequently in this testimony, I recommend placing all existing "wholesale services," initially in a separate basket subject to its own price cap. Services could then be moved out of that basket upon a showing that they are competitively supplied.

[2] Supplemental Testimony of Scott A. McIntyre (May 19, 2000) at i - ii.

3. PRICE REGULATION: EXPERIENCE IN OTHER JURISDICTIONS

Q. YOU HAVE CHARACTERIZED YOUR PROPOSAL AS "PRICE REGULATION." HAVE PLANS SIMILAR TO YOURS BEEN ADOPTED IN OTHER JURISDICTIONS? IF SO, WILL YOU IDENTIFY THEM?

A. Price regulation was first implemented in the United Kingdom ("U.K.") by the telecommunications regulator, the Office of Telecommunications ("Oftel"), and applied to British Telecom. At the time, it was privatised. Oftel rejected ROR regulation as an option. I should note that SPR consulted for Oftel for almost ten years and, thus my colleagues and I are familiar with the experience in the U.K. We have also worked for regulators in countries such as Mexico, Peru and Panama that have also adopted price regulation at the time of privatization. In Jamaica, where we assisted the regulator in obtaining a more advantageous concession contract with the privatized incumbent, the regulator implemented a price regulation plan as part of the new concession contract. Other countries have also followed the British lead. For example, in Denmark, France, Greece, Ireland, Japan, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland and Turkey, the regulator utilizes some form of price cap to regulate prices of the incumbent.[3]

Domestically, the FCC introduced price regulation in 1991. AT&T was regulated under price caps from 1991 until its reclassification as a nondominant carrier in 1995.[4] The FCC also extended price regulation to large incumbent local exchange carriers ("ILECs") in 1991. As many as 36 states regulate the largest ILECs (*i.e.*, the Regional Bell Companies, GTE and Sprint) under some form of price regulation.

[3] OECD, *Communications Outlook 1999* (1999) at 166-167.

[4] FCC, In the Matter of AT&T Corp. to Be Reclassified as a Non-Dominant Carrier, FCC 95-427 *Order* (adopted October 12, 1995; released October 23, 1995).

These states include: Alabama, Delaware, Florida, Georgia, Illinois, Louisiana, Maryland, Massachusetts, New York, North Carolina, South Carolina, Oklahoma, Texas, Virginia and West Virginia. Among U S WEST states, North Dakota, South Dakota, Iowa and Wyoming regulate U S WEST under a price-cap plan. Colorado has been in the process of determining an alternative regulation plan.

Often, price-cap plans include a variety of features. For example, some states such as Illinois, Wisconsin, New York and Pennsylvania, have included service quality components in their price-cap plans. States such as Texas, Florida and Pennsylvania, employ a more flexible price cap for non-basic services and a more stringent price cap on basic telecommunications services.

4. ADVANTAGES OF PRICE REGULATION

Q. IN YOUR OPINION, WHAT ARE THE ADVANTAGES OF PRICE REGULATION OVER TRADITIONAL ROR REGULATION?

A. The advantages of price regulation over ROR regulation are well-documented. In the first place, under ROR, regulators must rely on the accuracy and completeness of cost data provided by the regulated company. Time-consuming disputes arise, inevitably leading to arbitrary decisions about which costs are justified and which are not, as well as about how costs should be assigned among various services. Economists have often pointed to this disparity in information between the regulator and the regulated company in their criticisms of ROR regulation.[5] The adoption of price regulation, which does not rely on company-specific cost data, reduces such controversies.

[5] Alfred Kahn, "Deregulation: Looking Backward and Looking Forward," *Yale Journal on Regulation* (Vol. 7, No. 2, Summer 1990) at 340-341; and Paul L. Joskow and Richard Schmalensee, "Incentive Regulation for Electric Utilities, *Yale Journal on Regulation* (Vol. 4, No. 1, Fall 1986) at 12-13.

The problems of ROR regulation are exacerbated when the regulated firm offers a variety of services and when some of the markets (geographic or product) in which the regulated company operates are competitive. Cross-subsidy incentives arise that are extremely difficult to detect and prevent in such instances.[6]

Finally, it is generally agreed that agencies can reduce administrative costs by adopting price regulation, thereby freeing up resources to monitor issues such as service quality and competition.

Price regulation is specifically aimed at providing limits on incumbents' prices, particularly of basic services, while providing incentives for increased productivity of the regulated firm. Price regulation directly protects consumers and provides the incumbent with a greater flexibility to respond to competitors. The limits set by the price cap provide safeguards against anticompetitive pricing, preventing subsidies from non-competitive to competitive services and, thereby reducing the risk of predatory pricing. Both consumers and competitors benefit from this constraint. Under price regulation, more of the risk of investment is borne by the regulated firm (and its shareholders) rather than by customers. For example, when the price-regulated firm undertakes the risk of a new investment, it operates on the same basis as its unregulated competitors. Consumers of basic service will not pick up the tab if the venture fails.

Finally, through an appropriate price-cap mechanism, the firm is able to rebalance rates to produce more efficient prices that will, in turn, encourage efficient competition. The price-cap limits allow rate rebalancing to occur over time and avoids rate shock. I believe a price regulation plan such as I am proposing here can provide a better way to achieve the necessary rate rebalancing (by permitting

[6] Michael Einhorn, *Price Caps and Incentive Regulation in Telecommunications* (Kluwer Academic Publishers: Norwell, Massachusetts, 1991) at 8.

consumers to "self-select" rebalanced rates) than the approach taken by U S WEST (an across-the-board increase in basic rates).[7]

Q. HAVE THE BENEFITS YOU ENUMERATE BEEN REALIZED ELSEWHERE UNDER PRICE REGULATION?

A. Yes. Price regulation has been found to have a number of favorable impacts. Results from the U.K. have indicated the success of price-cap regulation from the beginning. For example, in the first four years of its price-cap plan, prices for a basket of telephone services in the U.K. rose at a rate much lower than in France, (West) Germany and Italy where the telephone companies were still government-owned monopolies.[8] More recently, Oftel found that consumers have fared even better under the current price-cap parameters than in the past. BT's introduction of discount calling plans has enabled consumers to reap benefits greater than those required by the price-cap plan.[9]

The FCC, in its first review of price-cap regulation of the ILECs, estimated that the cumulative savings derived from the price-cap plan over the period 1991-1994 exceeded $10 billion.[10] The FCC found that ILEC prices had "declined significantly" under price-cap regulation compared to the starting rates in 1991.[11] The FCC also found that during the first four years of price-cap regulation, ILECs made investments in new plant that exceeded the levels in prior years by over 4

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[7] John Haring and Harry M. Shooshan III, *Cutting the Gordian Knot of Rate Rebalancing*, prepared for the 29th Annual Conference of the Institute of Public Utilities, "Reconciling Competition and Regulation," Williamsburg, Virginia (December 5, 1997).

[8] Einhorn at 4.

[9] Oftel, *Price Controls Under Review:: Future Competitiveness of UK Telecommunications Markets* (July 1999) at Chapter 2, ¶ 6.

[10] FCC, In the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, *First Report and Order* (released April 7, 1995) at ¶ 60.

[11] *Ibid.* at ¶ 59.

percent.[12] Collectively, the ILECs filed tariffs for hundreds of new services, demonstrating that price regulation encouraged innovation and the development of new services.[13]

The fact that more and more states are adopting price regulation plans also demonstrates that its successes are now generally accepted.

Q. WHAT ARE THE PARTICULAR ADVANTAGES OF THE APPROACH YOU ARE RECOMMENDING OVER OTHER FORMS OF ALTERNATIVE REGULATION?

A. The need to move away from ROR regulation is not predicated on the presence of competition, but on the fundamental need to improve regulatory methods. The fact that markets have been opened to competition only exacerbates the problems associated with ROR regulation, as I described above. The FCC and some states first took incremental steps away from ROR to incentive regulation plans because of the shortcomings of ROR, not because of the presence of widespread competition. The states employed incentive plans that included features such as earnings sharing and specific infrastructure deployment commitments. These plans provided incentives for the regulated company to become more efficient in order to enjoy the profits that it could retain over an extended period. These plans retained earnings regulation, however.

Over time, as regulators experienced success with alternative regulation plans and as barriers to entry were removed, the trend has been to remove earnings regulation altogether. Of the 36 states that rely on price regulation, 35 states employ plans that concentrate, not on controlling the firm's earnings, but on providing a zone of reasonableness (defined by a price-cap index formula) within which services can be priced.

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[12] *Ibid.* at ¶ 63.

In my opinion, the Commission can benefit from other states' experience and should bypass incremental steps by adopting a true price regulation plan. The increasing presence of competition in varying degrees in various markets only enhances the need to move away from ROR. The plan I propose here meets that need, while providing significant consumer protections and incentives for U S WEST to increase its investment in the state.

5. COMPONENTS OF THE PRICE REGULATION PROPOSAL

Q. WOULD YOU NOW PLEASE DESCRIBE THE ESSENTIAL ELEMENTS OF YOUR PROPOSAL IN MORE DETAIL?

A. The proposal I have developed in consultation with the Staff focuses regulation on constraining prices rather than on the profits earned by U S WEST. I am proposing grouping services into three categories, or "baskets," each of which would be subject to its own overall pricing rules or "price cap."

Q. HOW ARE THE THREE "BASKETS" STRUCTURED IN YOUR PROPOSAL?

A. The basket structure I am recommending is contained in Attachment 1 to my testimony. The first basket ("Basic/Essential Retail") consists of all services that U S WEST currently offers which have not been classified as "competitive" or which are not currently afforded flexible pricing. A second basket ("Essential Wholesale") consists of all non-competitive "wholesale" services. These are the services that competitors rely upon for their offerings, and include intrastate access, unbundled network elements, local service resale and public payphone access lines. A third

[13] *Ibid.* at ¶ 58.

basket ("Competitive/Advanced") consists of any existing services that have been classified as "competitive" and also includes those services for which U S WEST has obtained flexible pricing authority. Among these services are Centrex Centron, ATM Call Relay, WATS and certain message toll services. Any new packaged or bundled retail offering would also be included in Basket Three as long as the major components of the packaged/bundled offering that are "non-competitive" are available under tariff as a separate service in either Baskets One or Two. The availability of the tariffed components provides a reasonable alternative for customers who do not want to take the new packages or bundles offered by U S WEST. New stand-alone retail services would also go into Basket Three. In addition, services (including existing packages or bundles that are not currently classified "competitive" or subject to flexible pricing) could be moved from Basket One to Basket Three (or withdrawn altogether) with the Commission's approval.

Q. HOW WOULD A SERVICE BE MOVED FROM THE "BASIC/ ESSENTIAL" BASKET TO THE "COMPETITIVE/ADVANCED" BASKET?

A. Initially, a service could be moved once it is shown to meet the requirements of A.C.C. R14-2-1108. I would emphasize, however, that since the adoption of this alternative regulation plan significantly reduces the risk to basic ratepayers of a service being "misclassified" (basic services would be in a separate basket subject to strict price limits and, therefore, would not be a source of cross-subsidy), a less rigorous test might be warranted once a price-cap plan is in place. For example, under this plan the Commission might consider a service competitive if at least one competitor exists and no longer look at "estimated market share" of the various providers.

Q. WILL YOU DESCRIBE HOW THE PRICES FOR EACH OF THE THREE BASKETS WILL BE ESTABLISHED? PLEASE START WITH BASKET ONE.

1 **A.** Yes. Basket One will be subject to an overall price cap and to some internal
2 constraints. I propose capping all basic services (which I define to include: Flat
3 Rate Residential and Business Services, Two-and Four-Party Service, Exchange
4 Zone Increment Charges, Low Use Option, Service Stations Service, Telephone
5 Assistance Programs, individual PBX Trunks and Features, Caller ID Block, Toll
6 Blocking, 900/976 Blocking, and Basic Listing Service) at existing prices for the
7 initial period of the plan; that is, five years. Otherwise, prices within this basket
8 could be increased or decreased as long as the weighted average price level for the
9 basket as a whole is within the overall price-cap index.

10 **Q. WHAT ABOUT BASKET TWO?**

11 **A.** Initially, Basket Two consists primarily of intrastate access and UNEs/local service
12 resale. These offerings would be governed by separate sub-constraints. I propose
13 that intrastate access prices be reduced by 20 percent per year from their initial
14 levels so that by the end of the initial five-year period they are equivalent to U S
15 WEST's interstate access charges at July 2000 levels. From that point on, I
16 recommend that intrastate access charges be adjusted to "mirror" the interstate
17 rates. Along with access, UNEs and local service resale are important inputs for
18 competitors, but are governed by the provisions of the 1996 Act and relevant FCC
19 rules. Thus, while they may be appropriately placed in Basket Two, the plan I
20 propose contemplates that prices would be established as required by federal law
21 and subject to the procedures already established by the Commission. Rates for
22 other services, such as public payphone access lines, that are identified for inclusion
23 in Basket Two, should initially be frozen at current levels subject to further review
24 by the Commission.

25 **Q. AND NOW FINALLY FOR BASKET THREE?**

26 **A.** Prices for services in Basket Three would qualify for streamlined rate treatment
27 comparable to that provided for in A.C.C. R14-2-1109 and R14-2-1110. The retail
28 services contained in this basket could be priced at any level between a maximum
29 specified in a tariff and a minimum of the total service long-run incremental cost of

1 the service. Price changes within this established range would be permitted at any
2 time as long as concurrent notice is provided to the Commission.

3 **Q. WHAT PRICE-CAP INDEX WOULD APPLY TO BASKET ONE?**

4 **A.** For Basket One, the price-cap index would be established in accordance with price-
5 cap plans generally (including the FCC's). It would be set based on inflation less an
6 adjustment for productivity (the so-called "X-Factor"). The weighted average price
7 level of the services within this basket must be less than or equal to the price-cap
8 index ("PCI"). For example, if U S WEST increases the price of a service assigned
9 to this basket and that price increase results in a weighted average price level above
10 the PCI, then the price of other services in that basket must be reduced in order to
11 maintain the average price level within the bounds of the index. I note here that
12 those basic services within Basket One that are capped at their existing levels going
13 into the plan could not be increased during the initial five-year term of the plan, but
14 could be decreased. The measure of inflation that is used in most price-cap plans is
15 the percent change in the gross domestic product-price index ("GDP-PI").[14]

16 To develop an appropriate productivity adjustment in the price-cap plan, we
17 requested from U S WEST any productivity studies it has conducted.[15] We
18 reviewed the productivity study that U S WEST conducted for its operations in
19 Arizona in response to SPR 003-001. For the years 1995-1998, following its most
20 recent rate case, we calculated an average productivity of 3.7 percent. We sought

[14] The FCC switched from using the gross national product-price index ("GNP-PI") to the GDP-PI in its review of interstate price caps when the Commerce Department ceased to provide the needed estimate of GNP-PI in 1991. Economic reasons further support the use of GDP-PI. GDP-PI reflects only domestic production of U.S. and foreign firms within the United States. *See* FCC, In the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, *First Report and Order* (released April 7, 1995) at ¶¶ 347-351.

[15] The measure of a company's productivity is the percent change in the ratio of the firm's output over its inputs from one year to the next. Complex productivity calculations have been conducted that analyze inputs and outputs on the basis of their quantities and prices. Such complex studies are referred to as "total factor productivity" studies. Because it is difficult to compare the units of "apples and oranges" (*i.e.*, minutes of use, number of access lines, units of labor or fiber miles), productivity studies often use methods that compare annual percent changes in the ratio of total revenue (as a proxy for outputs) and total costs (as a proxy for inputs).

revised data from U S WEST to further investigate its productivity.[16] Since these data were provided too late for us to analyze fully for use in this testimony, U S WEST's own study provides the only information available about the productivity of its operations in Arizona.

We also researched the productivity adjustments of other states that employ price regulation. The productivity adjustments used by price-cap states have ranged from zero to 5 percent. The average productivity adjustment used by these states is 3.2 percent.[17] Our analysis of other states' use of productivity suggests that U S WEST's productivity estimates are reasonable. In light of our research and analysis, I recommend that the Commission adopt a productivity adjustment that is based on the 3.7 percent annual productivity that U S WEST has achieved since the last rate proceeding in Arizona. To this historical productivity, I recommend that the Commission add a Consumer Productivity Dividend ("CPD") of 0.5 percent. Regulators include the CPD based on the expectation that the carrier will achieve greater levels of productivity under price-cap regulation than under ROR in order to ensure that some of those productivity gains flow through to consumers in the form of relative price reductions. Thus, I recommend a productivity adjustment of 4.2 percent based on a combination of U S WEST's historical performance and a forward-looking CPD.

6. BENEFITS OF THE PRICE REGULATION PROPOSAL

Q. WILL YOU PLEASE ENUMERATE THE WAYS IN WHICH YOUR PROPOSAL BENEFITS CONSUMERS?

[16] SPR issued its Fourth Set of Data Requests to U S WEST on January 24, 2000. We finally received a reply in late July, 2000.

[17] This estimate is based on SPR's analysis of information contained in J. Abel and Michael E. Clements, "A Time Series and Cross-Sectional Classification of State Regulatory Policy Adopted for Local Exchange Carriers," Divestiture to Present (1984-1998), National Regulatory Research Institute (December 1998).

1 **A.** My proposal will provide many tangible benefits to consumers. Basic/essential
2 retail services are governed separately from competitive/advanced services and
3 wholesale services. The opportunity to cross-subsidize among these service groups
4 is eliminated. Basic service customers are thus protected from the possibility of
5 having to subsidize advanced/competitive and wholesale services. While rate
6 rebalancing is an important objective, the mechanisms in this plan ensure rate
7 stability as rebalancing occurs over time.

8 The proposed plan will include a five-year "hard cap" for those basic services
9 identified by the Commission Staff. As I have stated, this hard cap prevents any
10 increase in the prices of specified services over the five-year period.

11 The inclusion of a productivity adjustment that embodies a CDP ensures that basic
12 service customers also benefit from the efficiencies in U S WEST's overall
13 operations over the period of the plan.

14 Consumers also stand to benefit from the creation of separate baskets for
15 basic/essential and competitive/advanced services. U S WEST now has incentive to
16 provide innovative services and service packages, including pricing plans, that have
17 not been available heretofore.

18 Finally, in my opinion, competition will develop more efficiently through the
19 implementation of this price regulation plan than under ROR. As a result,
20 consumers can expect more choices from U S WEST as well as its competitors.

21 **Q. WILL YOU PLEASE EXPLAIN HOW YOUR PROPOSAL WILL**
22 **PROMOTE COMPETITION?**

23 **A.** The alternative regulation proposal I am recommending will promote competition
24 in several ways. First, it will protect competitors against cross-subsidy far more
25 effectively than traditional ROR regulation. In short, any losses that U S WEST
26 might incur in its competitive services cannot be made up by increasing basic rates
27 which are capped under this plan for five years. Second, because this plan will
28 permit U S WEST to do some rate rebalancing, it will produce more efficient prices
29 which will, in turn, promote more efficient entry. Finally, by affording U S WEST

1 greater flexibility in offering and pricing new services and packages of services, this
2 plan will encourage more robust competition and help ensure that the varying needs
3 of customers are met in a timely fashion.

4 7. CONSTITUTIONAL AND LEGAL CONSIDERATIONS

5 **Q. ARE YOU AWARE OF THE PROVISIONS IN THE STATE**
6 **CONSTITUTION AND THE JUDICIAL PRECEDENTS THAT HAVE A**
7 **BEARING ON THE COMMISSION'S RATE-SETTING POLICIES?**

8 **A.** Yes.

9 **Q. DOES THE PLAN YOU ARE RECOMMENDING FALL WITHIN**
10 **THESE LEGAL PARAMETERS?**

11 **A.** Yes.

12 **Q. ON WHAT DO YOU BASE YOUR ANSWER TO THE PREVIOUS**
13 **QUESTION?**

14 **A.** Although I am not appearing as a legal expert and do not represent myself as an
15 expert on Arizona law, I have perused the relevant provisions of the State
16 Constitution and the key judicial opinions and have discussed them with the legal
17 Staff of the Commission. I am relying primarily on the opinion of the Staff that the
18 Commission has the discretion to implement the plan I am recommending.

19 **Q. ARE YOU AWARE THAT U S WEST HAS TAKEN A CONTRARY**
20 **POSITION IN PENDING LITIGATION?**

21 **A.** Yes.

22
23

1 Q. **WOULD YOU ELABORATE ON YOUR UNDERSTANDING?**

2 A. Yes. Specifically, under the plan I am proposing, services in Basket Three
3 ("Advanced/Competitive/Nonessential") are flexibly priced. "Just and reasonable"
4 rates are determined by marketplace forces, without explicit reliance on the fair
5 value of U S WEST's property in the State devoted to the provision of public
6 service. It is my understanding that U S WEST has taken the position that the
7 Commission may not lawfully establish rates in any manner other than by reference
8 to the fair value of a utility's assets. U S WEST is objecting to the Commission's
9 treatment of services offered by CLECs and is apparently seeking to have all carriers
10 held to the same regulatory standards in Arizona. While I understand that U S
11 WEST has a number of services subject to flexible pricing today, the company's
12 challenge to the Commission's authority, if successful, could foreclose adoption of
13 this plan or any similar price cap plan.[18]

14 Q. **IN YOUR OPINION, WHAT ARE THE IMPLICATIONS OF U S**
15 **WEST'S CHALLENGE OF THE COMMISSION'S AUTHORITY?**

16 A. As I suggested, the Commission should be cautious about approving the alternative
17 form of regulation that I am proposing while U S WEST continues to challenge its
18 authority.

19 Q. **WHAT COURSE OF ACTION WOULD YOU SUGGEST TO RESOLVE**
20 **THE CONSTITUTIONAL AND LEGAL UNCERTAINTY RAISED BY**
21 **U S WEST'S LITIGATION?**

22 A. I recommend that, as a condition to making the plan I am proposing effective, U S
23 WEST should be required to withdraw all pending litigation in which it is a plaintiff
24 seeking to have competitive pricing plans declared illegal in Arizona. Specifically, I

[18] I do not offer an opinion on whether the Commission would be required to eliminate the currently authorized competitive services tariff, but that is a distinct possibility.

1 believe U S WEST should move to dismiss all appeals from the issuance of
2 Certificates of Convenience & Necessity where the issue raised is whether the
3 Commission may lawfully set initial rates without a fair value finding or whether the
4 Commission may lawfully prescribe flexible rates by determining them to be just and
5 reasonable predicated on the existence of a competitive marketplace. As a further
6 condition, U S WEST should agree not to pursue similar litigation during the term
7 of a price cap plan. I am advised by Staff that conflicting decisions have been issued
8 by the Superior Court in similar litigation over these issues. Thus, I recommend, as
9 a final condition, that U S WEST should agree to intervene in support of the
10 Commission in any litigation filed by any other party challenging the Commission's
11 authority to adopt a plan such as the one I am proposing.

12 **8. SERVICE QUALITY IMPROVEMENT**

13 **Q. ARE YOU AWARE OF THE COMMISSION'S CONCERNS ABOUT**
14 **EXISTING SERVICE QUALITY PROBLEMS INVOLVING U S WEST'S**
15 **OPERATIONS IN ARIZONA?**

16 **A.** Yes. The problems are apparently quite serious and I applaud the Commission for
17 addressing them aggressively. I should point out, however, that these problems
18 have arisen under traditional ROR regulation.

19 **Q. ISN'T IT TRUE THAT UNDER A PRICE REGULATION PLAN, A**
20 **COMPANY MAY HAVE THE INCENTIVE TO REDUCE SERVICE**
21 **QUALITY TO INCREASE ITS PROFITS? IF SO, THEN PLEASE**
22 **EXPLAIN HOW YOUR PROPOSAL WOULD IMPACT THE SERVICE**
23 **QUALITY ISSUES.**

24 **A.** Under price regulation plans generally, companies have the incentive to become
25 more efficient. One risk is that they will seek to eliminate costs and increase profits
26 by reducing the quality of service, for example, by laying off installation and repair
27 technicians. While such actions may prove productive in the long run, especially as

1 firms face increased competition, there may be some short-term risk that the quality
2 of service — especially for the non-competitive offerings in Basket One — could be
3 adversely affected. Other regulatory bodies that have adopted price regulation have
4 had to deal with this potential problem. If the Commission is concerned about
5 offsetting this incentive to reduce service quality, it can build penalties into this
6 alternative regulation plan tied to improving and maintaining quality of service.

7 Q. SPECIFICALLY, WHAT WOULD YOU RECOMMEND?

8 A. To ensure that service quality does not deteriorate in the future, the Commission
9 could put U S WEST on notice that there will be an additional offset to the price
10 cap if U S WEST falls below required quality-of-service standards in the previous
11 year. Such a service quality offset would be used if U S WEST's overall service
12 quality were to decline based on the criteria in all areas of the current service quality
13 tariff: (1) access to repair and business offices; (2) held orders; and (3) out-of-
14 service repair times. In light of the Commission's continuing concerns about U S
15 WEST's current service quality problems, an initial offset may be warranted at this
16 time. The Commission can review the company's performance after one year and
17 decide whether to remove the initial offset, reduce it, maintain it or increase it,
18 depending on the company's performance. While it may be necessary to assess
19 penalties to correct existing problems[19] and to employ an additional productivity
20 offset to protect against any overall degradation in service during the term of a
21 price-cap regulation plan, I want to emphasize my belief that the alternative
22 regulation plan I am proposing will create positive incentives for U S WEST to
23 improve its performance, especially by making the necessary new investments in
24 plant and equipment.

[19] We agree with Utilitech that U S WEST should not treat service quality penalties as allowable expenses for ROR purposes. *See* Testimony of Michael L. Brosch.

9. INVESTMENT INCENTIVES

Q. BEYOND PROVIDING THE APPROPRIATE INCENTIVES AND PENALTIES FOR U S WEST TO MAKE THE INVESTMENTS NECESSARY TO IMPROVE SERVICE QUALITY, DOES YOUR ALTERNATIVE REGULATION PROPOSAL ACCELERATE INFRASTRUCTURE INVESTMENT?

A. In general, this alternative approach to regulation gives U S WEST a greater incentive to invest since it, like its competitors, can price advanced, competitive, and non-essential services (including new service packages) "to market." Moreover, as I explained earlier, this approach can also be expected to promote more robust competition with the result that all suppliers of telecommunications services will invest more than they otherwise would. Finally, alternative regulation plans in other states often include specific commitments to make accelerated investments in certain types of infrastructure. Typically, these commitments are proposed by the companies when they propose an alternative form of regulation. Since U S WEST is not seeking alternative regulation in this proceeding, it has understandably made no such commitment. I would note, however, that the company is free to make such a specific commitment at any time during this proceeding and might be encouraged to do so by the Commission. Such a commitment could initially be focused on specific investments needed to upgrade service quality and extend the reach of its DSL deployment.

10. CONCLUSION

Q. COULD YOU PLEASE SUMMARIZE YOUR TESTIMONY?

A. Yes. U S WEST proposes a plan that effectively retains ROR regulation and thus fails to provide effective safeguards against cross-subsidy, incentives for service quality improvement or incentives for infrastructure investment in Arizona. U S

1 WEST's proposal would be costly to administer and oversee. It also carries with it
2 an $88 million increase in basic service rates.

3 In the alternative, I have presented a price regulation plan that can prevent cross-
4 subsidies, creates incentives for service quality improvement and stimulates
5 infrastructure investment by U S WEST. Finally, the price regulation plan I am
6 recommending has concrete benefits for consumers of both basic and advanced
7 services, including a five-year cap on basic service.

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

9 **A.** Yes, it does.

10

Price Cap Plan for US West Proposed by SPR on Behalf of ACC Staff

Proposed Initial Service Baskets

BASKET ONE	BASKET TWO	BASKET THREE
Basic/Essential Retail Services Basket	**Essential Wholesale Services Basket***	**Advanced/Competitive/Nonessential Services Basket (Tariff Subsection)**
Subject to Price Cap Index (GDPPI - 4.2)	*20% reduction in access over 5 years with freeze on prices of other services*	*Granted Streamlined Treatment as in ACC R14-2-1109 & R14-2-1110*
Flat Rate Residential	Switched Access Services	Transparent LAN Service (Sect 1)
Flat Rate Business	Special Access Services	Frame Relay Service (Sect 2)
2 & 4 Party Service	Wholesale Services to non-LEC Payphones (i.e., answer supervision, payphone access line)	Megabit Services (Sect 3)
Exchange Zone Increment Charges	Other non-UNE wholesale offerings	LAN Switching Services (Sect 4)
Low Use Option Service		Exchange Services–Intra Call (Sect 5)
Service Stations Service		MTS (Sect 6)
Telephone Assistance Programs		Obsolete MTS (Sect 106)
Individual PBX Trunks, incl features		Traffic Data Report Service (Sect 10)
Caller ID Block		Inside Wire Maintenance (Sect 13)
Toll Blocking		Switched Digital Services Offerings-Switchnet 56 (Sect 15)
900/976 Blocking		ATM Relay Service
Basic Listing Service		Two - point MTS (Sect 6)
Existing Service Packages		1800 US West (Sect 6)
		DA (local & LD) (Sect 6)
		US West Complete a Call (Sect 6)
		Operator Verification/Interrupt (Sect 6)
		Optional Calling Plans (Sect 6)
		Outward WATS (Sect 7)
		800 Service (Sect 7)
		800 Service Line (Sect 7)
		Large Volume Discount (Sect 7)
		Centrex Centron (Sect 9)
		New "Stand-Alone" Services
		New Service Packages

* Wholesale services that are UNEs subject to the 1996 Act are not included in this basket as they are subject to FCC rules on UNE pricing.

Note: SPR's categorization of services among the baskets is based on discussions that we have held with ACC Staff throughout this process.

VITAE OF
HARRY M. SHOOSHAN III

Received a B.A. *magna cum laude* from Harvard University in Government and a J.D. from Georgetown University Law Center.

Before co-founding Strategic Policy Research, Inc. ("SPR"), Mr. Shooshan served for eleven years on Capitol Hill. He was chief counsel and staff director of the Subcommittee on Communications, U.S. House of Representatives and was active in congressional efforts to reform the nation's communications laws.

Mr. Shooshan specializes in communications public policy analysis, regulatory reform and the impact of new technology and competition. He also advises on business strategies and market opportunities.

Mr. Shooshan is the author of numerous studies and articles dealing with various aspects of the video marketplace, including the transition to digital television and the impact of the Internet. He is one of the nation's leading authorities on telecommunications infrastructure and its relationship to economic development and to the global competitiveness of U.S. businesses.

Mr. Shooshan coordinates SPR's telecommunications and electronic mass media practice in Europe and has advised clients in the United Kingdom, Canada and the Caribbean.

Mr. Shooshan has testified before several congressional committees, before the Federal Communications Commission ("FCC") and several state commissions. He has also testified as an expert witness in litigation concerning broadcasting, cable and wireless cable, and in proceedings before the Copyright Arbitration Royalty Panel concerning satellite broadcasting.

From 1976 to 1991, he was an adjunct professor of law at Georgetown University Law Center, teaching regulation and communications law.

EDUCATION

GEORGETOWN UNIVERSITY LAW CENTER
J.D., Communications Law, 1975

HARVARD COLLEGE
B.A., Government, *magna cum laude*, 1968

EMPLOYMENT

1992-Present	STRATEGIC POLICY RESEARCH, INC. — Bethesda, Maryland *Principal.* Telecommunications and public policy consulting services for a variety of clients in the telecommunications industry.
1989-1992	NATIONAL ECONOMIC RESEARCH ASSOCIATES, INC. — Washington, D.C. *Vice President.* Telecommunications and public policy consulting services for a variety of clients in the telecommunications industry.
1980-1989	SHOOSHAN & JACKSON INC. — Washington, D.C. *Principal.* Telecommunications and public policy consulting services for a variety of clients in the telecommunications industry.
1975-1980	SUBCOMMITTEE ON COMMUNICATIONS, INTERSTATE AND FOREIGN COMMERCE COMMITTEE, U.S. HOUSE OF REPRESENTATIVES — Washington, D.C. *Chief Counsel/Staff Director.* Legislative, oversight and investigating activities relating to telecommunications.
1974-1975	SUBCOMMITTEE ON COMMUNICATIONS AND POWER, INTERSTATE AND FOREIGN COMMERCE COMMITTEE, U.S. HOUSE OF REPRESENTATIVES — Washington, D.C. *Staff Director.* Legislative, oversight and investigating activities relating to telecommunications and energy.
1969-1974	U.S. HOUSE OF REPRESENTATIVES — Washington, D.C. *Administrative Assistant to the Honorable Torbert H. Macdonald.* Legislative and political coordination and support.

PROFESSIONAL ACTIVITIES

Member, Federal Communications Bar Association.

TESTIMONIES

Testimony before the Pennsylvania Public Utility Commission on behalf of Bell Atlantic - Pennsylvania. June 26, 2000.

Testimony before the Board of Public Utilities in New Jersey on behalf of Bell Atlantic -New Jersey, BPU Docket No. TO99120934. May 17, 2000.

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BEFORE THE

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IN THE MATTER OF THE APPLICATION	)	
OF US WEST COMMUNICATIONS, INC. A	)	
COLORADO CORPORATION, FOR A	)	
HEARING TO DETERMINE THE EARNINGS	)	DOCKET NO. T-01051B-99-0105
OF THE COMPANY FOR RATEMAKING	)	
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REASONABLE RATE OF RETURN THEREON	)	
AND TO APPROVE RATE SCHEDULES	)	

DIRECT TESTIMONY

OF

THOMAS REGAN

ON BEHALF OF

THE STAFF OF THE ARIZONA CORPORATION COMMISSION

AUGUST, 2000

I. STATEMENT OF QUALIFICATIONS AND INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Thomas M. Regan. My business address is 8625 Farmington Cemetery Road, Pleasant Plains, Illinois, 62677.

Q. WHAT IS YOUR PRESENT OCCUPATION?

A. I am an Economist with the firm of William Dunkel and Associates. I have been employed by William Dunkel and Associates since 1994. Since that time, I have regularly provided consulting services in telephone regulatory proceedings throughout the country.

Q. HAVE YOU PREVIOUSLY TESTIFIED?

A. Yes. I testified on behalf of the Colorado Office of Consumer Counsel in a rate rebalancing case involving U.S. West Communications, Inc., Docket No. 96S-257T et al. In addition, I pre-filed testimony in Pennsylvania Docket No. R-00953409. However, that case was settled prior to hearings.

Q. HAVE YOU PREPARED AN APPENDIX THAT DESCRIBES YOUR QUALIFICATIONS?

A. Yes. My qualifications are shown on Appendix A.

Q. WHAT IS THE PURPOSE OF YOUR DIRECT TESTIMONY IN THIS PROCEEDING?

A. The purpose of my Direct Testimony in this proceeding is to discuss the proper economic

principles that apply to the calculation of economic costs, and the role that these costs have in this proceeding. In this testimony, I discuss the Total Service Long-Run Incremental Cost (TSLRIC), and its proper role as a price floor for services. In addition, I discuss the Stand-Alone Cost, and its proper role as a price ceiling for services. Finally, I discuss how the TSLRIC and Stand-Alone Costs are properly used to identify the existence of subsidies.

Q. WHAT IS THE TSLRIC, AND HOW IS IT CALCULATED?

A. There are at least two ways the TSLRIC of a service can be determined. One way to determine the TSLRIC is to calculate the costs that are avoided when the service in question is discontinued or eliminated, while all other services continue to be provided. This can be determined by calculating the difference between the total costs of providing all services, including the service in question, and the total cost of providing all services without the service in question. This method of calculating TSLRIC is consistent with USWC's definition of TSLRIC, as provided by Mr. Thompson in his Direct Testimony in this proceeding:

> The TSLRIC studies identify the total cost of offering the service - defined as the total costs incurred by U S WEST while offering the service, less the total costs that would be incurred by U S WEST if the service were not offered.[1]

An alternative method of calculating the TSLRIC is to determine the additional cost that is incurred when the service in question is added to a network that already provides all other services provided by the company. This method of calculating TSLRIC is consistent with the

[1]Thompson Direct Testimony, page 4, line 23.

1 definition of TSLRIC contained in the Arizona Corporations Commission's Rules and

2 Regulations, Section R14-2-1102 (17), which provides the following definition:

3 **"Total Service Long Run Incremental Cost."** The total additional cost incurred by a
4 telecommunications company to produce the entire quantity of a service, given that the
5 telecommunications company already provides all of its other services. Total Service
6 Long run Incremental Cost is based on the least cost, most efficient technology that is
7 capable of being implemented at the time the decision to provide the service is made.
8
9
10 When properly applied, either of the above definitions will lead to the proper calculation of

11 TSLRIC costs.

12

13 Q. WHY IS THE TSLRIC THE APPROPRIATE PRICE FLOOR FOR A SERVICE?

14 A. As USWC indicated in its response to Data Request WDA 2-6 in this proceeding, as long as a

15 service is priced equal to or above its properly calculated TSLRIC, the service is not receiving a

16 cross-subsidy. If a service is priced below its properly calculated TSLRIC, the service is

17 receiving a cross subsidy. Therefore, a price set equal to TSLRIC represents the minimum level

18 at which a service could be priced and not receive a subsidy. As long as the price for a service is

19 at least covering the additional cost that is directly caused by that service, the company is better

20 off providing that service than not providing it. If the price for a service does not cover at least

21 the additional cost that is directly caused by the provision of that service, the company is better

22 off by not providing that service. For these reasons, the TSLRIC is generally accepted as the

23 appropriate price floor for a service.

24

25 Q. IS IT COMMON FOR THE TSLRIC COSTS TO EXCLUDE A LARGE PORTION OF THE

1 TOTAL COSTS OF PROVIDING TELECOMMUNICATIONS SERVICES?

2 A. Yes. It is common for the TSLRIC costs to exclude a large portion of the total costs of providing
3 telecommunications services. As Mr. Dunkel testified in his Direct Testimony, the provision of
4 telecommunications services is engineered such that many services are provided over shared
5 network facilities whose costs would not be avoided even if any one of the services that are
6 provided using those facilities were eliminated or discontinued. As Mr.. Dunkel points out, the
7 costs of such network facilities represent a large portion of USWC's total investment in all
8 facilities combined. As a result, the calculated TSLRIC based on this conclusion exclude a
9 significant portion of the total costs of providing telecommunications services.

10

11 Q. IS THERE ANY PRACTICAL WAY TO ASSIGN SHARED COSTS ON THE BASIS OF
12 COST-CAUSATION?

13 A. No. The fundamental principle of TSLRIC costs is to assign costs on the basis of cost-causation.
14 If the costs of a facility are shared by more than one service, there is no practical way to assign
15 the costs of those facilities on the basis of cost-causation. In the case of shared costs, all of the
16 costs would be required to provide at least one other service in addition to the service in question.
17 Therefore, none of the shared costs would be added (avoided) if the service in question were
18 added (eliminated or discontinued) from a network that continued to provide all other services.

19

20 Q. HAS THE FCC RECOGNIZED THE DIFFICULTY OF ASSIGNING SHARED FACILITY
21 COSTS ON THE BASIS OF COST-CAUSATION?

A. Yes. The FCC has specifically indicated that the some telecommunications facilities cannot be allocated on the basis of cost-causation principles, because all of the facilities would be required even if they were used only to provide local service, or if they were used to only provide interstate access service. The FCC specifically stated:

> These costs pose particularly difficult problems for the separations process: The costs of such facilities cannot be allocated on the basis of cost-causation principles because all of the facilities would be required even if they were used only to provide local service or only to provide interstate access services. A significant illustration of this problem is allocating the cost of the local loop, which is needed both to provide local telephone service as well as to originate and terminal long-distance calls.[2]

Q. IF SHARED COSTS CANNOT BE ASSIGNED ON THE BASIS OF COST-CAUSATION, ON WHAT BASIS ARE THEY TO BE ASSIGNED?

A. Since there are no strict economic principles that dictate how shared costs are to be recovered, the recovery of the costs of shared facilities is really a pricing matter that is based upon someone's judgement. When it comes to the recovery of shared costs, public policy principles are applied rather than economic principles.

For example, for public policy reasons, a Commission may choose to price residential basic exchange service such that it makes a smaller percentage contribution over and above TSLRIC toward the shared and common costs of USWC, compared to other more discretionary services. However, this is no longer a matter of "subsidy." This is merely a policy decision to impose a

[2] ¶23, *FCC Access Charge Reform Order*, FCC 97-158.

relatively smaller markup above TSLRIC for residential basic exchange service than for more discretionary services. As long as a service is priced at or above its properly calculated TSLRIC, the service is not receiving a subsidy.

Q. WHAT IS THE STAND-ALONE COST?

A. The Stand-Alone Cost is the cost that would have to be incurred to provide a service if that service "stood alone", and did not share facilities with any other service. In economic theory, the Stand-Alone Cost generally determines the price "ceiling" for a service.

Q. WHY DOES THE STAND-ALONE COST REPRESENT THE PRICE CEILING?

A. Economic theory dictates that in order for a price to not provide a subsidy, it must be at or below the properly calculated Stand-Alone Cost for that service. If a service has a price that is above its Stand-Alone Cost, then that service could be providing a subsidy to one or more of the company's other services. If a service is priced above Stand-Alone Cost, but no services are receiving a subsidy (i.e. no services are priced below their properly calculated TSLRIC), the payment of rates above Stand-Alone Cost for that service could be thought of as a "subsidy" to the company's shareholders in the form of higher earnings, rather than actually subsidizing some other service. Since the price for a service must be at or below the Stand-Alone Cost to not provide a subsidy, the Stand-Alone Cost is generally considered to be the price ceiling for a service.

1 Q. HAS THE FCC ACKNOWLEDGED THAT THE TSLRIC IS THE PRICE FLOOR AND THE

2 STAND-ALONE COST IS THE PRICE CEILING FOR A SERVICE?

3 A. Yes. These widely accepted, economic principles are discussed in the following quotation from

4 an FCC Order:

5 Economists would say that in order to give incumbent local exchange carriers the proper
6 incentives to build multi-service facilities, where such facilities are economically rational,
7 cost allocated to each individual service or subset of services should be less than the
8 stand-alone cost but greater than the incremental cost. ... These are the upper and lower
9 bounds within which costs allocated to regulated and nonregulated services should fall.[3]
10

11 Q. IF A PRICE IS SET ABOVE ITS TSLRIC FLOOR OR BELOW ITS STAND-ALONE PRICE

12 CEILING, IS THAT INDICATIVE OF ANY PRICING PROBLEM?

13 A. No. The proper range for a price is between the TSLRIC price floor and the Stand-Alone price

14 ceiling. This is the range of subsidy-free rates where prices should generally fall. If a service is

15 priced above its TSLRIC floor, this is not indicative of a problem, since prices are generally set

16 above the floor to provide contribution toward the shared, joint and common costs of providing

17 services. If a service is priced below its Stand-Alone ceiling, this is not indicative of any pricing

18 problem either, since prices are normally set below their ceiling.

19

20 Q. IF SWITCHED ACCESS, TOLL OR VERTICAL SERVICES ARE SHOWN TO BE PRICED

21 ABOVE THEIR RESPECTIVE TSLRIC COSTS, DOES THIS DEMONSTRATE THAT

22 THESE SERVICES PROVIDE A "SUBSIDY" TO RESIDENTIAL BASIC EXCHANGE

[3]¶20, FCC 's Notice of Proposed Rulemaking, CC Docket No. 96-112, adopted and released May 10, 1996.

1 SERVICE?

2 A. No. Demonstrating that a service is priced above TSLRIC does not provide sufficient evidence
3 of that service providing a subsidy to other services. Rather, a service must be demonstrated to
4 be priced above its properly calculated Stand-Alone Cost to be demonstrated to be providing a
5 subsidy. Furthermore, even if a service is demonstrated to be priced above its properly
6 calculated Stand-Alone Cost, in order to demonstrate that the service is providing a subsidy to
7 another service, some other service must be demonstrated to be priced below its properly
8 calculated TSLRIC. If no services are found to be priced below their properly calculated
9 TSLRIC, the "subsidy" may actually be flowing elsewhere, such as to the company's
10 shareholders in the form of higher earnings, rather than as a subsidy to another service.
11

12 Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

13 A. Yes.

Appendix A

Thomas M. Regan, Consultant
8625 Farmington Cemetery Road
Pleasant Plains, IL 62677

PRESENT POSITION
William Dunkel and Associates
Position: Consultant

- Prefiled testimony on behalf of the Pennsylvania Office of Consumer Advocate in a case involving Bell Atlantic-Pennsylvania, Docket No. R-953409 in which he addressed stimulation as a result of toll price reductions. That proceeding was settled prior to going to hearing.
- Testified on behalf of the Colorado Office of Consumer Counsel in a rate rebalancing case involving U.S. West Communications, Inc., Docket No. 96S-257T et al.

- Participated in, but did not testify in, the following proceedings:

  -New Mexico Case No. 3008 (General Rate/Depreciation case of USWest)
  -Arizona Docket No. T-01051B-97-0689 (Depreciation case of US West)
  -Illinois Docket No. 99-0412 (EAS case involving Geneseo Telephone Company)
  -Illinois Docket Nos. 98-0200/98-0537 (Consolidated) (Usage sensitive service of GTE)
  -Florida Undocketed Special Project (Fair and Reasonable Rates of BellSouth, GTE, and Sprint)
  -Pennsylvania Docket No. A-310125F002 (GTE North Interconnection Proceeding)
  -Washington Docket UT-960369 (US West Communications, Inc. Interconnection Case)
  -Utah Docket No. 97-049-08 (US West Communications, Inc. General Rate Case)
  -Oklahoma Cause No. PUD 96-0000214 (Public Service of Oklahoma Depreciation Case)
  -Hawaii Docket No. 7702 (GTE Hawaiian Tel General Rate Case)
  -Washington Docket UT-950200 (US West Communications, Inc. General Rate Case)
  -Pennsylvania Docket R-00953409 (Bell Atlantic Toll Automatic Savings Plan)
  -Pennsylvania Docket R-00963550 (Bell Atlantic Rate Rebalance Proceeding)
  -Iowa Docket RPU-95-11 (US West Communications, Inc. General Rate Case - Withdrawn by USWC just prior to hearings)
  -Arizona Docket E-1051-93-183 (US West Communications, Inc. General Rate Case - Remand)
  -Colorado Docket 95S-523T (US West Communications, Inc. CustomChoice Case - Withdrawn)
  -Utah Docket 95-049-05 (US West Communications, Inc. General Rate Case)
  -Iowa Docket RPU-95-10 (US West Communications, Inc. Interconnection Case)
  -Hawaii Docket 94-0298 (General Telephone and Electronics (GTE) Depreciation Case)
  -Indiana Cause No. 39938 (Indianapolis Power and Light Company - Depreciation Case)

Participation in the above proceedings included some or all of the following:

Developing analyses, writing draft testimony, preparing data requests, analyzing issues, analyzing price elasticity and other economic issues, writing draft testimonies, prepared data requests and responses, prepared draft questions for cross-examination, and developed various quantitative models

Member of the Economic Advisory Board at the University of Illinois-Springfield.

PREVIOUS EMPLOYMENT

Sangamon State University
Graduate Assistant

-Prepared research projects on various economic topics
-Formed theoretical and statistical models
-Analyzed results of empirical models
-Formulated policy recommendations based on results.
-Worked with students

EDUCATION

Master of Arts in Economics from Sangamon State University in Springfield, Illinois
GPA 3.97/4.0

Bachelor of Arts in Liberal Arts Economics from University of Illinois, Urbana, Illinois

Relevant Coursework:
-Mathematics and Calculus
-Statistical Analysis
-Accounting/Financial Analysis
-Economic and Statistical Modeling
-Economics in Management
-International Economics
-Environmental Economics
-Marketing

Academic Awards and Honors:
-Phi Theta Kappa Honor Fraternity
-Economics Marshall Award
-Omicron Delta Epsilon Economics Honor Society
-Who's Who at America's Colleges and Universities
-Outstanding Student in Economics Award
-Highest graduate GPA in history of Economics program

Calculation of the
Modernization Incentive Credit
For Calendar Year _____

Step:

1. Calculate the percent of investment retired:

a.	Plant in Service at Start of Year	$_____
b.	Retirements in Year	$_____
c.	Percent Retired (Line b/Line a)	____%

2. Compare to the annual retirement expectations in the ACC approved depreciation rates:

d.	Annual retirement expected in approved depreciation rates	13 %
e.	Percent of expectation not met (1-(Line c/line d))	____%

3. Calculate the credit for the expectation not met:

f.	Intrastate depreciation expense accrued in year	$_____
g.	Annual credit amount ((Line f x Line e)	$_____
h.	Monthly credit amount (Line g/12)	$_____
i.	Working loops in year[1]	_____
j.	Monthly credit per line (Line h/Line i)	$_____

4. Credit the bills if expectations not met

a. Commencing with the June bills, the customers will receive a per line credit which is the amount shown on line j. This initial credit will be calculated using the figures as filed by USWC.

b. The monthly per line credit will appear on customer bills for the twelve consecutive months starting with June. The credit or revised credit will be paid to the customers on a per line basis, based upon the number of lines they have in service the month in which the credit is paid.

c. In the event that the Commission subsequently determines that adjustments to the figures as filed by USWC are required, the credits following that determination will be adjusted so that the total credit amount shown on line g corrected is returned to the customers.

d. The amount of the credit will be deducted from intrastate accumulated depreciation (Account 32.3100).

[1] "Working loops" per FCC Rules Part 36.611(h). (The number of "working loops" is reported in ARMIS reports, which are publicly available.)

Notes:

1. The filled out schedule is to be filed by May 1 of the immediately following year.

2. If the actual retirements exceed expectations, that will be carried forward to the credit calculation in the following year. Specifically, if line e is over 100%, enter 100% and carry the additional percent forward as an addition to line c in the following year's calculation. (For example, if line c was 15%, then 2% (15%-13%) would be carried forward and added to the line c figure in the following year.

3. All figures are for USWC Arizona regulated operations.

4. One goal of this Modernization Incentive Credit is to stimulate actual physical modernization in Arizona, not to simply generate "book entry" retirements that do not reflect current physical retirements and modernization. The retirement amounts the Company provides on line b should be the booked retirement amounts associated with investments that have physically retired within the calendar year being addressed, or at the most, had physically retired in the year prior to that year (but were booked in the calendar year being addressed).

5. Concurrent with filing the report, the Company will provide supporting workpapers, and will also make available to the Commission Staff the underlying records. The Company will provide Staff with access to knowledgeable personnel, and will respond to relevant Staff inquiries.

Calculation of the
Modernization Incentive Credit
For Calendar Year XXXX

Step:

1. Calculate the percent of investment retired:

a.	Plant in Service at Start of Year	$5,000,000,000	
b.	Retirements in Year	$ 500,000,000	
c.	Percent Retired (Line b/Line a)		10.00%

2. Compare to the annual retirement expectations in the ACC approved depreciation rates:

d.	Annual retirement expected in approved depreciation rates	13 %
e.	Percent of expectation not met (1-(Line c/line d))	3 %

3. Calculate the credit for the expectation not met:

f.	Intrastate depreciation expense accrued in year	$600,000,000
g.	Annual credit amount ((Line f x Line e)	$ 18,000,000
h.	Monthly credit amount (Line g/12)	$ 1,500,000
i.	Working loops in year[1]	2,500,000
j.	Monthly credit per line (Line h/Line i)	$0.60

4. Credit the bills if expectations not met

a. Commencing with the June bills, the customers will receive a per line credit which is the amount shown on line j. This initial credit will be calculated using the figures as filed by USWC.

b. The monthly per line credit will appear on customer bills for the twelve consecutive months starting with June. The credit or revised credit will be paid to the customers on a per line basis, based upon the number of lines they have in service the month in which the credit is paid.

c. In the event that the Commission subsequently determines that adjustments to the figures as filed by USWC are required, the credits following that determination will be adjusted so that the total credit amount shown on line g corrected is returned to the customers.

d. The amount of the credit will be deducted from intrastate accumulated depreciation (Account 32.3100).

[1] "Working loops" per FCC Rules Part 36.611(h). (The number of "working loops" is reported in ARMIS reports, which are publicly available.)

SCHEDULE WDA-6 CONTAINS INFORMATION

CLAIMED TO BE PROPRIETARY BY USWC.

THEREFORE, IT HAS BEEN DELETED

FROM THIS TESTIMONY.

The calculation of the 6.6 year remaining life using 1/1/97 investments used in the USWC calculation of the 5.8% Radio Systems depreciation rate.

COMPANY: U S WEST
STATE: ARIZONA
ACCOUNT: 2231
CATEGORY: Radio Systems
TABLE: 1-VG/ELG

GENERATION ARRANGEMENT
DEVELOPMENT OF AVERAGE REMAINING LIFE AND AVERAGE SERVICE LIFE

	VINTAGE YEAR	EXPERIENCE AS OF 1/1/1997 AGE A	AMOUNT SURVIVING B	PROP SURV C	REAL LIFE D	REMAINING LIFE YEARS E++	VINTAGE AVERAGE LIFE YEARS F+++	AVERAGE LIFE WEIGHTS G=B/F	REMAINING LIFE WEIGHTS H=E*G
*	1996	0.5	527188	1	0.5	12.04	12.54	42,045	506,166
*	1995	1.5	183990	0.96536015	1.44804022	11.15	12.65	14,543	162,175
*	1994	2.5	3093115	0.98131795	2.47266801	10.33	12.83	241,066	2,490,449
*	1993	3.5	1320328	0.94865869	3.47736762	9.57	13.07	101,023	966,748
*	1992	4.5	2199377	0.95905479	4.41845149	8.86	13.36	164,582	1,458,756
*	1991	5.5	953138	0.86483941	5.32192761	8.21	13.71	69,524	570,755
*	1990	6.5	2523789	0.82005472	6.18418471	7.61	14.11	178,928	1,360,759
*	1989	7.5	3929215	0.9174314	7.09604591	7.05	14.55	270,124	1,903,287
*	1988	8.5	5218816	0.76347528	6.83268469	6.53	15.03	347,244	2,267,244
*	1987	9.5	5146432	0.86651789	8.73551219	6.05	15.55	330,938	2,002,520
*	1986	10.5	1105211	0.82449726	9.85187203	5.61	16.11	68,614	384,761
*	1985	11.5	6247736	0.74764048	10.83539779	5.19	16.69	374,264	1,943,703
*	1984	12.5	951213	0.74990027	10.30429468	4.81	17.31	54,963	264,181
*	1983	13.5	1825149	0.74268878	11.62447148	4.45	17.95	101,698	452,229
**	1982	14.5	295670	0.54785815	11.27048385	4.59	13.79	21,447	98,476
**	1981	15.5	261512	0.35514227	10.4586675	4.19	11.95	21,888	91,778
**	1980	16.5	218900	0.22982345	11.984206	3.82	12.86	17,018	65,046
**	1979	17.5	366013	0.18856386	12.16528611	3.48	12.82	28,549	99,222
**	1978	18.5	434649	0.21232552	14.1925212	3.15	14.86	29,247	92,133
**	1977	19.5	701103	0.31004747	14.19114488	2.84	15.07	46,514	132,277
**	1976	20.5	354927	0.18276883	15.17414576	2.55	15.64	22,692	57,942
**	1975	21.5	108255	0.05503655	12.36107017	2.28	12.49	8,670	19,739
**	1974	22.5	150991	0.10468624	13.64589448	2.01	13.86	10,897	21,924
**	1973	23.5	348912	0.14136796	18.12259153	1.76	18.37	18,993	33,344
**	1972	24.5	303394	0.20527675	17.10866425	1.51	17.42	17,418	26,244
**	1971	25.5	326874	0.14760742	17.61372992	1.26	17.80	18,364	23,198
**	1970	26.5	74225	0.16273347	18.73789539	1.02	18.90	3,926	4,019
**	1969	27.5	15868	0.05732311	14.49509025	0.79	14.54	1,091	865
**	1968	28.5	70498	0.10815829	19.31460583	0.58	19.38	3,638	2,125
**	1967	29.5	44480	0.06788322	19.01954757	0.50	19.05	2,334	1,167
**	1966	30.5	46195	0.20695498	19.92420019	0.50	20.03	2,307	1,153
**	1965	31.5	9742	0.02112731	17.08773391	0.50	17.10	570	285
**	1964	32.5	31321	0.03718241	17.51468185	0.50	17.53	1,786	893
**	1963	33.5	6129	0.0154294	16.1416416	0.50	16.15	380	190
**	1962	34.5	15537	0.01541005	16.98562563	0.50	16.99	914	457
**	1961	35.5	15856	0.01325496	16.37295116	0.50	16.38	968	484
**	1960	36.5	3520	0.01241958	15.53386449	0.50	15.54	227	113
**	1959	37.5	2236	0.0643213	16.83188195	0.50	16.86	133	66
**	1958	38.5	2000	0.00455	14.256725	0.50	14.26	140	70
**	1957	39.5	4362	0.0579	15.5979	0.50	15.63	279	140
**	1956	0.0	2362	0.01583274	10.31426459	0.50	10.32	229	114
**	1955	0.0	3336	0.0412	14.5129	0.50	14.53	230	115
**	1954	0.0	0	0	0	0.50	0.00	0	0
**	1953	0.0	0	0	0	0.50	0.00	0	0
**	1952	0.0	0	0	0	0.50	0.00	0	0
**	1951	0.0	0	0	0	0.50	0.00	0	0
**	1950	0.0	2365	0.90370164	10.16275575	0.50	10.61	223	111
	TOTAL		39,445,929					2,640,627	17,507,423
	NON-ELG		4,221,232					281,071	773,691
	ELG		35,224,697					2,359,556	16,733,732

	ALL VINTS	NELG VINTS	ELG VINTS
AVG SERVICE LIFE:			
TOT B/TOT G	14.93809	15.01837	14.92853
AVG REMAINING LIFE:	ALL VINTS	NELG VINTS	ELG VINTS
TOT H/TOT G	6.63002	2.75265	7.09190
COMPUTED GROSS ADDS-ALL VINTS:			
SUM OF (B/C)	69,439,144		
AVG PROPORTION SURVIVING:			
B/SUM OF(B/C)	0.56806		

NOTES:
REMAINING LIFE VALUES CALCULATED USING ELG TARGETING
++ FROM TABLE 2-VG/ELG; COL H FOR ELG, COL I FOR VG
+++ FROM TABLE 2-VG/ELG FOR ELG VINTAGES, COMPUTED AS D+(C*E) FOR VG VINTAGES

AVG LIFE: 15.1

IOWA CURVE: S1.5

THE FOLLOWING PAGES ARE FROM

USWC'S RESPONSE TO DATA REQUEST WDA 21-001S1

07/06/00
02:55 PM
XREF: 07
PRES: 1991,SF,02
PROP: 2000,SA,02

COMPANY: U S WEST
STATE: ARIZONA
ACCOUNT: 2231 RADIO SYSTEMS
CATEGORY: 2231 RADIO SYSTEMS
TABLE 1-VG/ELG

GENERATION ARRANGEMENT
DEVELOPMENT OF AVERAGE REMAINING LIFE AND AVERAGE SERVICE LIFE

VINT AGE	AGE	EXPERIENCE AS OF 1-1-2000% AMOUNT SURVIVING	PROP SURV	REAL LIFE	REMAINING LIFE YEARS	VINT AVG LIFE YEARS	AVERAGE LIFE WEIGHTS	REMAINING LIFE WEIGHTS
N	A	B	C	D	E++	F+++	G=B/F	H=E*G
*1999	0.5	1,082,552	1.0000	0.50	12.04	12.54	86,338	1,039,383
*1998	1.5	727,226	0.9561	1.45	11.15	12.65	57,486	640,998
*1997	2.5	297,847	0.9095	2.44	10.33	12.83	23,215	239,808
*1996	3.5	729,679	0.9240	3.41	9.57	13.07	55,837	534,249
*1995	4.5	142,245	0.7318	4.08	8.86	13.36	10,645	94,340
*1994	5.5	2,846,386	0.9109	5.34	8.21	13.71	207,638	1,704,380
*1993	6.5	1,310,723	0.9735	6.43	7.60	14.10	92,938	706,626
*1992	7.5	1,714,157	0.8007	7.04	7.04	14.54	117,861	830,201
*1991	8.5	857,900	0.8229	7.95	6.53	15.03	57,093	372,607
*1990	9.5	2,421,797	0.8014	8.64	6.05	15.55	155,778	941,908
*1989	10.5	3,358,029	0.7993	9.74	5.60	16.10	208,553	1,168,218
*1988	11.5	4,623,326	0.6924	9.07	5.19	16.69	277,053	1,437,212
*1987	12.5	4,401,567	0.7427	11.11	4.80	17.30	254,406	1,221,486
*1986	13.5	762,163	0.6200	12.20	4.44	17.94	42,484	188,629
*1985	14.5	5,371,671	0.7799	13.45	4.10	18.60	288,788	1,184,251
*1984	15.5	659,442	0.5323	12.40	3.78	19.28	34,201	129,323
*1983	16.5	1,359,496	0.5580	13.59	3.48	19.98	68,046	236,737
1982	17.5	163,485	0.3098	12.71	3.48	13.78	11,860	41,221
1981	18.5	178,361	0.2429	11.40	3.15	12.17	14,656	46,171
1980	19.5	182,674	0.1844	12.54	2.84	13.07	13,980	39,756
1979	20.5	227,207	0.1485	12.91	2.55	13.29	17,101	43,664
1978	21.5	304,728	0.1489	14.75	2.28	15.09	20,195	45,978
1977	22.5	295,324	0.1327	14.76	2.01	15.03	19,651	39,539
1976	23.5	232,464	0.1222	15.61	1.76	15.82	14,691	25,792
1975	24.5	91,617	0.0466	12.51	1.51	12.58	7,283	10,972
1974	25.5	77,131	0.0545	13.87	1.26	13.94	5,534	6,992
1973	26.5	330,274	0.1362	18.53	1.02	18.67	17,692	18,120
1972	27.5	247,659	0.1804	17.80	0.79	17.95	13,800	10,942
1971	28.5	169,794	0.0813	17.92	0.59	17.97	9,450	5,533
1970	29.5	50,837	0.1114	19.16	0.50	19.22	2,646	1,323
1969	30.5	7,337	0.0293	14.60	0.50	14.61	502	251
1968	31.5	45,268	0.0715	19.61	0.50	19.65	2,304	1,152
1967	32.5	7,289	0.0114	18.68	0.50	18.68	390	195
1966	33.5	6,235	0.0306	20.27	0.50	20.29	307	154
1965	34.5	1,818	0.0066	17.14	0.50	17.14	106	53
1964	35.5	16,819	0.0200	17.61	0.50	17.62	955	477
1963	36.5	2,877	0.0072	16.17	0.50	16.18	178	89
1962	37.5	4,353	0.0044	17.00	0.50	17.00	256	128
1961	38.5	6,716	0.0070	16.38	0.50	16.39	410	205
1960	39.5	6,677	0.0070	15.57	0.50	15.57	429	214
TOTAL		35,323,148					2,212,736	13,009,278

07/06/00
02:55 PM
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COMPANY: U S WEST
STATE: ARIZONA
ACCOUNT: 2231 RADIO SYSTEMS
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TABLE 1-VG/ELG

GENERATION ARRANGEMENT
DEVELOPMENT OF AVERAGE REMAINING LIFE AND AVERAGE SERVICE LIFE

VINT AGE	AGE	EXPERIENCE AS OF 1-1-2000% AMOUNT SURVIVING	PROP SURV	REAL LIFE	REMAINING LIFE YEARS	VINT AVG LIFE YEARS	AVERAGE LIFE WEIGHTS	REMAINING LIFE WEIGHTS
N	A	B	C	D	E++	F+++	G=B/F	H=E*G
NON-ELG	V	2,656,944					174,375	338,921
ELG	V	32,666,204					2,038,361	12,670,357

	ALL VINTS	NELG VINTS	ELG VINTS
AVG SERVICE LIFE: TOT B/TOT G	15.96356	15.23695	16.02572
AVG REMAINING LIFE: TOT H/TOT G	5.87927	1.94363	6.21595

COMPUTED GROSS ADDS-ALL VINTS: SUM OF (B/C) 68,256,071
AVG PROPORTION SURVIVING: B/ SUM OF (B/C) 0.51751

USING IOWA CURVE: S1.5
• ELG VINTAGES, PROJECTION LIFE 15.1
++ FROM TABLE 2-VG/ELG; COL H FOR ELG, COL I FOR VG
+++ FROM TABLE 2-VG/ELG FOR ELG VINTAGES, COMPUTED AS D+(C*E) FOR VG VINTAGES
% ACTUAL

SCHEDULE WDA-9 CONTAINS INFORMATION

CLAIMED TO BE PROPRIETARY BY USWC.

THEREFORE, IT HAS BEEN DELETED

FROM THIS TESTIMONY.

COMPANY: U S WEST
STATE: ARIZONA
ACCOUNT: 2124
CATEGORY: Genl Purp Computers
TABLE: 2-VG/ELG

PROJECTED LIFE TABLE
AVERAGE SERVICE LIFE AND REMAINING LIFE BY AGE

PROJECTION LIFE TABLE PARAMETERS

AVG LIFE: 5

IOWA CURVE: O1

BEGINNING OF YEAR		AMOUNT RETIRED	AGE OF	ANNUAL ACCRUALS FOR BOY AGE A		ELG AVG	ELG AVG	VG VINT
AGE	AMOUNT IN SERVICE	DURING YEAR (LIFE GROUP)	AMOUNT RETIRED	EACH LIFE GROUP	ALL REMAINING LIFE GROUPS	SERVICE LIFE	REMAINING LIFE	REMAINING LIFE
A	B	C=B-next B	D	E=C/D	F	G=B/F	H=G-A	I
0.0	100,000	5,000	0.5	10,000	38,790	2.58	2.58	5.00
0.5	95,000	10,000	1.0	10,000	28,790	3.30	2.80	4.76
1.5	85,000	10,000	2.0	5,000	18,790	4.52	3.02	4.26
2.5	75,000	10,000	3.0	3,333	13,790	5.44	2.94	3.77
3.5	65,000	10,000	4.0	2,500	10,457	6.22	2.72	3.27
4.5	55,000	10,000	5.0	2,000	7,957	6.91	2.41	2.77
5.5	45,000	10,000	6.0	1,667	5,957	7.55	2.05	2.28
6.5	35,000	10,000	7.0	1,429	4,290	8.16	1.66	1.79
7.5	25,000	10,000	8.0	1,250	2,861	8.74	1.24	1.30
8.5	15,000	10,000	9.0	1,111	1,611	9.31	0.81	0.83
9.5	5,000	5,000	10.0	500	500	10.00	0.50	0.50
0.0	0	0	11.0	0	0	11.00	0.50	0.50

Arizona
Docket No. T-1051B-99-105
WDA 21-001S1

INTERVENOR: Arizona Corporation Commission Staff (Dunkel)

REQUEST NO: 001S1

Please provide each of the following on an intrastate basis (not FCC) for each depreciable account:

A. Separately for December 31, 1998 and December 31, 1999, for each depreciable account please provide the complete generations arrangements on an intrastate basis not FCC basis. In addition to the paper copy, please also provide this requested information in electronic format on an IBM compatible 3.5" disk or an Iomega 100 MB Zip Disk.

B. For each depreciable account please provide the depreciation reserve balance as of December 31, 1998 and separately December 31, 1999.

C. For each depreciable account please provide the total retirements. separately for 1998 and 1999.
Please provide each of the following on an intrastate basis (not FCC) for each depreciable account:

D. For each depreciable account please provide the retirements by vintage separately for 1998 and 1999. In addition to the paper copy, please also provide this requested information in electronic format on an IBM compatible 3.5" disk or an Iomega 100 MB Zip Disk.

E. For each depreciable account please provide the total additions separately for 1998 and 1999.

F. For each depreciable account please provide the plant in service as of December 31, 1998 and separately December 31, 1999.

RESPONSE:

A. On January 6, 2000 and April 25, 2000, the Commission decided upon depreciation parameters and lives to be used in Docket No. T-1051B-99-105. WDA 21-1, Part A requests generation arrangements which require completely new depreciation studies and are no longer relevant for this rate case. Therefore, generation arrangements have not been provided.

B. Please see Attachment D.

C. Please see Attachments A and B for the December 1998 and 1999 versions,

respectively, of the JR 2A report. The "Plant Retired" column displays the requested information. Totals only are reported, this information is not available on an intrastate basis.

D. Please see Confidential Attachment C for the 1998 and 1999 retirements by vintage.

E. Please see Attachments A and B for the December 1998 and 1999 versions, respectively, of the JR 2A report. The "Plant Added" column displays the requested information.

F. Please see Attachments A and B for the December 1998 and 1999 versions, respectively, of the JR 2A report. The "Total at End of Period" column displays the requested information.

Confidential Attachment C is being provided pursuant to the terms of the Proctective Agreement.

Bill Muir
Technical Accountant
1600 17th Street, Rm. 3008
Seattle WA

Kathleen Tuttle
Manager - Capital Recovery
1314 DOTM
Omaha, NE

<u>Supplemental Response 07/10/00</u>
Attachments A-1 and A-2 contain the requested generation arrangement data for 1998 and 1999, respectively. Attachment B contains the generation arrangement data for both years in FCC electronic format.

Jim Jones
Manager - Capital Recovery
1801 California Street
Denver, CO 80202

07/06/00
02:55 PM
XREF: 07
PRES: 1991,SF,02
PROP: 2000,SA,02

COMPANY: U S WEST
STATE: ARIZONA
ACCOUNT: 2232 CIRCUIT DIGITAL
CATEGORY: 2232 CIRCUIT DIGITAL
TABLE 1-VG/ELG

GENERATION ARRANGEMENT
DEVELOPMENT OF AVERAGE REMAINING LIFE AND AVERAGE SERVICE LIFE

VINT AGE	AGE	EXPERIENCE AS OF 1-1-2000% AMOUNT SURVIVING	PROP SURV	REAL LIFE	REMAINING LIFE YEARS	VINT AVG LIFE YEARS	AVERAGE LIFE WEIGHTS	REMAINING LIFE WEIGHTS
N	A	B	C	D	E++	F+++	G=B/F	H=E*G
*1999	0.5	140,227,026	1.0000	0.50	4.59	5.09	27,523,079	126,465,486
*1998	1.5	123,445,446	0.9999	1.50	5.30	6.80	18,161,555	96,203,114
*1997	2.5	81,098,786	0.9406	2.46	5.56	8.06	10,066,887	55,931,567
*1996	3.5	121,882,842	0.9578	3.47	5.63	9.13	13,352,068	75,150,604
*1995	4.5	80,249,683	0.9340	4.41	5.60	10.10	7,946,836	44,488,920
*1994	5.5	62,727,461	0.9298	5.39	5.51	11.01	5,698,648	31,384,897
*1993	6.5	44,952,094	0.9179	6.28	5.38	11.88	3,783,465	20,359,571
*1992	7.5	51,192,730	0.9303	7.23	5.24	12.74	4,018,489	21,054,063
*1991	8.5	54,557,795	0.8801	8.14	5.10	13.60	4,011,893	20,456,708
*1990	9.5	53,834,118	0.8480	8.94	4.98	14.48	3,718,708	18,506,389
*1989	10.5	41,665,493	0.7668	9.57	4.89	15.39	2,707,903	13,232,515
*1988	11.5	46,458,503	0.7368	9.85	4.84	16.34	2,843,286	13,760,715
*1987	12.5	41,471,890	0.6837	10.22	4.84	17.34	2,392,200	11,569,390
*1986	13.5	51,645,717	0.6930	11.25	4.86	18.36	2,812,336	13,679,182
*1985	14.5	49,313,875	0.6753	11.95	4.90	19.40	2,541,925	12,455,969
*1984	15.5	29,096,112	0.6637	12.76	4.92	20.42	1,424,987	7,008,810
*1983	16.5	21,143,649	0.5436	12.62	4.90	21.40	988,107	4,839,877
1982	17.5	12,388,237	0.4760	12.94	5.46	15.54	797,229	4,349,716
1981	18.5	6,515,999	0.4660	12.67	5.23	15.11	431,203	2,256,376
1980	19.5	3,727,123	0.3381	12.60	4.96	14.28	260,973	1,295,265
1979	20.5	2,002,245	0.2582	12.10	4.65	13.30	150,512	700,216
1978	21.5	1,038,904	0.2023	11.64	4.31	12.51	83,026	357,467
1977	22.5	712,952	0.1382	11.33	3.93	11.87	60,043	235,880
1976	23.5	1,085,942	0.0671	11.82	3.53	12.06	90,050	317,526
1975	24.5	834,144	0.1267	12.67	3.10	13.06	63,853	198,121
1974	25.5	1,196,551	0.2597	15.22	2.66	15.91	75,199	200,227
1973	26.5	951,699	0.2252	15.66	2.21	16.16	58,903	130,151
1972	27.5	495,276	0.2715	16.75	1.75	17.22	28,760	50,237
1971	28.5	466,490	0.1594	16.34	1.28	16.55	28,191	36,121
1970	29.5	208,647	0.2456	16.50	0.83	16.70	12,494	10,322
1969	30.5	327,820	0.3082	19.54	0.50	19.70	16,641	8,321
1968	31.5	9,779	0.3381	20.61	0.50	20.78	471	235
1967	32.5	77,917	0.1092	17.74	0.50	17.79	4,379	2,189
1966	33.5	59,510	0.1088	17.71	0.50	17.76	3,351	1,675
1965	34.5	20,933	0.0463	17.83	0.50	17.86	1,172	586
1964	35.5	43,099	0.1025	18.61	0.50	18.66	2,310	1,155
1963	36.5	6,884	0.0088	16.92	0.50	16.92	407	203
1962	37.5	1,336	0.0180	17.21	0.50	17.22	78	39
1961	38.5	22,563	0.0513	17.84	0.50	17.87	1,263	631
1960	39.5	1,262	0.0025	16.91	0.50	16.91	75	37
1959	40.5	666	0.0267	18.24	0.50	18.26	36	18
1958	41.5	544	0.0010	17.52	0.50	17.52	31	16

07/06/00
02:55 PM
XREF: 07
PRES: 1991,SF,02
PROP: 2000,SA,02

COMPANY: U S WEST
STATE: ARIZONA
ACCOUNT: 2232 CIRCUIT DIGITAL
CATEGORY: 2232 CIRCUIT DIGITAL
TABLE 1-VG/ELG

GENERATION ARRANGEMENT
DEVELOPMENT OF AVERAGE REMAINING LIFE AND AVERAGE SERVICE LIFE

VINT AGE	AGE	EXPERIENCE AS OF 1-1-2000% AMOUNT SURVIVING	PROP SURV	REAL LIFE	REMAIN ING LIFE YEARS	VINT AVG LIFE YEARS	AVERAGE LIFE WEIGHTS	REMAINING LIFE WEIGHTS
N	A	B	C	D	E++	F+++	G=B/F	H=E*G
1957	42.5	1,641	0.0025	17.09	0.50	17.09	96	48
1956	43.5	394	0.0032	19.69	0.50	19.69	20	10
1955	44.5	737,034	0.1710	14.82	0.50	14.90	49,460	24,730
1954	45.5	749	0.0749	19.50	0.50	19.54	38	19
1953	46.5	0	0.0000	0.00				
1952	47.5	3,609	0.0259	13.71	0.50	13.73	263	131
1951	48.5	0	0.0000	0.00				
1950	49.5	151,692	0.1596	20.25	0.50	20.33	7,460	3,730
TOTAL		1,128,054,860					116,220,359	596,729,176
NON-ELG V		33,091,641					2,227,986	10,181,400
ELG V		1,094,963,219					113,992,373	586,547,777

	ALL VINTS	NELG VINTS	ELG VINTS
AVG SERVICE LIFE: TOT B/TOT G	9.70617	14.85271	9.60558
AVG REMAINING LIFE: TOT H/TOT G	5.13446	4.56978	5.14550

COMPUTED GROSS ADDS-ALL VINTS: SUM OF (B/C) 1,386,424,807
AVG PROPORTION SURVIVING: B/ SUM OF (B/C) 0.81364

USING IOWA CURVE: O2.0
* ELG VINTAGES, PROJECTION LIFE 10.0
++ FROM TABLE 2-VG/ELG; COL H FOR ELG, COL I FOR VG
+++ FROM TABLE 2-VG/ELG FOR ELG VINTAGES, COMPUTED AS D+(C*E) FOR VG VINTAGES
% ACTUAL

Depreciation Systems

FRANK K. WOLF

W. CHESTER FITCH

IOWA STATE UNIVERSITY PRESS / AMES

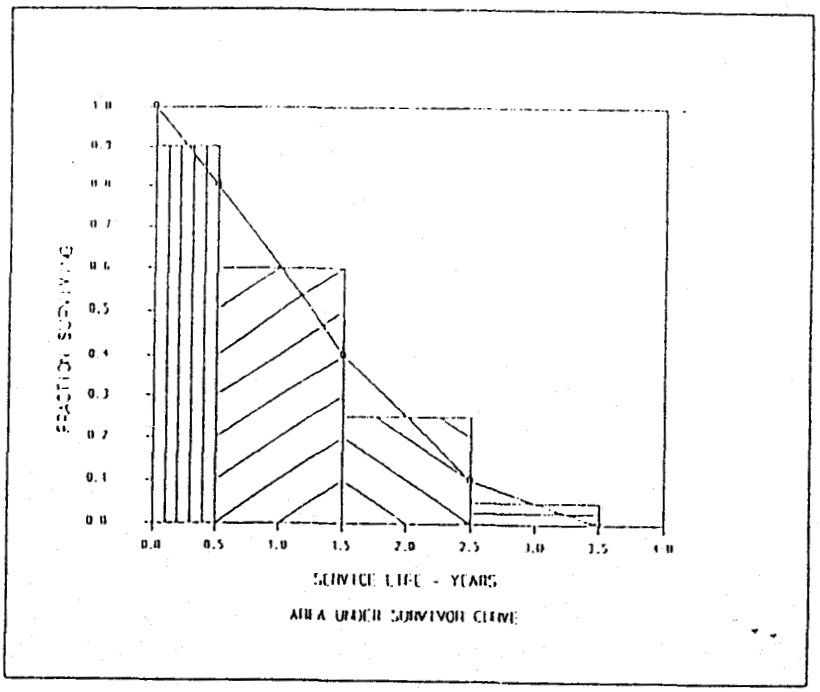

Figure 3.4. The area under the survivor curve.

cent surviving). This calculation is [(0.4 + 0.1)/2 + (0.1 + 0)/2]/0.4 = 0.3/0.4 = 0.75 years.

The terms *expectancy* and *average remaining life* are both commonly used to describe the E(remaining life at beginning of age interval i). The term average remaining life, which is often shortened to *remaining life*, is more descriptive and will be used in this text. The term *probable life* is used to describe the total life expectancy of the property surviving at any age and is equal to the remaining life plus the current age. The remaining life and probable life of the example property are shown below.

Age	% Surviving	Area under Curve, Right of Age, % – Years	Remaining Life, Years	Probable Life, Years
0.0	100%	135	1.35	1.35
0.5	80%	90	1.125	1.625
1.5	40%	30	0.75	2.25
2.5	10%	5	0.50	3.00
3.5	0%	0	...	...

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 12/31/99	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/99	Life Expectancy (Average Remaining Life) 12/31/99	Probable Service Life	Condition Percent	Reproduction Cost New Less Depreciation
A	B	C	D	E=B*D	F	G	H=F+G	I=(H-F)/H	J=E*I
1950	151,692	44.6	1.982	300,663	49.50	0.00	49.50	0.00%	0
1951	0	46.3	1.909	0	48.50	0.00	48.50	0.00%	0
1952	3,609	42.4	2.085	7,524	47.50	0.00	47.50	0.00%	0
1953	0	38.9	2.272	0	46.50	0.00	46.50	0.00%	0
1954	749	39.3	2.249	1,685	45.50	0.00	45.50	0.00%	0
1955	737,034	39.2	2.255	1,662,087	44.50	0.00	44.50	0.00%	0
1956	394	39.8	2.221	875	43.50	0.00	43.50	0.00%	0
1957	1,641	41.4	2.135	3,504	42.50	0.00	42.50	0.00%	0
1958	544	42.3	2.090	1,137	41.50	0.00	41.50	0.00%	0
1959	666	41.5	2.130	1,419	40.50	0.00	40.50	0.00%	0
1960	1,262	40.6	2.177	2,748	39.50	0.00	39.50	0.00%	0
1961	22,563	40.4	2.188	49,371	38.50	0.00	38.50	0.00%	0
1962	1,336	39.6	2.232	2,982	37.50	0.00	37.50	0.00%	0
1963	6,884	39.8	2.221	15,290	36.50	0.00	36.50	0.00%	0
1964	43,099	39.8	2.221	95,727	35.50	0.00	35.50	0.00%	0
1965	20,933	38.7	2.284	47,816	34.50	0.00	34.50	0.00%	0
1966	59,510	38.3	2.308	137,355	33.50	0.00	33.50	0.00%	0
1967	77,917	39.0	2.267	176,612	32.50	0.00	32.50	0.00%	0
1968	9,779	40.4	2.188	21,398	31.50	0.00	31.50	0.00%	0
1969	327,820	41.5	2.130	698,296	30.50	0.00	30.50	0.00%	0
1970	208,647	42.6	2.075	432,967	29.50	0.23	29.73	0.77%	3,334
1971	466,490	44.4	1.991	928,777	28.50	0.66	29.16	2.26%	20,990
1972	495,276	45.6	1.939	960,140	27.50	1.12	28.62	3.91%	37,541
1973	951,699	47.7	1.853	1,763,736	26.50	1.65	28.15	5.86%	103,355
1974	1,196,551	53.0	1.668	1,995,757	25.50	2.10	27.60	7.61%	151,877
1975	834,144	57.5	1.537	1,282,406	24.50	2.97	27.47	10.81%	138,628
1976	1,085,942	59.8	1.478	1,605,306	23.50	3.35	26.85	12.48%	200,342
1977	712,952	61.1	1.447	1,031,505	22.50	3.70	26.20	14.12%	145,649
1978	1,038,904	61.3	1.442	1,498,191	21.50	4.02	25.52	15.75%	235,965
1979	2,002,245	62.8	1.408	2,818,447	20.50	4.29	24.79	17.31%	487,873
1980	3,727,123	64.2	1.377	5,132,051	19.50	4.52	24.02	18.82%	965,852
1981	6,515,999	69.9	1.265	8,240,548	18.50	4.70	23.20	20.26%	1,669,535
1982	12,388,237	75.4	1.172	14,524,140	17.50	4.83	22.33	21.63%	3,141,571
1983	21,143,649	83.4	1.060	22,411,254	16.50	4.90	21.40	22.90%	5,132,177
1984	29,096,112	87.6	1.009	29,361,830	15.50	4.92	20.42	24.09%	7,073,265
1985	49,313,875	97.0	0.911	44,941,717	14.50	4.90	19.40	25.26%	11,352,278
1986	51,645,717	101.8	0.868	44,847,558	13.50	4.86	18.36	26.47%	11,871,149
1987	41,471,890	100.2	0.882	36,587,975	12.50	4.84	17.34	27.91%	10,211,704
1988	46,458,503	100.0	0.884	41,069,317	11.50	4.84	16.34	29.62%	12,164,732
1989	41,665,493	99.1	0.892	37,163,358	10.50	4.89	15.39	31.77%	11,806,799
1990	53,834,118	98.2	0.900	48,460,089	9.50	4.98	14.48	34.39%	16,665,425
1991	54,557,795	99.6	0.888	48,439,803	8.50	5.10	13.60	37.50%	18,164,926
1992	51,192,730	94.7	0.933	47,779,075	7.50	5.24	12.74	41.13%	19,651,533
1993	44,952,094	91.2	0.969	43,571,075	6.50	5.38	11.88	45.29%	19,733,340

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 12/31/99	Telephone Plant Index	Telephone Plant Translator	Reproduction Cost New	Age as of 12/31/99	Life Expectancy (Average Remaining Life) 12/31/99	Probable Service Life	Condition Percent	Reproduction Cost New Less Depreciation
A	B	C	D	E=B*D	F	G	H=F+G	I=(H-F)/H	J=E*I
1994	62,727,461	88.8	0.996	62,446,508	5.50	5.51	11.01	50.05%	31,254,477
1995	80,249,683	86.2	1.026	82,322,587	4.50	5.60	10.10	55.45%	45,647,875
1996	121,882,842	86.9	1.017	123,986,689	3.50	5.63	9.13	61.66%	76,450,192
1997	81,098,786	84.5	1.046	84,841,807	2.50	5.56	8.06	68.98%	58,523,878
1998	123,445,446	88.1	1.003	123,865,805	1.50	5.30	6.80	77.94%	96,541,008
1999	140,227,026	88.4	1.000	140,227,026	0.50	4.59	5.09	90.18%	126,456,732
	1,128,054,861		0.982	1,107,763,931				52.90%	586,004,003

Notes:
Columns B, C, D, and E are from USWC's filing, these columns have not been certified by William Dunkel.

TABLE 2 FROM USWC EXHIBIT NHH-1, SUPPLEMENTAL TESTIMONY OF NANCY HELLER-HUGHES, WITH PERCENT CONDITION CORRECTED

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
		A	B	C	D	E
2112	Motor Vehicles	$67,008,716	1.079	$72,326,913	38.2%	$27,623,678
2114	Special Purpose Vehicles	25,794	1.219	31,447	28.2%	8,863
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	51.8%	173,760,612
2122	Furniture	1,703,616	1.122	1,910,709	57.1%	1,090,371
2123	Company Comm Equip	6,944,455	0.957	6,646,073	29.2%	1,940,726
2124	Gen Purpose Computer	112,016,697	0.469	52,564,359	45.2%	23,767,388
2211	Analog SW Equip	138,599,056	1.206	167,207,907	19.9%	33,276,899
2212	Digital SW Equip	819,225,291	0.987	808,935,651	53.2%	430,156,707
2220	Operator Systems	7,080,061	1.021	7,228,640	46.9%	3,387,638
2231	Radio Systems	35,323,150	1.016	35,891,456	34.3%	12,297,503
2232	Circuit Equip	1,185,447,017	0.993	1,177,608,648	51.1%	601,620,960
2362	Other Term Equip	48,461,067	1.061	51,412,073	56.2%	28,899,178
2411	Pole Lines	46,616,809	4.341	202,360,271	41.8%	84,506,657
2421	Aerial Cable	170,704,495	1.723	294,160,265	23.5%	69,085,320
2422	Underground Cable	435,295,207	1.218	530,303,739	25.4%	134,877,931
2423	Buried Cable	1,273,669,392	1.352	1,722,089,520	33.3%	572,694,705
2424	Sub Cable	2,572	1.256	3,232	0.0%	0
2426	Intra Bldg Cable	41,603,544	1.825	75,914,620	23.7%	17,970,027
2431	Aerial Wire	8,798,956	1.346	11,843,641	40.0%	4,732,011
2441	Conduit Systems	305,067,487	2.216	676,048,139	46.5%	314,118,808
	Total Vintage Plant	$4,890,129,675		$6,257,477,341		$2,548,485,457

Notes:
Columns A, B, and C are from USWC's filing, these columns have not been certified by William Dunkel.
These are from Exhibit NHH-1, Supplemental Exhibit of Nancy Heller-Hughes, page 8.

CORRECTION OF THE "PERCENT CONDITION" FOR "VINTAGE PLANT"

A.	As calculated by USWC[1]	$6,257,477,341	$2,769,795,340	$3,487,682,001
B.	"Percent Condition" Corrected[2]	$6,257,477,341	$3,709,011,884	$2,548,485,457
Difference in RCNLD				($939,196,544)
Intrastate Separations Factor[3]				x .7230
Intrastate Difference				($679,039,101)
Weighting in "Fair Value"				x 50%
Adjustment to the "Fair Value Rate Base" As calculated by USWC				($339,519,551)

[1] Pages 7 and 8, Exhibit NHH-1, Supplemental Testimony of Nancy Heller-Hughes.
[2] Revised "Table 2"-Schedule WDA-14.
[3] USWC Worksheet B, provided in response to Request UTI 58-2.

BEFORE THE

RECEIVED
AZ CORP COMMISSION

ARIZONA CORPORATION COMMISSION

AUG 9 2 28 PM '00

DOCUMENT CONTROL

IN THE MATTER OF THE APPLICATION	)	
OF US WEST COMMUNICATIONS, INC. A	)	
COLORADO CORPORATION, FOR A	)	
HEARING TO DETERMINE THE EARNINGS	)	DOCKET NO. T-01051B-99-0105
OF THE COMPANY FOR RATEMAKING	)	
PURPOSES, TO FIX A JUST AND	)	
REASONABLE RATE OF RETURN THEREON	)	
AND TO APPROVE RATE SCHEDULES	)	

DIRECT TESTIMONY AND SCHEDULES

ON MODERNIZATION, DEPRECIATION, AND RCNLD ISSUES

OF

WILLIAM DUNKEL

ON BEHALF OF

THE STAFF OF THE ARIZONA CORPORATION COMMISSION

AUGUST, 2000

NOTICE: INFORMATION CLAIMED TO BE PROPRIETARY BY USWC HAS BEEN DELETED FROM THIS TESTIMONY. THROUGHOUT THIS TESTIMONY, PROPRIETARY INFORMATION IS DESIGNATED AS FOLLOWS: **PROPRIETARY**

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WILLIAM DUNKEL
DOCKET NO. T-01051B-99-0105

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I. STATEMENT OF QUALIFICATIONS AND INTRODUCTION

Q. PLEASE STATE YOUR NAME AND YOUR BUSINESS ADDRESS.

A. My name is William Dunkel. My business address is 8625 Farmington Cemetery Road, Pleasant Plains, Illinois 62677.

Q. WHAT IS YOUR PRESENT OCCUPATION?

A. I am a consultant providing services in telephone rate proceedings. I am the principal of William Dunkel and Associates, which was established in 1980. Since that time, I have regularly provided consulting services in telephone regulatory proceedings throughout the country. I have participated in over 130 state regulatory telephone proceedings before over one-half of the state commission in the United States, as shown on Appendix A attached hereto. I have participated in telephone regulatory proceedings for over 20 years.

I currently provide, or in the past have provided, services in telecommunications proceedings to the following clients:

The Public Utility Commission or the Staffs in the States of:

Arkansas	Missouri
Arizona	New Mexico
Delaware	U.S. Virgin Islands
Georgia	Utah
Guam	Virginia
Illinois	Washington
Maryland	Kansas
Mississippi	

The Office of the Public Advocate, or its equivalent, in the States of:

Colorado	Missouri
District of Columbia	New Jersey
Georgia	New Mexico
Hawaii	Ohio
Illinois	Oklahoma
Indiana	Pennsylvania
Iowa	Utah
Maine	Washington
Florida	

The Department of Administration in the States of:

Illinois	South Dakota
Minnesota	Wisconsin

Q. ON WHOSE BEHALF ARE YOU TESTIFYING?

A. I am testifying on behalf of the Staff of the Arizona Corporation Commission (ACC).

Q. HAVE YOU PREVIOUSLY PARTICIPATED IN ANY PROCEEDINGS IN ARIZONA?

A. Yes. I have participated in three previous matters in Arizona. I recently filed Rebuttal testimony in Docket No. T-01051B-97-0689 on behalf of the ACC Staff regarding depreciation. In addition, I conducted a Cost of Service Study on behalf of the Staff of the Arizona Corporation Commission in an undocketed matter preparing a cost study pertaining to USWC.[1] I also a rate design witness in general rate case, Docket No. E-1051-93-183, involving USWC on behalf of the ACC Staff.

In this testimony I address depreciation issues. In addition, in the modernization section, I address the retirements that were incorporated in the depreciation projection lives adopted by the ACC. In the reconstruction cost new less depreciation (RCNLD) section, I address issues including the calculation of the remaining life from the depreciation studies.

[1] At the time this case was initiated, the Company's name was U S West Communications, Inc. (USWC). However, since that time, a merger between USWC and Qwest has occurred, and the new Company name is Qwest. However, throughout this testimony, the Company will be referred to as USWC.

1

2 Q. CAN YOU PLEASE HIGHLIGHT SOME OF YOUR EXPERIENCE IN DEPRECIATION

3 FOR REGULATED UTILITIES?

4 A. Yes. I commenced working on depreciation pertaining to regulated utilities over 20 years ago

5 when I was on the Staff of the Illinois Commerce Commission. Over the years, I have

6 participated in depreciation studies and testified on depreciation pertaining to regulated utilities

7 in many proceedings.

8

9 I have established a reputation as being a reasonable depreciation analyst. In a Public Service of

10 Oklahoma (PSO) proceeding before the Oklahoma Corporation Commission, Docket No. PUD

11 96-214, five different depreciation experts presented different depreciation recommendations for

12 PSO. They were Mr. Jacob Pous on behalf of the Oklahoma Corporation Commission Staff, Mr.

13 Douglas L. Burton on behalf of Transok, Inc., Mr. James T. Selecky on behalf of the Oklahoma

14 Industrial Energy Consumers, Mr. John S. Ferguson on behalf of PSO, and myself on behalf of

15 the Oklahoma Attorney General. For all accounts, the settlement in the case adopted the

16 depreciation rates and parameters which I had determined, except for two general plant accounts

17 where the depreciation rates were adjusted to meet certain overall limitations that were agreed to

18 in the settlement.

19

20 I have taken advanced depreciation programs entitled "Forecasting Life" and "Forecasting

21 Salvage and Cost of Retiring" offered by Depreciation Programs, Inc.

22

23 Q. ARE YOU A MEMBER OF ANY DEPRECIATION PROFESSIONAL ORGANIZATION?

24 A. Yes. I am a member of the Society of Depreciation Professionals.

25

26 Q. DO YOU HAVE EXTENSIVE EXPERIENCE IN TELECOMMUNICATIONS RATE

27 DESIGN AND COST OF SERVICE?

A. Yes. The Commissioners' statements quoted above correctly indicate that the depreciation parameters are based on the assumption that USWC would be modernizing much more rapidly in the future. In recent years, USWC has been retiring 2% to 4% of its Arizona investment per year.[2] The new depreciation lives approved by the Commission assume USWC will be retiring over 13% of its Arizona investment per year. For example, the projection lives the Commission approved assume USWC will retire 13.8% of its Arizona investment in the year 2000, as shown in Column B on Schedule WDA-1.

The projection lives the Commission adopted for most accounts were much shorter than the existing lives in Arizona. The projection lives and retirements are inversely related. That is, in order to achieve a shorter average life, the annual retirements must be higher than the retirement level needed to achieve a longer average life. The customers' prices set in this proceeding will be set much higher than they otherwise would be, based upon the expectation that USWC will be accelerating its retirements and modernization in Arizona. Therefore, it is very appropriate for the Commission to require that these expected future retirements and the associated modernization actually occur in Arizona.

Q. IN PRIOR TESTIMONY AND IN COLUMN B OF SCHEDULE WDA-1, YOU STATED THAT THE PROJECTION LIVES THE COMMISSION APPROVED CONTAINED SPECIFIC FUTURE RETIREMENTS. CAN YOU PLEASE DEMONSTRATE THAT?

A. Yes. Schedule WDA-2 is a copy of one of the calculations that was performed as part of the depreciation proceeding. As can be seen from the top of this page, the Commission approved

[2] For example, in 1998, in Arizona USWC retired 1.8% of its investment. In 1999, USWC retired 3% of its investment in Arizona. (Calculated from USWC response to Request WDA 21-001, Attachments A and B)

A. Yes. For two decades, I have providing services in regulatory telecommunications proceedings across the nation. Specifically, in the USWC states, I have provided rate design testimony pertaining to USWC (or its predecessors "Mountain Bell" and "Northwestern Bell") in the following jurisdictions: Arizona, Colorado, Iowa, Minnesota, New Mexico, South Dakota, Utah, and Washington, as is shown on Appendix A attached hereto.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I address three primary issues in this testimony. They are:

1. In the April 25, 2000 Open Meeting in the depreciation proceeding, the Commissioners requested a method to assure that the rapid retirements and modernization that were assumed in the approved depreciation rates actually occurred in Arizona. I present Staff's proposal to monitor and incent USWC to actually make the modernization that are incorporated and assumed in the depreciation parameters the Commission has approved.

2. I quantify and present the impact of the Commission approved depreciation parameters on the depreciation expense to be utilized in this proceeding.

3. In addition, the calculation of the "percent condition" used in the RCNLD calculation.

II. ARIZONA MODERNIZATION INCENTIVE

Q. WERE THE HIGHER DEPRECIATION EXPENSES APPROVED BY THE COMMISSION BASED UPON AN EXPECTATION OF GREATLY ACCELERATED RETIREMENT AND MODERNIZATION BY USWC IN ARIZONA?

projection life of seven years for the Office Equipment Account, and a Commission approved Iowa curve shape of L0.5 have been entered. Based upon these inputs, the program calculates a specific expected future retirement pattern by year, as shown in Column C. The specific amounts shown in this column are "per $100,000" of initially installed investment. This figure can be applied to the actual investment for each age to arrive at the expected retirements each year. The Commission approved parameters assume USWC will be making a specific level of retirements each year in the future.

Q. HAS THE COMMISSION ACTION GIVEN USWC THE OPPORTUNITY TO RAPIDLY ACCELERATE RETIREMENTS AND MODERNIZATION IN ARIZONA?

A. Yes. The Commission has given USWC the opportunity to rapidly accelerate retirements and modernization in Arizona. The ACC will be providing USWC a huge amount of additional customer funds based upon the expectation that USWC will make the expected accelerated retirements and modernization. At this point, there is no guarantee that USWC management will take advantage of this opportunity to modernize at the expected accelerated rate. If USWC management does take advantage of this opportunity and use the customer funds for their intended purpose, that is fine. However, the USWC management instead could divert the funds to other purposes. The Commission has done its part to accelerate modernization. The customers will be doing their part by paying higher rates that are based upon that assumed accelerated modernization. After that, it will be up to USWC management to decide if they will take advantage of this opportunity to actually make the expected modernization, or if they attempt to divert the funds to other purposes.

Q. HAS USWC PROVIDED ANY ASSURANCE THAT THEY ARE ACTUALLY PLANNING TO MAKE THE FUTURE RETIREMENTS THAT ARE ASSUMED IN THE ACC APPROVED DEPRECIATION LIVES?

A. No. Staff has not been able to obtain any assurance from USWC that USWC is planning to actually make the level of retirements incorporated in the Commission approved depreciation lives. For example, attached as Schedule WDA-3 is a Staff request asking for USWC's plans to actually make the retirements assumed in the approved depreciation lives. As can be seen from that response, USWC did not provide any assurance that they are actually planning to make those retirements.

Q. WHAT DOES USWC'S BUDGET SHOW THEIR RETIREMENT PLANS ARE FOR THE YEAR 2000?

A. As previously discussed, the Commission approved depreciation lives assumed USWC would be retiring 13.8% of its Arizona investment in the year 2000. However, USWC's most recent budget for the year 2000 shows USWC plans to retire less than ** ** of its Arizona investment in the year 2000, as shown in Column C of Schedule WDA-1. The retirements that USWC has actually planned for the year 2000 are only ** ** of the retirements for that year that are assumed in the ACC approved depreciation lives.

Q. WHAT WOULD THE IMPACT BE IF THE PRICES CHARGED CUSTOMERS ASSUME MORE RAPID RETIREMENTS AND MODERNIZATION IN ARIZONA, BUT USWC DOES NOT ACTUALLY MAKE THOSE RETIREMENTS AND ASSOCIATED MODERNIZATION?

1 A. This would be the worst of both worlds. If this occurs, the customers will not be receiving the
2 modernization for which they are paying. In addition, collecting the money from the Arizona
3 customers, but not making the expected Arizona modernization, harms the Arizona economy. If
4 this money would have been left in the customers' hands, that would have been spendable
5 income in Arizona. Customers could have spent on goods and services in Arizona, thereby
6 promoting Arizona employment and business activity. However, when these additional funds
7 are collected from the customers in the USWC rates, the customers can no longer spend those
8 funds in Arizona for other purposes. If the money is collected but all the expected modernization
9 is not made, the portion of that money that is not utilized in Arizona will be removed from the
10 Arizona economy. This harms the economy and employment. It is important to the Arizona
11 economy and employment that the funds collected from the Arizona customers for the purpose of
12 accelerating Arizona retirements and modernization be used for the intended purpose. If a
13 portion of these Arizona funds are diverted to other jurisdictions, that will harm the Arizona
14 economy. The diversion of Arizona funds from their intended purpose, or even to other
15 jurisdictions, could result in Arizona being a "cash cow" which provides funds for Qwest's
16 operations in other states, or even in other countries.
17
18 Q. WHAT DO YOU RECOMMEND?
19 A. I propose the Commission monitor USWC's retirements to be sure that the expectations built into
20 the depreciation rates, and therefore into the prices paid by customers, are being met. I propose
21 that each year the actual retirements that USWC makes in Arizona be compared to the expected
22 retirements that were incorporated into the approved depreciation lives. If USWC is making the
23 retirements that were expected when the depreciation rates were set, then no further action is

needed. However, if USWC fails to meet the expected commitments, customers should be given a credit. The amount of that credit will depend on how close USWC is to the expected modernization level. This proposal provides a very powerful incentive to USWC management to actually make the expected modernization in Arizona. With this requirement in place, USWC management will know that if it attempts to divert the relevant revenues they are collecting from the Arizona customers to other purposes, then they will no longer be allowed to collect the portion of those revenues they are attempting to divert.

Q. IS THERE A SIMPLE WAY TO MONITOR THE ACTUAL RETIREMENTS TO THE EXPECTED RETIREMENTS?

A. Yes. From the data in the depreciation proceeding we know what annual retirements are required in order to achieve projection lives adopted by the Commission. As previously discussed, shorter lives require higher annual retirement rates than do longer lives. After the end of a year, the Company records show the investments they retired that year. Therefore, the actual retirements can be compared to the expected retirements, and an appropriate credit calculated if the actual retirements do not meet the expectations that were incorporated in the depreciation rates.

The retirements cause two things to happen--(1) equipment to retire, and (2) new equipment to be installed. Therefore, there are theoretically two ways to measure USWC's rate of retirements. We could either (1) monitor the retirements, or (2) monitor their replacement of new equipment. Either of these two items would measure the same thing, which is the replacement of existing equipment with new equipment. However, of these two possibilities, we only have actual expectations as to what USWC will retire. Therefore, the retirements must be monitored, but by

1 doing so the modernization rate is also being monitored, much the same as would occur if the
2 new investments were monitored.
3
4 Retirements are used as the measure of USWC's compliance because expected future retirement
5 levels are specifically included in the depreciation calculations. For example, Schedule WDA-2,
6 Column C shows the specific retirement pattern that is established by the Commission prescribed
7 parameters per $100,000 of initial investment. The depreciation calculations do not include any
8 specific assumption as to what USWC will invest to replace that equipment when it retires. By
9 holding USWC accountable to the retirement that is incorporated in the depreciation parameters,
10 that will require USWC to retire the existing older plant. That forces USWC to make the
11 modernization by replacing it with the newer, more efficient equipment.
12
13 It is actually the retirement plans of the existing equipment that is used to calculate the
14 depreciation remaining lives. As a result, there is a schedule for the expected future retirements
15 that were specifically used in calculating the depreciation rates.
16
17 In fact, monitoring the dollar amount of the retirements is probably preferable than monitoring
18 the dollar amount of the new investments (even if there was a standard to use for that, which
19 there is not), because rewarding the Company for spending large amounts of money on new
20 investments would encourage "gold plating."
21
22 Q. WHAT IS SCHEDULE WDA-4?
23 A. Schedule WDA-4 is a form that should be filled out and filed by USWC in May showing data for
24 the prior year. If USWC had met the retirement expectations, then no credit would be calculated.
25 However, if USWC had not met the retirement expectations, there would be a credit to

customers. The amount of the credit would depend on how close USWC's actual performance was to the expectations incorporated in the Commission approved depreciation lives.

Q. WHAT IF USWC RETIRES MORE THAN IS EXPECTED IN A YEAR?

A. In that event, the additional retirements will be carried over and would reduce the customer credit in the following year.

Q. HAVE THE COMMISSIONERS ALSO STATED THAT THEY WANT ACTUAL MODERINZATION, NOT JUST "SOMETHING ON PAPER"?

A. Yes. In the Open Meeting, the Commissioners stated that they wanted to assure that the modernization was actually "put into the ground."

> Commissioner Mundell:
> ...If you get this accelerated depreciation, get this additional money so we're not just doing something on paper, an accounting procedure here, but the money actually goes into infrastructure and improving technology?[3]

> Commissioner Irvin:
> Commissioner Mundell, I will look forward to working with you and Commissioner Kunasek seeing updated equipment is put into the ground.[4]

Staff's proposal addresses this Commissioner concern by requiring that the retirements be physical retirements, not just accounting entries. This requirement is shown in Note 4 of Schedule WDA-4.

Q. CAN YOU ILLUSTRATE HOW THE FORM ON SCHEDULE WDA-4 WOULD BE FILLED OUT?

---

[3] Tr. 46-47, April 25, 2000 Open Meeting.

1 A. Yes. Schedule WDA-5 contains hypothetical numbers as an example of how this form would
2 work. Only four numbers need to be input into this form from the Company's books and records
3 after the close of the year. These include the plant in service at the beginning of the year. This
4 goes on line 1a. The amount of retirements in the year goes on line 1b. The intrastate
5 depreciation expense accruals in the year goes on line 3f. The working loops in the year goes on
6 line 3i. The other calculations work off of these four numbers, as can be seen from this form.
7 As a hypothetical, I am inputting a $5,000,000,000 plant in service at the beginning of the year,
8 $500,000,000 retirements in the year, $600,000,000 intrastate depreciation expense, and
9 2,500,000 lines in service in the year. The resulting credit would be 60¢ per line per month, as
10 shown on Schedule WDA-5.
11
12 Q. DOES THIS MONITORING PENALIZE USWC?
13 A. No. It just requires accountability. As long as USWC uses the funds for the purpose for which
14 they were intended, there will be no credit. A credit will apply only if USWC attempts to divert
15 a portion of these funds from their intended purpose. No prudent business person or homeowner
16 would have a contract which obligated them to make large payments to a contractor based upon
17 assumptions that the contractor would perform certain services, but not actually require the
18 contractor to do so. A prudent business person or homeowner that agreed to make payments
19 would undoubtedly require accountability, so that they would not be obligated to continue to
20 make those payments if the contractor did not provide the expected services. Likewise, the
21 USWC customers are entitled to receive the rate of modernization for which they will be paying.
22

[4] Tr. 52, April 25, 2000 Open Meeting.

1 Q. DOES YOUR PROPOSAL ALLOW TIME TO SEE WHAT USWC WILL DO BEFORE THE
2 CREDIT APPLIES?
3 A. Yes. USWC has been booking the new depreciation rates since May, 2000. Under my proposal,
4 the first review will not commence until May, 2001, with the potential credit (if any) first
5 appearing on the customers' bills in June, 2001. It will be up to USWC whether or not they meet
6 the expectations that are incorporated in the depreciation rates. Only if USWC chooses not to
7 make the retirements that are expected in the ACC approved depreciation lives, would a credit
8 apply.
9
10 It is also important to note that the amount of the credit depends upon how close USWC came to
11 the expected goals. Therefore, even if USWC does not meet the goal in one year, they will still
12 have an incentive to increase their retirements and modernization. Any increase in retirements
13 reduces or eliminates the credit next year that is based on that period.
14
15 Q. WHAT DO YOU RECOMMEND ON THIS ISSUE?
16 A. I recommend the Commission require USWC to file the filled out form contained on Schedule
17 WDA-4. If any credit is appropriate because USWC has failed to meet the retirement
18 expectations that are built into the customers' rates, the appropriate credit as calculated on that
19 form should appear on the customers' bills.
20
21
22
23

III. DEPRECIATION

Q. WHAT IS THE PRIMARY PROBLEM WITH THE DEPRECIATION EXPENSE CALCULATION OF USWC?

A. The Commission approved depreciation parameters (future net salvage, projection life, and curve shapes) to be used in the rate case. USWC has applied those Commission-approved parameters to 1999 investments, but to 1997 reserves.

Q. IN HIS DIRECT TESTIMONY MR. WU PRESENTS THE DEPRECIATION EXPENSE CHANGE OF $79.2 MILLION, WHICH THE COMMISSION DISCUSSED IN THE OPEN MEETING[5] IN WHICH THEY APPROVED THE DEPRECIATION PARAMETERS, BUT THEN HE ARGUES THAT WITH THE TEST YEAR UPDATE, AN ADJUSTMENT OF $99.7 MILLION CAN BE CALCULATED. IN ADDITION, MR. REDDING ON HIS SUPPLEMENTAL EXHIBIT GAR-S7C CLAIMS A $107,968,000 DEPRECIATION EXPENSE CHANGE AS THE IMPACT OF THE DEPRECIATION CHANGE. PLEASE COMMENT.

A. These USWC witnesses were calculating the impact of the change in parameters approved by the Commission by applying those parameters to 12/31/99 investments, and to 1/1/97 reserve levels. The use of the "book" values from inconsistent time periods results in over-stating the depreciation expense calculation.

[5] Open Meeting April 25, 2000.

1 Q. MR. WU ARGUES THAT "THE $79.2 MILLION AMOUNT WAS BASED ON
2 INVESTMENT LEVELS AS OF 1/1/97" AND "SINCE THAT TIME U S WEST HAS MADE
3 SUBSTANTIAL INVESTMENT IN ARIZONA". PLEASE RESPOND.
4 A. In his "updated" 1999 calculation, Mr. Wu has used the 12/31/99 investment, but also used the
5 1/1/97 reserve percent. What Mr. Wu proposes is a selective recalculation of the $79.2 million
6 figure in which he selectively changes some of the "per book" figures from the 1/1/97 level to the
7 1999 level, while leaving other of the "per book" figures back at the 1/1/97 level. Mr. Wu's
8 revised calculation would recognize the increase in investment which has occurred in the past
9 three years, but would ignore the increase in the depreciation reserve percent which has also
10 occurred in the past three years.
11
12 The $79.2 million figure was calculated using the investment book value on depreciation reserve
13 book values as of 1/1/97. The investments have increased since that time. It is also true that the
14 depreciation reserve, and the reserve as a percent of investment, has substantially increased since
15 1/1/97. Mr. Wu proposes to update the investment amount, but does not propose to update the
16 reserve percent used in the $79.2 million calculation to the 1999 level. Instead he proposes to
17 leave the reserve percent in this calculation back at the 1/1/97 level. In the last three years,
18 hundreds of millions of additional dollars have been accrued into the depreciation reserves.
19 These depreciation accruals are recovered in customer rates. This would be like a loan company
20 failing to consider the impact of the loan payments a customer had made for the past three years.
21
22 Q. CAN YOU DEMONSTRATE THAT MR. WU IS USING THE 1/1/97 RESERVE PERCENT
23 IN HIS SUPPOSEDLY "UPDATED" 1999 CALCULATION?

A. Yes. On Wu Exhibit KDW-1,page 1, which show the 1/1/97 calculation, Mr. Wu uses the percent reserve as of 1/1/97 of 64.0% for Radio Systems. Using that and other inputs, he calculated a rate of 5.8%.[6] That 5.8% figure is calculated specifically using the 1/1/97 reserve percent, but the 5.8% figure is what Mr. Wu also uses in his supposed 12/31/99 calculation, as can be seen in column D of Mr. Wu Exhibit KDW-2.

In fact the percent reserve for this account had grown from 64% as of 1/1/97 to 82.5%, as of 12/31/99, as shown on Schedule WDA-6, page 1, Column I. Mr. Wu ignores the growth by using the older 1/1/97 reserve percent in the "1999" calculation.

Q. DID MR. WU UPDATE THE INVESTMENTS TO THE 12/31/99 LEVEL IN ALL PARTS OF THE CALCULATION OF THE "UPDATED" DEPRECIATION EXPENSE CALCULATION?

A. No. In his "updated" calculation, Mr. Wu replaced the 1/1/97 investment with the 12/31/99 investment in one part of the calculation, but left the investment in another part of the calculation at the 1/1/97 level.

Schedule WDA-7 shows the calculation of the 6.6 years remaining life as of 1/1/97 that was used for the Radio Systems account in the $79.2 million calculation. As this Exhibit shows, this 6.6 year average remaining life was calculated by applying the ACC approved Projection Life to the 1/1/97 investment figures.[7] The 6.6 year remaining life is based on 1/1/97 investments. Mr. Wu

[6](100% - 64.0% - (-2%))/6.6 = 5.8%

[7]The ACC order specifies the parameters (net salvage and projection life) to be used. For example, for the Digital Circuit Account, the Commission Order approved a 10 year Projection Life, but did not approve a specific depreciation rate for that Account. (Page 11, Decision 62507) Depreciation rates are calculated by applying the Commission approved parameters to the book investment and reserve figures. Even with the same parameters, the depreciation rate and resulting accruals calculated can vary depending upon the date of the "per book" figures to which the Commission prescribed parameters are applied.

used the 6.6 year remaining life in calculating the 5.8% depreciation rate.[8] Therefore, the 5.8% rate is specifically based on 1/1/97 investments.

However in the "updated" 1999 calculation Mr. Wu uses the same 5.8% rate, as can be seen on Exhibit KDW-2, Column D. That figure is specifically calculated on the 1/1/97 investment level, but Mr. Wu used it in the "updated" 1999 calculation.

Q. DOES USWC HAVE THE CALCULATION WHICH APPLIED THE ACC APPROVED PROJECTION LIVES TO THE 12/31/99 INVESTMENTS?

A. Yes. Attached as Schedule WDA-8 is a copy of the USWC provided "generation arrangement" that shows the average remaining life of 5.9 years which USWC calculated by applying the ACC approved projection life to the 12/31/99 investment. USWC has recalculated the remaining life by applying the ACC approved parameters to the 12/31/99 investments (but this is not what Mr. Wu used in his "updated " 1999 calculation). In her testimony, USWC witness Nancy Hughes states she used the 12/31/99 "generation arrangements."[9] These are the documents that calculate the average remaining life by applying the ACC approved projection lives and curve shapes to the 12/31/99 investments, as shown on Schedule WDA-8.

Q. WERE THE RATES APPROVED BY THE COMISSION IN THE DEPRECIATION CASE BASED UPON BOTH 1997 INVESTMENT AND 1997 RESERVE LEVELS?

[8] (100% - 64.0% - (-2%))/6.6 = 5.8%.

[9] Page 4, Supplemental Testimony of Nancy Heller Hughes (Hughes Supplemental Testimony).

1 A. Yes. The Commission Order stated that the depreciation rates calculated using the Commission
2 approved parameters shall be used in the rate case. The Commission Orders do not say "In the
3 rate case, these Commission approved parameters shall be applied to 1999 investments, but to
4 1997 reserves."
5
6 Q. USWC FILED DEPRECIATION RATES IN MAY, 2000, WHICH THEY ARE NOW
7 BOOKING. HOW WERE THOSE CALCULATED?
8 A. For most accounts, USWC applied the ACC approved projection lives, curves, and net salvage to
9 the 1/1/97 book investment and 1/1/97 reserve amounts. For two accounts, the USWC
10 depreciation rates did not use the Commission approved parameters.[10]
11
12 This testimony is not objecting to USWC "booking" those rates for now. I am addressing the
13 depreciation expense to be calculated based upon a 1999 test year and the Commission approved
14 parameters. I recommend that when the customer rates that result from this proceeding go into
15 effect, USWC should at that time commence booking the updated test year depreciation rates.
16 These are the rates that are calculated by applying the ACC approved parameters to the test year
17 12/31/99 investments and reserves, as shown on Schedule WDA-6.
18
19 Q. IS USING A DEPRECIATION RATE IN THE YEAR 2000 WHICH IS CALCULATED
20 USING AN "END OF 1996/START OF 1997" RESERVE LEVEL CONTRARY TO
21 ACCEPTED DEPRECIATION PRACTICES?

[10] Dr. Le's April, 1999 Supplemental Testimony, Schedule 12 recommended a projection life of 8.5 years for the Stand Alone and 8.5 years for PBX and Key Intrasystems accounts, Account 2123.2. The Commission Order directed those Staff projection lives be adopted. However, USWC's filing improperly shows a projection life of 8.3 years for this Account.

1 A. Yes. All major telephone companies are required to update their depreciation rates at least every
2 three years (Triennial Represcription). In the interstate jurisdiction, companies are allowed to
3 update the depreciation reserve percent and investment amounts used in their depreciation rates
4 annually. Standard depreciation requirements prevent companies from using depreciation rates
5 that include reserve figures that are more than three years old. The use of the more than three
6 years old depreciation reserve figures that USWC is currently advocating in Arizona is not
7 acceptable under standard depreciation practices, because that data is too far removed from
8 current data.
9
10 Q. WHAT DO YOU RECOMMEND?
11 A. Staff agrees that Commission approved parameters should be applied to 12/31/99 book figures
12 instead of 1/1/97 book figures for purposes of the rate case. However, I do not agree that only
13 some of the "book" figures should be changed to the 12/31/99 levels while other "book" figures
14 used in the calculation should remain at the 12/31/97 levels. The only consistent way to update
15 is to update all "per book "investment and reserve figures used in this calculation is to use the
16 12/31/99 book figures. To use the 12/31/99 investment in one part of the calculation , but use the
17 1/1/97 investment and 1/1/97 reserves in other parts of the calculation for the same account is
18 improper.
19
20 The parameters as ordered by the ACC would be applied to these 12/31/99 "per book"
21 investment and reserve amounts.
22
23 Q. HAVE YOU PERFORMED THIS UPDATED CALCULATION?

1 A. Yes. The result is an increase in the intrastate annual depreciation expense of $68,258,000 are
2 shown on Schedule WDA-6, page 1. The 12/31/99 investment and reserve figures used in
3 Schedule WDA-6, are the actual 12/31/99 "per book" figures.[11] Adjusted for the sale of
4 exchanges, the figure for the retained exchanges is $62,080,000, as shown on page 2 of Schedule
5 WDA-6.
6
7 Q. IS THERE ANOTHER DEPRECIATION EXPENSE ADJUSTMENT THAT IS
8 APPROPRIATE?
9 A. Yes. The adjustment just discussed shows the impact of the change in the depreciation
10 parameters. In addition, when using an end of year rate base, you must adjust for end of year
11 investment levels.
12
13 USWC books the investment by applying a monthly depreciation rate to the investments each
14 month. The end of year 1999 investment is higher than the average was throughout 1999. Had
15 the higher investment levels that existed at the end of the year been in effect throughout 1999,
16 USWC would have booked more depreciation expense than they actually booked in 1999.
17 Adjusting the depreciation expense to the end of year level results in $10,054,000 increase in the
18 depreciation expense, as shown on Schedule WDA-9. This figure has already been adjusted for
19 the sale of exchanges, and would be in addition to the $62.0 million impact of the depreciation

[11] If anything, these reserves are conservative, since USWC had stopped flowing depreciation accruals into some accounts in 1999. Specifically, in 1999, USWC had the depreciation accruals for the General Purpose Computers Account turned "off", although they continued to collect revenues from customers to cover this expense. USWC was not flowing those revenues into the depreciation reserve for that Account. In the latter part of 1999, this Account was not "fully depreciated", and therefore, the funds that were being collected from the customers for that purpose should have been flowed into that Account, but they were not. They had an undepreciated balance by at least May, 1999, and therefore it should have been turned "on" by at least May, 1999. (USWC response to Request UTI 18-023) Having this Account turned "off" means the "booked" depreciation reserve is smaller than it otherwise would have been. I have not adjusted for this, and therefore the reserve amounts I utilize are conservative.

1 rate change. The $72,134,000 sum of these two adjustments ($62,080,000 – $10,054,000) is the
2 depreciation expense change.
3
4 Q. IS THE DEPRECIATION EXPENSE CHANGE AS A RESULT OF THE TEST YEAR
5 UPDATE ORDERED BY THE COMMISSION, SIMILAR TO THE IMPACT THE
6 COMMISSION EXPECTED AT THE TIME IT APPROVED THE DEPRECIATION
7 PARAMETERS IN THE DEPRECIATION CASE?
8 A. Yes. In its April 25, 2000 Open Meeting, in which the Commission approved the depreciation
9 parameters, the Commissioners indicated that they expected these parameters to have an annual
10 impact of $79.2 million per year.[12] At that time, the Commissioners recognized that if exchanges
11 were sold, a portion of this would go with the sold exchanges.[13] The figure of $73.1 million is
12 the portion of the $79.2 million figure that would remain after adjusting for the sale of the
13 exchanges.
14
15 Q. WHAT DO YOU RECOMMEND?
16 A. I recommend that the depreciation rates calculated using the ACC approved parameters shown
17 on Schedule WDA-6, page 1, Column K, be utilized in this proceeding. The depreciation rates
18 are calculated by applying the ACC approved parameters to the end of test year investments and
19 reserves as of 12/31/99. USWC "partially" updated depreciation expense calculation should be
20 rejected. That "partially" updated calculation utilizes reserve levels from the end of 1996/start of
21 1997. Those reserve levels are outdated and have no relevance to the 1999 test year. To
22 continue to use those outdated reserve levels would ignore the hundreds of millions of dollars of

[12] Tr. 16-17.
[13] Tr. 52.

depreciation accruals (supported in customers' rates), and have flowed into those reserve accounts since 1996. I also recommend that USWC commence booking the updated test year depreciation rates at the same time the customer rates that result from this proceeding go into effect. In addition, an "end of period" adjustment, such as that shown on Schedule WDA-9 is also appropriate.

IV. THE "PERCENT CONDITION" IN THE "RECONSTRUCTION COST NEW LESS DEPRECIATION" CALCULATION

Q. DID USWC CORRECTLY CALCULATE THE "PERCENT CONDITION" IN THEIR "RECONSTRUCTION COST NEW LESS DEPRECIATION" (RCNLD) CALCULATION?[14]

A. No. The USWC calculation of the "percent condition" contains at least three errors.

1. In this calculation, USWC calculated the remaining life using the vintage group (VG) procedure. However, the ACC has ordered the equal life group (ELG) procedure be used.
2. Ms. Hughes improperly took one-half year off of all of the ages.
3. Ms. Hughes started with the correct "percent condition" formulas, but she then improperly modified those formulas to remove "age" from the calculation.

Q. BEFORE DISCUSSING THESE THREE PROBLEMS, IS THERE ANOTHER ISSUE THAT NEEDS TO BE CLARIFIED?

[14] The Supplemental Testimony of Nancy Heller-Hughes and associated exhibits filed June 9, 2000 which addressed the updated test year of 1999.

A. Yes. Many of Ms. Hughes' Exhibits also show the 6/30/98 date instead of the 12/31/99 date in the column headings. On page 12 of Exhibit NHH-1, Supplemental Exhibit of Ms. Hughes, shows the correct date of 12/31/99, in the column headings. However, on all of the following pages of that Exhibit, Ms. Hughes shows the incorrect date. The numbers Ms. Hughes shows in those columns are 12/31/99 numbers, but the column headings are incorrect.

Q. THE FIRST ERROR YOU PREVIOUSLY LISTED IS THAT MS. HUGHES CHANGED THE REMAINING LIFE CALCULATION FROM THE ELG PROCEDURE TO THE VG PROCEDURE. PLEASE EXPLAIN.

A. One of the issues addressed in the depreciation proceeding was whether the remaining life should be calculated using the VG or ELG procedures. On page 1 of the Procedural Order dated January 7, 2000 in Docket No. T-01051B-97-0689, the Commission required that the ELG procedure be used:

> IT IS FURTHER ORDERED that each party shall utilize the Equal Life Group approach without the use of truncation.

Q. DOES THE ELG PROCEDURE PRODUCE A DIFFERENT AVERAGE REMAINING LIFE THAN THE VG PROCEDURE, EVEN WHEN ALL OTHER INPUTS ARE THE SAME?

A. Yes. For example, Schedule WDA-10 is a table from the computer program that USWC uses for depreciation calculations. The last two columns show the average remaining life under the ELG procedure, and separately under the VG procedure. As can be seen by comparing these columns, the ELG procedure generally produces a shorter average remaining life than does the VG procedure, even with the same inputs.

1 Q. DID MS. HUGHES USE THE ELG REMAINING LIFE?

2 A. No. In her testimony, Ms. Hughes stated that she had "USWC generation arrangement" as of
3 12/31/99, and that this was the data that was "used to support the depreciation rates prescribed by
4 the ACC."[15] Those USWC "generation arrangements" calculated the remaining life using the
5 ELG procedure. However, Ms. Hughes changed the remaining lives shown on the USWC
6 generation arrangements by replacing them with the remaining lives calculated using the VG
7 procedure. Replacing the ELG remaining life with the VG remaining life is contrary to the
8 Commission Order. It is also using a remaining life procedure that is inconsistent with the
9 remaining life used in the depreciation expense calculation.

10

11 Q. CAN YOU PLEASE DEMONSTRATE THAT MS. HUGHES REPLACED THE ELG
12 REMAINING LIFE WITH THE VG REMAINING LIFE?

13 A. Yes. Schedule WDA-11 contains pages from the USWC calculated "generation arrangement"
14 for the Circuit Digital Equipment account.[16] The remaining life and other values on that
15 generation arrangement were calculated using the Commission specified remaining life and
16 Commission required ELG procedure. However, instead of using the "ELG" remaining life, Ms.
17 Hughes replaced that with the VG remaining life. For example, for Digital Circuit Equipment,
18 the ELG remaining life for the 1997 vintage is 5.56 years as shown in Column E of the USWC
19 "generation arrangement", Schedule WDA-11. However, Ms. Hughes used the VG remaining
20 life of 9.09 years for that vintage, as shown in Column H, page 35 of Exhibit NHH-1 of Ms.
21 Hughes' Supplemental Testimony. The term "expectancy" that Ms. Hughes uses in Column H

[15] Page 4, Hughes Supplemental Testimony.
[16] This USWC response included the generation arrangement for virtually all of the depreciable accounts. This Schedule contains only several pages pertaining to the Digital Circuit account.

means the same as the average remaining life, as is stated in standard textbooks, as shown on Schedule WDA-12.

Q. WHAT IS THE SECOND IMPROPER CALCULATION IN THE USWC "PERCENT CONDITION" CALCULATION?

A. Ms. Hughes reduced all of the investments' age by one-half year, for no valid reason. The "generation arrangement" that USWC had provided to her showed the correct age, but she changed those ages. For example, as Schedule WDA-11, page 3, Column D shows, the USWC calculated generation arrangement shows that the investments installed in 1999 have an average age of 0.5 years as of 12/31/99 (1/1/2000). This is correct because the investments in 1999 were installed throughout the year. On the average, they would be six months old by the end of that year. However, instead of using the correct age, Ms. Hughes changed the 1999 vintages' age to be zero as of 12/31/99, as can be seen in Column F of page 35 of Ms. Hughes' Supplemental Exhibit NHH-1. This age is incorrect and inconsistent with the correct ages shown on USWC's own "generation arrangement." Ms. Hughes also improperly reduced the ages by 0.5 years in the other vintages and in the other accounts.

Q. WHAT IS THE THIRD ERROR YOU DISCUSSED ABOVE?

A. "Age" is one of the factors used in the correct calculation of the "percent condition." However, Ms. Hughes improperly modified the "percent condition" formula to exclude "age" from the calculation. The "percent condition" is the percent of the total life of the investment that remains. For example, if investment has only 20% of its total life left, then that investment would have a 20% "percent condition."

Without even discussing the "formulas", it is obvious that the percent condition figures that Ms. Hughes used do not accurately reflect the portion of the life remaining. For example, the 1980 vintage Digital Circuit Equipment investment has an age of 19 years, and a remaining life of 5.02 years, according to page 34 of Ms. Hughes Supplemental Exhibit NHH-1. From these two numbers, it is obvious that this equipment has already lived well past one-half of its total expected life. However, Ms. Hughes shows the "percent condition" for this investment as 50.20%. This is clearly an error since this investment has far less than half of its life remaining. The correct "percent condition" for this 1980 vintage investment in the Circuit Digital account is 18.82%, as shown in Column I, page 1 of Schedule WDA-13, which are my corrected calculations. Even without discussing any formulas, it is obvious that an investment which is already 19 years old, and has only 4.5 to 5 years of life remaining, does not have 50% of its life remaining, but has closer to 20% of its life remaining.

Q. WHAT IS WRONG WITH THE FORMULA MS. HUGHES USED IN THE ABOVE CALCULATION?

A. Ms. Hughes started out with the correct formulas, but she improperly modified those formulas to remove the "age" from the calculation. Ms. Hughes correctly identified the two formulas properly used to calculate the "percent condition". These formulas are:

1. $$\text{Percent condition} = \frac{\text{(Probable average service life - age)}}{\text{Probable average service life}}$$ [17]

2. Probable average service life = Age + Life Expectancy[18]

[17] Supplemental Exhibit NHH-1, page 3, last paragraph.

[18] Supplemental Exhibit NHH-1, page 3, last line, continued onto page 4. As previously noted, the term "life expectancy" means the same as "average remaining life", as shown on page 2 of Schedule WDA-12.

We do not dispute Ms. Hughes' statement that the above are the correct formulas used to calculate the "percent condition". However, these are not the formulas Ms. Hughes actually utilized.

After identifying the correct formulas, she combined those formulas. The result of properly combining these two formulas is the following:

$$\text{Percent condition} = \frac{((\text{Age} + \text{Life expectancy}) - \text{Age})}{(\text{Age} + \text{Life expectancy})}$$

This reduces to:

$$\text{Percent condition} = \frac{\text{Life expectancy}}{(\text{Age} + \text{Life expectancy})}$$

It is important to note that "age" is still one of the factors used to calculate percent condition in the properly combined formulas. However, this correct formula is not what Ms. Hughes used. Instead. she modified this formula by removing the "age" from the calculation and created an improperly modified formula, which is:

$$\text{Percent condition} = \frac{\text{Life expectancy at age X}}{\text{Divided by life expectancy when new}}$$ [19]

This modified formula is not correct. One obvious difference between the correct formula and the formula used by Ms. Hughes is that the correct formula uses "age" in the calculation, whereas Ms. Hughes improper formula removes age from the calculation. There is no valid basis for the modification that Ms. Hughes made to the correct formulas. It is the use of this incorrect formula which produces the illogical result previously discussed.

[19] Supplemental Exhibit NHH-1, page 4.

1

2 Q. DOES THE INCORRECT FORMULA THAT MS. HUGHES UTILIZED EVER PRODUCE

3 THE CORRECT FIGURE?

4 A. This formula produces the same answer as the correct formula only for brand new investments,

5 where the age equals zero.[20] However, for all investments where age is not equal to zero, the

6 formula Ms. Hughes utilized will not produce the correct "percent condition." As can be seen

7 from Schedules WDA-11 and WDA-13 , all or virtually all investments have an age other than

8 "zero." If Ms. Hughes, in rebuttal, says that her formula is correct for "new investments," or

9 "assuming age equals zero", that is a clear indication that she is avoiding addressing the area

10 where the USWC error exists.

11

12 Q. HAVE YOU CORRECTED THESE THREE ERRORS IN THE USWC CALCULATION OF

13 THE PERCENT CONDITION?

14 A. Yes. Schedule WDA-13 shows the correction of RCNLD for the Circuit Digital account with the

15 "percent condition" calculation corrected. For example, the 1980 vintage I previously discussed

16 is already 19.5 years old, and has an average remaining life of 4.52 years. It has an 18.82%[21]

17 condition, not the 50.2% condition that Ms. Hughes improperly calculated.

18

19 The "age" I used is the correct age. The age I used is also the same age shown in the USWC

20 generation arrangement for this Account, as can be seen by comparing Schedule WDA-13 to

[20] When the age equals zero, age would have had a zero value in the correct calculation. Therefore, removing age does not change the answer when the age equals zero. However, removing age from the calculation will produce an error if age has a value of anything other than zero.

[21] $4.52 (S4.52 ÷ 19.5) = 18.82%.

Schedule WDA-11. (For example, for the 1992 vintage the age I used and the "generation arrangement" age are both 7.5 years.)

The remaining life I used is the ELG remaining life. The remaining life figures I used are also the same remaining life figures that USWC used in its generation arrangement, as can be seen by comparing Column G of my Schedule WDA-13, to Column E of USWC's generation arrangement shown on Schedule WDA-11. (For example, for the 1992 vintage, the average remaining life figure I used was 5.24 years, which is the same average remaining life shown in USWC's generation arrangement.)

In my correct calculations shown on Schedules WDA-13 and 14, I have used the formulas which Ms. Hughes has acknowledged are the correct formulas. These correct formulas are used in Columns H and I of Schedule WDA-13. Applying these correct formulas result in the correct probable service life. The fact that the service lives I have used are appropriate can be verified by the fact that the service lives I used are the same as the service lives shown in the USWC generation arrangement, as can be seen by comparing Column H of Schedule WDA-13 to column F of USWC's generation arrangement shown on Schedule WDA-11. For example, for the 1992 vintage, the probable service life I used in Column H is 12.74 years, which is exactly the same service life figure which appears on USWC's generation arrangement.

The corrected percent condition for each account is shown on Schedule WDA-14.[22] The "reconstruction cost new less depreciation" with the correctly calculated percent condition is $2,548,485,457 as compared to the $3,487,682,001 figure Ms. Hughes calculated. When the

1 intrastate separations factor is applied to the difference between these two figures, and the 50%
2 "reconstruction cost new less depreciation" weighting that is used in "fair value" is applied, the
3 correction to the "fair value" rate base, is a reduction of $339,520,000, as is shown on Schedule
4 WDA-15.
5
6 Q. ARE THERE ANY EVENTS IN THE DEPRECIATION PROCEEDING THAT HAVE
7 RESULTED IN THE PERCENT CONDITION BEING LOWER THAN IT WOULD
8 NORMALLY BE?
9 A. Yes. In the depreciation proceedings, the Commission greatly shortened the projection lives.
10 For example, for the largest account, Buried Cable-Metallic, the Commission approved a 12 year
11 projection life, which compares to the 24 year projection life that had previously been in effect.
12 In no other USWC state, has the state commission approved a projection life lower than 20 years
13 for this account. It is expected that much of the investment that currently exists in Arizona will
14 be retired in the near future. This results in very short remaining lives. Since the percent
15 condition is a relationship between the remaining lives and total lives, the fact that the remaining
16 lives are short means the percent condition is lower than it otherwise would have been. In other
17 words, an investment that does not have much of its life left has a low percent condition, and that
18 is generally the circumstance in Arizona at the present time.
19
20 Q. OTHER THAN ADDRESSING THE "PERCENT CONDITION" CALCULATION, ARE YOU
21 ADDRESSING ANY OTHER PORTION OF THE RECONSTRUCTION COST NEW OR
22 FAIR VALUE CALCULATION?

---

[22] This Schedule is otherwise similar to Table 2, page 8 of Ms. Hughes Supplemental Exhibit.

1 A. No. The purpose of this portion of my testimony is only to address the calculation of the

2 "percent condition", and the impact of correcting that. Other than in calculating the "percent

3 condition", I have used the same values that USWC used for all portions of this calculation.."[23]

4

5 Q. WHAT DO YOU RECOMMEND ON THIS ISSUE?

6 A. I recommend that the fair value rate base as calculated by USWC be reduced in the amount of

7 $339,520,000, to correct the errors in the "percent condition" calculation as performed by

8 USWC.

9 Q. DOES THIS CONCLUDE THIS TESTIMONY?

10 A. Yes.

[23] Use of the other USWC values for this calculation does not imply approval or agreement, but simply reflects the fact that those values other than "percent condition" are outside of the scope I am addressing.

William Dunkel, Consultant
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Qualifications

William Dunkel is a consulting engineer specializing in telecommunication regulatory proceedings. He has participated in over 130 state telephone regulatory proceedings as listed attached hereto.

Mr. Dunkel has provided cost analysis, rate design, jurisdictional separations, depreciation, expert testimony and other related services to state agencies throughout the country in numerous telecommunication state proceedings.

Mr. Dunkel made a presentation pertaining to Video Dial Tone at the NASUCA 1993 Mid-Year Meeting held in St. Louis.

In addition, Mr. Dunkel also made a presentation to the NARUC Subcommittee on Economics and Finance at the NARUC Summer Meetings held in July, 1992. That presentation was entitled "The Reason the Industry Wants to Eliminate Cost Based Regulation--Telecommunications is a Declining Cost Industry."

William Dunkel and Associates provides services almost exclusively to public agencies, including the Public Utilities Commission, the Public Counsel, or the State Department of Administration in various states.

In April, 1974, Mr. Dunkel was employed by the Illinois Commerce Commission in the Electric Section as a Utility Engineer. In November of 1975, he transferred to the Telephone Section of the Illinois Commerce Commission and from that time until July, 1980, he participated in essentially all telephone rate cases and other telephone rate matters that were set for hearing in the State of Illinois. During that period, he testified as an expert witness in numerous rate design cases and tariff filings in the areas of rate design, cost studies and separations. During the period 1975-1980, he was the Separations and Settlements expert for the Staff of the Illinois Commerce Commission.

From July, 1977 until July, 1980, he was a Staff member of the FCC-State Joint Board on Separations, concerning the "Impact of Customer Provision of Terminal Equipment on Jurisdictional Separations" in FCC Docket No. 20981 on behalf of the Illinois Commerce Commission. The FCC-State Joint Board is the national board which specifies the rules for separations in the telephone industry.

Mr. Dunkel has taken the AT&T separations school which is normally provided to the AT&T personnel.

Mr. Dunkel has taken the General Telephone separations school which is normally provided for training of the General Telephone Company personnel in separations.

Since July, 1980 he has been regularly employed as an independent consultant in telephone rate proceedings across the nation.

He has testified before the Illinois House of Representatives Subcommittee on Communications, as well as participating in numerous other schools and conferences pertaining to the utility industry.

Prior to employment at the Illinois Commerce Commission, Mr. Dunkel was a design engineer for Sangamo Electric Company designing electric watt-hour meters used in the electric utility industry. He was granted patent No. 3822400 for a solid state meter pulse initiator.

Mr. Dunkel graduated from the University of Illinois in February, 1970 with a Bachelor's of Science Degree in Engineering Physics with emphasis on economics and other business-related subjects. He has taken several post-graduate courses since graduation.

Appendix A

RELEVANT WORK EXPERIENCE OF

WILLIAM DUNKEL

ARIZONA

-	U.S. West Communications	Cost of Service Study
	General rate case	Docket No. E-1051-93-183
	Depreciation case	Docket No. T-01051B-97-0689

ARKANSAS

-	Southwestern Bell Telephone Company	Docket No. 83-045-U

CALIFORNIA

(on behalf of the California Cable Television Association)

-	General Telephone of California	I.87-11-033
-	Pacific Bell	
	Fiber Beyond the Feeder Pre-Approval Requirement	

COLORADO

-	Mountain Bell Telephone Company	
	General Rate Case	Docket No. 96A-218T et al.
	Call Trace Case	Docket No. 92S-040T
	Caller ID Case	Docket No. 91A-462T
	General Rate Case	Docket No. 90S-544T
	Local Calling Area Case	Docket No. 1766
	General Rate Case	Docket No. 1720
	General Rate Case	Docket No. 1700
	General Rate Case	Docket No. 1655
	General Rate Case	Docket No. 1575
	Measured Services Case	Docket No. 1620
-	Independent Telephone Companies	
	Cost Allocation Methods Case	Docket No. 89R-608T

DELAWARE

-	Diamond State Telephone Company	
	General Rate Case	PSC Docket No. 82-32
	General Rate Case	PSC Docket No. 84-33
	Report on Small Centrex	PSC Docket No. 85-32T
	General Rate Case	PSC Docket No. 86-20
	Centrex Cost Proceeding	PSC Docket No. 86-34

DISTRICT OF COLUMBIA

- C&P Telephone Company of D.C.	
Depreciation issues	Formal Case No. 926

FLORIDA

- BellSouth, GTE, and Sprint	
Fair and reasonable rates	Undocketed Special Project

GEORGIA

- Southern Bell Telephone & Telegraph Co.	
General Rate Proceeding	Docket No. 3231-U
General Rate Proceeding	Docket No. 3465-U
General Rate Proceeding	Docket No. 3286-U
General Rate Proceeding	Docket No. 3393-U

HAWAII

- GTE Hawaiian Telephone Company	
Depreciation/separations issues	Docket No. 94-0298
Resale case	Docket No. 7702

ILLINOIS

- Central Telephone Company	
(Staunton merger)	Docket No. 78-0595
- General Telephone & Electronics Co.	
Usage sensitive service case	Docket Nos. 98-0200/98-0537
General rate case (on behalf of CUB)	Docket No. 93-0301
(Usage sensitive rates)	Docket No. 79-0141
(Data Service)	Docket No. 79-0310
(Certificate)	Docket No. 79-0499
(Certificate)	Docket No. 79-0500
- General Telephone Co.	Docket No. 80-0389
- Illinois Bell Telephone Company	
Area code split case	Docket No. 94-0315
General Rate Case	Docket No. 83-0005
(Centrex filing)	Docket No. 84-0111
General Rate Proceeding	Docket No. 81-0478
(Call Lamp Indicator)	Docket No. 77-0755
(Com Key 1434)	Docket No. 77-0756
(Card dialers)	Docket No. 77-0757
(Concentration Identifier)	Docket No. 78-0005
(Voice of the People)	Docket No. 78-0028
(General rate increase)	Docket No. 78-0034
(Dimension)	Docket No. 78-0086

ILLINOIS (CONT.)

(Customer controlled Centrex)	Docket No. 78-0243
(TAS)	Docket No. 78-0031
(Ill. Consolidated Lease)	Docket No. 78-0473
(EAS Inquiry)	Docket No. 78-0531
(Dispute with GTE)	Docket No. 78-0576
(WUI vs. Continental Tel.)	Docket No. 79-0041
(Carle Clinic)	Docket No. 79-0132
(Private line rates)	Docket No. 79-0143
(Toll data)	Docket No. 79-0234
(Dataphone)	Docket No. 79-0237
(Com Key 718)	Docket No. 79-0365
(Complaint - switchboard)	Docket No. 79-0380
(Porta printer)	Docket No. 79-0381
(General rate case)	Docket No. 79-0438
(Certificate)	Docket No. 79-0501
(General rate case)	Docket No. 80-0010
(Other minor proceedings)	Docket No. various
- Home Telephone Company	Docket No. 80-0220
- Northwestern Telephone Company	
Local and EAS rates	Docket No. 79-0142
EAS	Docket No. 79-0519

INDIANA

- Public Service of Indiana (PSI)	
Depreciation issues	Cause No. 39584
- Indianapolis Power and Light Company	
Depreciation issues	Cause No. 39938

IOWA

- U S West Communications, Inc.	
Local Exchange Competition	Docket No. RMU-95-5
Local Network Interconnection	Docket No. RPU-95-10
General Rate Case	Docket No. RPU-95-11

KANSAS

- Southwestern Bell Telephone Company	
Commission Investigation of the KUSF	Docket No. 98-SWBT-677-GIT

MAINE

- New England Telephone Company	
General rate proceeding	Docket No. 92-130

MARYLAND

- Chesapeake and Potomac Telephone Company

General rate proceeding	Docket No. 7851
Cost Allocation Manual Case	Case No. 8333
Cost Allocation Issues Case	Case No. 8462

MINNESOTA

- Access charge (all companies) — Docket No. P-321/CI-83-203
- U. S. West Communications, Inc. (Northwestern Bell Telephone Co.)

Centrex/Centron proceeding	Docket No. P-421/91-EM-1002
General rate proceeding	Docket No. P-321/M-80-306
Centrex Dockets	MPUC No. P-421/M-83-466
	MPUC No. P-421/M-84-24
	MPUC No. P-421/M-84-25
	MPUC No. P-421/M-84-26
General rate proceeding	MPUC No. P-421/GR-80-911
General rate proceeding	MPUC No. P-421/GR-82-203
General rate case	MPUC No. P-421/GR-83-600
WATS investigation	MPUC No. P-421/CI-84-454
Access charge case	MPUC No. P-421/CI-85-352
Access charge case	MPUC No. P-421/M-86-53
Toll Compensation case	MPUC No. P-999/CI-85-582
Private Line proceeding	Docket No. P-421/M-86-508

- AT&T

Intrastate Interexchange	Docket No. P-442/M-87-54

MISSISSIPPI

- South Central Bell

General rate filing	Docket No. U-4415

MISSOURI

- Southwestern Bell

General rate proceeding	TR-79-213
General rate proceeding	TR-80-256
General rate proceeding	TR-82-199
General rate proceeding	TR-86-84
General rate proceeding	TC-89-14, et al.
Alternative Regulation	TC-93-224/TO-93-192

- United Telephone Company

Depreciation proceeding	TR-93-181

- All companies

Extended Area Service	TO-86-8
EMS investigation	TO-87-131

NEW JERSEY

- New Jersey Bell Telephone Company

General rate proceeding	Docket No. 802-135
General rate proceeding	BPU No. 815-458
	OAL No. 3073-81
Phase I - General rate case	BPU No. 8211-1030
	OAL No. PUC10506-82
General rate case	BPU No. 848-856
	OAL No. PUC06250-84
Division of regulated	BPU No. TO87050398
from competitive services	OAL No. PUC 08557-87
Customer Request Interrupt	Docket No. TT 90060604

NEW MEXICO

- U.S. West Communications, Inc.

E-911 proceeding	Docket No. 92-79-TC
General rate proceeding	Docket No. 92-227-TC
General rate/depreciation proceeding	Case No. 3008

OHIO

- Ohio Bell Telephone Company

General rate proceeding	Docket No. 79-1184-TP-AIR
General rate increase	Docket No. 81-1433-TP-AIR
General rate increase	Docket No. 83-300-TP-AIR
Access charges	Docket No. 83-464-TP-AIR

- General Telephone of Ohio

General rate proceeding	Docket No. 81-383-TP-AIR

- United Telephone Company

General rate proceeding	Docket No. 81-627-TP-AIR

OKLAHOMA

- Public Service of Oklahoma

Depreciation case	Cause No. 96-0000214

PENNSYLVANIA

- GTE North, Inc.
  - Interconnection proceeding — Docket No. A-310125F002
- Bell Telephone Company of Pennsylvania
  - Alternative Regulation proceeding — Docket No. P-00930715
  - Automatic Savings — Docket No. R-953409
  - Rate Rebalance — Docket No. R-00963550
- Enterprise Telephone Company
  - General rate proceeding — Docket No. R-922317
- All companies
  - InterLATA Toll Service Invest. — Docket No. I-910010
- GTE North and United Telephone Company
  - Local Calling Area Case — Docket No. C-902815

SOUTH DAKOTA

- Northwestern Bell Telephone Company
  - General rate proceeding — Docket No. F-3375

TENNESSEE

(on behalf of Time Warner Communications)

- BellSouth Telephone Company
  - Avoidable costs case — Docket No. 96-00067

UTAH

- U.S. West Communications (Mountain Bell Telephone Company)
  - General rate case — Docket No. 84-049-01
  - General rate case — Docket No. 88-049-07
  - 800 Services case — Docket No. 90-049-05
  - General rate case/ incentive regulation — Docket No. 90-049-06/90-049-03
  - General rate case — Docket No. 92-049-07
  - General rate case — Docket No. 95-049-05
  - General rate case — Docket No. 97-049-08

VIRGIN ISLANDS, U.S.

- Virgin Islands Telephone Company
  - General rate case — Docket No. 264
  - General rate case — Docket No. 277
  - General rate case — Docket No. 314
  - General rate case — Docket No. 316

VIRGINIA

- General Telephone Company of the South	
Jurisdictional allocations	Case No. PUC870029
Separations	Case No. PUC950019

WASHINGTON

- US West Communications, Inc.	
Interconnection case	Docket No. UT-960369
General rate case	Docket No. UT-950200
- All Companies-	Analyzed the local calling areas in the State

WISCONSIN

- Wisconsin Bell Telephone Company	
Private line rate proceeding	Docket No. 6720-TR-21
General rate proceeding	Docket No. 6720-TR-34

SCHEDULE WDA-1 CONTAINS INFORMATION

CLAIMED TO BE PROPRIETARY BY USWC.

THEREFORE, IT HAS BEEN DELETED

FROM THIS TESTIMONY.

02/16/00
09:55 AM
XREF: 03
PRES: 1991,SF,02
PROP: 1997,SG,82

COMPANY: U S WEST
STATE: ARIZONA
ACCOUNT: 2123.1 OFFICE EQUIPMENT
CATEGORY: 2123.1 OFFICE EQUIPMENT
TABLE 2-VG/ELG

PROJECTION LIFE TABLE
AVERAGE SERVICE LIFE AND REMAINING LIFE BY AGE

PROJECTION LIFE TABLE PARAMETERS AVG LIFE 7.00

USING IOWA CURVE: L0.5

BEGINNING OF YEAR		AMOUNT RETIRED		ANNUAL ACCRUALS FOR BOY AGE A		ELG	ELG	
AGE	AMOUNT IN SERVICE	DURING YEAR (LIFE GROUP)	AGE OF AMOUNT RETIRED	EACH LIFE GROUP	FOR ALL REMAINING GROUPS	AVG. SERVICE LIFE	AVG. REMAINING LIFE	VG VINT REMAIN. LIFE
A	B	C=B-next B	D	E=C/D	F*	G=B/F	H=G-A	I#
0.0	100,000	1,198	0.5	2,396	24,583	4.07	4.07	7.00
0.5	98,802	4,651	1.0	4,651	22,187	4.45	3.95	6.58
1.5	94,151	7,025	2.0	3,513	17,536	5.37	3.87	5.88
2.5	87,126	8,882	3.0	2,961	14,023	6.21	3.71	5.32
3.5	78,244	9,745	4.0	2,436	11,063	7.07	3.57	4.87
4.5	68,499	9,609	5.0	1,922	8,626	7.94	3.44	4.49
5.5	58,890	9,247	6.0	1,541	6,704	8.78	3.28	4.14
6.5	49,643	8,677	7.0	1,240	5,163	9.61	3.11	3.82
7.5	40,966	7,936	8.0	992	3,924	10.44	2.94	3.52
8.5	33,030	7,066	9.0	785	2,932	11.27	2.77	3.24
9.5	25,964	6,113	10.0	611	2,147	12.10	2.60	2.99
10.5	19,851	5,127	11.0	466	1,535	12.93	2.43	2.76
11.5	14,724	4,162	12.0	347	1,069	13.77	2.27	2.54
12.5	10,562	3,256	13.0	250	722	14.62	2.12	2.35
13.5	7,306	2,449	14.0	175	472	15.48	1.98	2.17
14.5	4,856	1,762	15.0	117	297	16.35	1.85	2.01
15.5	3,094	1,208	16.0	75	180	17.24	1.74	1.87
16.5	1,886	786	17.0	46	104	18.14	1.64	1.75
17.5	1,100	485	18.0	27	58	19.05	1.55	1.64
18.5	615	284	19.0	15	31	19.96	1.46	1.54
19.5	330	160	20.0	8	16	20.88	1.38	1.44
20.5	170	88	21.0	4	8	21.77	1.27	1.32
21.5	82	45	22.0	2	4	22.66	1.16	1.20
22.5	37	23	23.0	1	2	23.52	1.02	1.05
23.5	14	9	24.0	0	1	24.40	0.90	0.92
24.5	5	4	25.0	0	0	25.19	0.69	0.70
TOTAL		99,999						

* F(AGE A) = SUM OF COL E AGE A TO END
\# I = 0.5 + ((SUM OF COL B FROM AGE A+1 THROUGH END)/(COL B AT AGE A))

Arizona
Docket No. T-1051B-99-105
WDA 23-005S1

INTERVENOR: Arizona Corporation Commission Staff (Dunkel)

REQUEST NO: 005S1

A. Please provide U S WEST's plans to use the money from the increase in depreciation annual accruals approved in Docket No. T-01051B-97-0689 to update the current infrastructure in Arizona. If available, this plan should detail the wirecenters that are being updated and the average age of the plant being replaced.

B. The dollar amount of investment to be retired in each depreciable account should be separately provided for each year in the plan.

RESPONSE:

U S WEST objects to Data Request WDA 23-005 on the grounds that it is not reasonably calculated to lead to the discovery of admissible evidence. This data request concerns U S WEST's depreciation rates, a matter that has already been decided by the Commission.

U S WEST Law Department
1801 California Street
Denver, CO 80202

Supplemental Response 07/10/00:
U S WEST has not received monies from the increase in depreciation annual accurals approved in Docket No. T-01051B-97-0689.

Qwest Law Department
1801 California St.
Denver, CO 80202

BEFORE THE

ARIZONA CORPORATION COMMISSION

RECEIVED
AZ CORP COMMISSION
AUG 9 2 28 PM '00
Arizona Corporation Commission
DOCKETED
AUG 0 9 2000
DOCUMENT CONTROL
DOCKETED BY

IN THE MATTER OF THE APPLICATION OF US WEST COMMUNICATIONS, INC. A COLORADO CORPORATION, FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES	) DOCKET NO. T-01051B-99-0105

DIRECT TESTIMONY AND SCHEDULES

ON RATE DESIGN ISSUES

OF

WILLIAM DUNKEL

ON BEHALF OF

THE STAFF OF THE ARIZONA CORPORATION COMMISSION

AUGUST, 2000

NOTICE: INFORMATION CLAIMED TO BE PROPRIETARY BY USWC HAS BEEN DELETED FROM THIS TESTIMONY. THROUGHOUT THIS TESTIMONY, PROPRIETARY INFORMATION IS DESIGNATED AS FOLLOWS: **PROPRIETARY**

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WILLIAM DUNKEL
DOCKET NO. T-01051B-99-0105

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I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND YOUR BUSINESS ADDRESS.

A. My name is William Dunkel. My business address is 8625 Farmington Cemetery Road, Pleasant Plains, Illinois 62677.

Q. ARE YOU THE SAME WILLIAM DUNKEL WHO IS FILING TESTIMONY AND SCHEDULES ADDRESSING CERTAIN MODERNIZATION, DEPRECIATION, AND RECONSTRUCTION COST NEW LESS DEPRECIATION (RCNLD) ISSUES IN THIS SAME PROCEEDING?

A. Yes. My qualifications are included in that testimony.

Q. CAN YOU PLEASE SUMMARIZE YOUR TESTIMONY?

A. Yes. Below is a summary of my testimony.

1. When utilities face competition in limited areas, they will attempt to charge very low rates in the competitive areas, while charging much higher rates in other areas. It is this discriminatory pattern of rates in response to competition, that was the original reason the regulation of utilities began. This rate pattern is a natural reaction by a utility to competition in limited areas or for limited services. This pricing pattern is in the Company's interest, but it is anti-competitive, discriminatory, and not in the public interest.

2. Through its "competitive zone" proposal in this proceeding, USWC is attempting to implement the same type of pricing strategies that originally prompted the regulation of the railroad industry over a century ago. USWC should not be allowed to freely price discriminate and to use that freedom to impede the emerging competition.

3. Allowing USWC to price lower where there is competition while pricing higher where there is not competition would effectively load a higher share of the joint and common costs onto the monopoly ratepayers, while loading a lower share of those joint and common costs onto the prices of competitive services. This is

contrary to the requirements of Section 254(k), which specifically prohibits this type of price discrimination.

4. USWC's proposal to automatically classify any new service offerings as competitive should be rejected. To be deemed truly competitive, new services should have to pass the same competitive test that other services must pass. In addition, if a "new" service includes a service that is currently not classified as competitive, that "new" service clearly cannot be classified as competitive.

5. I recommend that the Commission deny the USWC "competitive zone" proposal. I recommend that whatever regulatory structure is adopted, include a requirement that prices in different geographic areas may not vary by an amount that is greater than the variation that is justified by any variation in the cost of providing service. If the regulatory structure allows price flexibility or "revenue neutral" restructuring, any such restructure may not increase the rate differential between geographic areas that is incorporated in the specifically approved ACC rates, without specific Commission approval.

6. USWC's "competitive zone" proposal is not supported by the evidence that the Commission rules require it to provide to show a service or area is competitive. Many of the services in many areas that USWC considers to be competitive will not meet the requirements of the Commission rule, and are not competitive by standard criteria.

7. The wire centers that USWC proposes be immediately classified as "competitive zones" for business services are the wire centers that serve ** ** of USWC's total business access lines, and produce ** ** of USWC's total business revenue in the State of Arizona. The residential "competitive" zones that USWC proposes be immediately established cover over ** ** of USWC's residential lines in service in Arizona.

8. Under USWC's "competitive zone" proposal, USWC could increase its rates as much as it wanted to, up to double the current rates, and up to $19.00 for Residential Basic Exchange Service. Even in areas where it has significant monopoly power, the approval of this concept would allow the Company to as much as double most of its current rates.

9. The data that USWC has provided in this proceeding indicates that fewer than ** ** of the residential lines in service have been ported in the 23 wire centers that USWC proposes be immediately established as residential "competitive zones".

10. The data USWC provided shows that USWC has "lost" only about ** ** of the business lines, and is serving ** ** of the business lines, even within the 49 wire centers that USWC proposes be immediately established as "competitive zones".

11. Under unbundled network element competition, the underlying facilities used to provide the services are still owned and operated by USWC, and the competitors merely rent the facilities owned by USWC. Therefore, competition using unbundled loops, to the small extent that it even exists in Arizona is not really effective competition to USWC.

12. The level of resale competition in Arizona does not put pressure on USWC's retail rates. USWC's wholesale rate is USWC's retail rate less a certain percent for avoided costs. Therefore, USWC's wholesale rates are automatically adjusted to reflect any changes in the retail rates.

13. Resale competition is actually only competition for the marketing and billing/collection for a service. Under resale competition, competitors are merely reselling the services that are provided by USWC. The actual service is provided by USWC using the facilities that are owned and operated by USWC.

14. Wireless and cellular service are not a practical alternative to USWC's residential basic exchange service. USWC's 1FR Residential Basic Exchange rate is $13.18. A wireless rate plan with the comparable number of usage minutes would cost about $49.99 per month.

15. Despite the fact that wireless service has been around for many years now, USWC continues to serve an ever-increasing number of access lines in Arizona. USWC's own forecast projections show that its lines in service will continue to grow in the future.

16. The standard definition of TSLRIC dictates that any costs that would not be eliminated if the service in question is eliminated or discontinues, while continuing to provide all other services, is not properly included in the definition of TSLRIC. The loop facilities would not be eliminated if basic exchange service was discontinued, while all other services were still being offered. Therefore, the loop cost is not part of the properly calculated TSLRIC using the standard definition of TSLRIC.

17. USWC's claims that residential basic exchange service is priced below cost, is being subsidized, or is in need of support, are all based upon residential basic exchange service TSLRIC costs that improperly include 100% of the loop facility costs, in spite of the fact that basic exchange service is only one of the services that shares the loop facility. Therefore, USWC's claimed TSLRIC costs of basic exchange service are in direct violation of standard TSLRIC costing principles.

18. USWC places other shared costs, such as the cost of the standard sized envelope and first unit of postage used to send that bill, entirely in the TSLRIC of basic exchange service. Despite the fact that the first unit of postage and the billing envelope are costs of billing services other than basic exchange service (e.g. toll,

vertical services, etc.,), USWC improperly places 100% of these shared costs in its claimed TSLRIC of basic exchange service. USWC includes none of the standard envelope or first unit of postage cost in its TSLRIC of toll services, or other non-basic services.

19. USWC's violation of the TSLRIC definition was "selective." Although USWC violated the definition of TSLRIC for residential basic exchange service, USWC did not make that violation when it calculated its claimed TSLRIC costs of toll and switched access services. When calculating the TSLRIC of toll and switched access services, USWC properly excluded the loop costs, since the loop costs would not be avoided if one of these services were discontinued while holding all other products or services offered by the firm constant.

20. The properly calculated TSLRIC of residential basic exchange service is ** ** per month for USWC. Determining the TSLRIC is important because the TSLRIC is generally accepted as being the "floor" for a proper price. TSLRIC is also the standard for determining whether a service is receiving a subsidy. As USWC admitted in this proceeding, a service is not receiving a subsidy if that service is priced equal to or above its properly calculated TSLRIC.

21. The result of this selective violation of the TSLRIC definition by USWC is to distort beyond recognition the actual contributions from each of the different services. When the TSLRIC costs are properly and consistently calculated across all services, it is found that residential basic exchange services provides the most per-line contribution above TSLRIC of any service that shares the residential loop facilities.

22. The current residential basic exchange service rates alone provide an average of ** ** per line, per month in contribution above TSLRIC toward the shared, joint and common costs of USWC in Arizona. This is more contribution above TSLRIC than any other service which shares the residential loop facilities.

23. Residential basic exchange service alone provides approximately ** ** the per-line contribution that USWC's intrastate switched access provides, and over ** ** the per-line contribution that USWC's intrastate toll services provide toward the shared, joint and common costs of USWC in Arizona.

24. The unbundled loop rate that the Commission approved for USWC is $21.98. Under the FCC's Part 36 Separations requirements, 25% of the loop costs are allocated to the interstate jurisdiction and recovered in interstate rates. Therefore, the intrastate portion of the loop rate is $16.49 per month. The contribution above TSLRIC provided by residential local services alone (including charges for basic exchange service and vertical services) is ** ** per line, per-month. Therefore, the contribution from residential local services alone covers over ** ** of the intrastate portion of the unbundled loop rate the Commission has established for USWC in Arizona.

25. In addition to local contributions, residential basic exchange subscribers pay an additional ** ** per line, per month for the interstate EUCL charge (average of primary and additional line EUCL rate) that residential end users also must pay in order to obtain basic exchange service.

26. Residential basic exchange service is currently contributing more toward the recovery of the joint, shared and common costs of providing telecommunications services in Arizona than is toll, switched access, or even vertical services.

27. USWC's inclusion of 100% of the loop cost on residential basic exchange service (while placing none of it on the other services that share the loop facilities) violates the requirements and findings of the TA96, the FCC, the Supreme Court, and the Commissions in the vast majority of other states.

28. Under the FCC's Separations Rules, 25% of the loop facility costs are allocated to the interstate jurisdiction, and are recovered in interstate rates. Therefore, if rates were to be based upon USWC's cost study that includes 100% of the loop facility costs in its claimed cost of intrastate services, those rates would result in a double-recovery of the interstate portion of the loop facility costs.

29. The Staff proposed rates are just and reasonable, and are in the public interest. Staff's proposed rates balance the numerous criteria that must be considered when establishing telephone service rates. Staff recommends the rates shown on Schedule WDA-20 be adopted.

II. USWC'S COMPETITIVE ZONE PROPSAL

A. IT IS IN A UTILITIES' FINANCIAL INTEREST TO IMPROPERLY PRICE DISCRIMINATE WHEN FACED WITH COMPETITION IN A LIMITED AREA

Q. WHAT REACTION IS IN A UTILITY'S SELF-INTEREST WHEN IT HAS MONOPOLY POWER IN SOME AREAS, BUT FACES COMPETITION IN OTHER AREAS?

A. In such a circumstance, it is in a utility's self-interest to charge lower prices where it faces competition, while charging higher prices where it has monopoly power. In fact, the

utilities' reaction to such a situation is one of the factors that gave rise to the regulation of utilities.[1] For example, in the old days before railroads were regulated:

> Customers shipping goods from Chicago to New York always pick the route that offers even a few pennies saving. Thus, each of the three or four trunk lines would intermittently undercut the existing rate schedules, until finally a disastrously low level of rates was reached. At the same time, for short hauls where shippers had no alternative, the railroads would jack up the rates, thus creating an anomalous, discriminatory pattern of charges. We have seen that the Interstate Commerce Commission was established in 1887 to regulate railroad rates and earnings and prevent such unstable price conditions.[2]

As the above quotation indicates, one of the reason utility rates are regulated is because when faced with competition in some areas, the utilities will charge low rates where they have competition, but higher rates where they have little or no competition. This improper discrimination is a natural "self-interest" reaction by a utility to competition in limited areas or for limited services.

Discriminating based upon the level of competition is in the utilities' self-interest, but it is not in the public interest. The prevention of this type of undue price discrimination is one of the reasons that utilities are regulated, either by traditional regulation or by alternative regulation.

Q. WHY IS DISRIMINATION BASED UPON THE LEVEL OF COMPETITION FOR A REGULATED MONOPOLY IMPROPER?

A. If this is allowed, it has two adverse effects:. (1) It discourages the growth of competition, and (2) it allows the extraction of monopoly profits where the company has

[1] These concepts generally apply to both "traditional" regulation as well as alternative regulation.
[2] Page 499, Economics, An Introductory Analysis by Paul A. Samuelson.

monopoly power. Both of these effects are in the company interest, but not in the public interest. For example, assume two areas are identical except that there is competition in one area and not in the other. If a company charges $20 per month for a particular service in the non-competitive area, but charges $10 per month for that same service in a competitive area, that is improper. If $10 per month is the fair rate where competition exists, there is no valid reason for the rate to be higher in the other areas where competition does not exist. In fact, one of the standard goals of regulation is to establish rates for monopoly services that are similar to the rates that would exist if competition existed. Allowing such discriminatory pricing clearly violates that concept. In addition, this type of pricing discourages competition. Companies, including the competitors, have joint and common costs that must be recovered in addition to their incremental or direct costs. Therefore, for a company to be profitable, it must be able to price its services not only to cover its "direct" (incremental) costs, but to cover its common costs as well.

Assume, for example, that a company must price a service at $15 in order to recover both its incremental and its joint and common costs. In the above example, the LEC would be recovering its common costs, because it is recovering more than a reasonable share of the common costs from the monopoly customers, while failing to recover a reasonable share of the common costs from the customers in the competitive areas. However, the competitor must also recover a total of $15 per service, but they cannot do so in the competitive areas, because they are facing a low "competitive" LEC price of $10. Therefore, the competitors lose money, and that discourages other competitors.

It should be noted that the high "monopoly" rate of $20 in this example will not attract competitors, because the competitors by experience will know that the utility would reduce the rate in that area to a low "competitive" rate if the competitor started doing business in that area. Therefore, if the LEC was charging the "non-competitive" $20 rate, as soon as the competitor started doing business, the LEC would cut the rate to the "competitive" $10 rate in this example. Therefore, the competitors would soon learn that the profitable rates would not be available for them to compete against.

Q. DOES USWC PROPOSE TO IMPROPERLY PRICE DISRIMINATE IN THIS PROCEEDING?

A. Yes. USWC has proposed a "competitive zone" proposal in which a significant portion of USWC customers would be deemed to be in competitive zones. USWC could establish rates and charges without Commission approval, within very broad maximum and minimum levels.

In his testimony, Mr. Teitzel states the following:

> Offerings and prices may vary between competitive zones. With this flexibility, U S WEST will be able to effectively respond to customer and market demands in the areas subject to competition.[3]

In short, USWC's competitive zone proposal would give USWC the freedom to improperly discriminate based upon the level of competition. This is in USWC's interest, but is not in the public interest, and should be rejected.

[3]Teitzel Direct, Page 19.

1 Q. DOES USWC'S OWN INTERNAL STUDIES INDICATE THAT **

2

3 **?

4 A. Yes. USWC's own internal study conducted by the U S WEST Consumer Services

5 Group states:

6 **
7
8
9
10 .**[4]
11

12 USWC recognizes that it is in their interest to see that the existing competitors are not

13 successful, so as to not encourage additional competitors. Under their proposal, USWC

14 would have the price flexibility to discriminatorily price services in limited geographic

15 areas so that USWC could help assure that competitors were not successful.

16

17 Q. CAN YOU GIVE AN EXAMPLE OF HOW USWC COULD USE THE PRICING

18 FLEXIBILITY BASED UPON THE "MARKET DEMANDS" TO IMPROPERLY

19 DISCOURAGE COMPETITION WHILE CHARGING MUCH HIGHER RATES IN

20 AREAS THAT ARE OTHERWISE SIMILAR EXCEPT FOR THE LEVEL OF

21 COMPETITION?

22 A. Yes. In limited geographic areas where it offers services, Cox Communications[5] offers

23 residential basic exchange service at $11.75 per month to its cable subscribers.[6] USWC's

---

[4]U S WEST Consumer Services Group, Cox, October 13, 1998, page 4. This study was provided by USWC in response to Data Request RUC6-6, Attachment C.

[5] Cox offers residential basic exchange service at $13.00 per month to customers who are not its cable subscribers. (Teitzel Direct, Exhibit DLT-9)

1 current rate of $13.18 is already over 12% higher than the $11.75 rate being offered by
2 Cox. USWC's proposed rate for residential basic exchange service of $15.68 is over 33%
3 higher than the rate that is currently being offered by COX.[7] Even USWC's proposed
4 residential basic exchange rate of $13.93 for Lifeline service is over 18% higher than the
5 $11.75 rate that is currently being offered by Cox.[8] Under the "competitive zone"
6 proposal, USWC could choose to underprice the Cox rate in those zones in which Cox
7 competes. This would discourage competitors. As will be discussed later, the criteria
8 needed to establish a "competitive zone" does not ensure that competition actually exists.
9 In the other so-called "competitive" zones where effective competition does not exist,
10 USWC is proposing that it be allowed to charge any residential basic exchange rate it
11 wanted to, up to a maximum of $19.00.[9] Discriminatory pricing is in USWC's interest, in
12 that it would discourage competition and at the same time extract monopoly profits where
13 monopoly power exists, but it is not in the public interest.
14
15 Q. WHAT DO YOU RECOMMEND ON THIS ISSUE?
16 A. I recommend that the Commission deny the USWC "competitive zone" proposal. I
17 recommend that whatever regulatory structure is adopted, include a requirement that
18 prices in different geographic areas may not vary by an amount that is greater than the
19 variation that is justified by any variation in the cost of providing service. If the

---

[6] However, in the wire centers where USWC wants to be granted "pricing flexibility", USWC is asking for the Commission to allow USWC to raise its residential basic exchange rates up to $19.00 per month.
[7] On page 29, line 2 of his Direct Testimony, Mr. Teitzel indicates that USWC's proposed rate for flat rate residential basic exchange service is $15.68 per month. ($15.68 - $11.75) / $11.75 = 33.45%.

[8] On page 28 of his Direct, Mr. Teitzel indicates that USWC's proposed flat one party rate for Lifeline is $13.93 per month.

[9] Teitzel Direct, page 18.

regulatory structure allows price flexibility or "revenue neutral" restructuring, any such restructure may not increase the rate differential between geographic areas that is incorporated in the specifically approved ACC rates, without specific Commission approval.

Q. YOU PREVIOUSLY DISCUSSED USWC BEING ABLE TO CHARGE HIGHER PRICES IN ZONES THAT HAD BEEN DESIGNATED AS "COMPETITIVE", BUT WHERE USWC ACTUALLY DID NOT FACE EFFECTIVE COMPETITION. IS THAT POSSIBLE UNDER USWC'S PROPOSAL?

A. Yes. If a competitor offers even one residential service in that zone, then all residential services are deemed competitive. This means a service could be deemed "competitive" even if there is no competitor providing a competitive service in that zone. Likewise, if a competitor offers even one business service in that zone, then all business services are deemed competitive. As Mr. Teitzel states in his testimony,

> Once an area is designated as a competitive zone, all services offered by U S WEST will be afforded the flexibility outlined above.[10] (Emphasis added)
>
> Of course, it is very likely there will be competition for both residence and business customers in a certain competitive zone, in which case all of U S WEST's product family will be afforded flexibility.[11] (Emphasis added)

In addition, all wholesale services within a competitive zone would be afforded flexibility under the USWC proposal. As Dr. Wilcox states in her Direct Testimony:

[10]Teitzel Direct, Page 19, lines 20-21.

[11]Teitzel Direct, page 19, lines 34-36.

> U S WEST is requesting pricing flexibility for finished wholesale services in all of the wire centers listed by Mr. Teitzel as being competitive. Competition for both residence and business local exchange service has direct impact on switched access, as well as other finished wholesale services. Therefore, U S WEST's proposal is that any wire center that is declared competitive for either residence or business services also is declared competitive for finished wholesale.[12]

Under USWC's proposed criteria, all USWC must do is demonstrate that there is some company that is at least offering one service that is competing with a USWC service. After that, USWC would be granted pricing flexibility on a host of other services, even if there is no alternative provider offering those services.

B. THE SO-CALLED "COMPETITIVE ZONES" HAVE NOT BEEN DEMONSTRATED TO BE COMPETITIVE, AND THEY ARE NOT COMPETITIVE BY ACCEPTED CRITERIA.

Q. MR. TEITZEL PROPOSES TO CLASSIFY CERTAIN WIRE CENTERS AS "COMPETITIVE ZONES". MR. TEITZEL STATES "THE PRESENCE OF SIGNIFICANT COMPETITION IN THESE WIRE CENTERS QUALIFIES THEM, UNDER ARTICLE 11, R-14-2-1108 OF THE COMMISSION RULES, FOR 'COMPETITIVE' CLASSIFICATION."[13] DOES MR. TEITZEL'S PROPOSAL MEET THE CRITERIA FOR BEING A COMPETITIVE SERVICE UNDER THE COMMISSION'S RULES?

A. No. USWC has not provided evidence that the Commission rules require it to provide to show a service or area is competitive. Many of the services in many areas that USWC

[12]Wilcox Direct Testimony, page 27, line 15.

[13]Teitzel Direct Testimony, page ii.

considers to be competitive will not meet the requirements of the Commission rule, and are not competitive by standard criteria.

Q. WHAT DO THE COMMISSION RULES REQUIRE BE DEMONSTRATED IN ORDER TO CLASSIFY A SERVICE AS COMPETITIVE?

A. Article 11, Section R14-2-1108 (B) of the Commission's Rules and Regulations set forth a number of pieces of information that must accompany any USWC petition for classifying a service or group of services as competitive. The current rules require the following minimum information to be provided:

1. A description of the general economic conditions that exist which make the relevant market for the service one that is competitive;

2. The number of alternative providers of the service;

3. The estimated market share held by each alternative provider of the service;

4. The names and addresses of any alternative providers of the service that are also affiliates of the telecommunications company, as defined in R14-2-801;

5. The ability of alternative providers to make functionally equivalent or substitute services readily available at competitive rates, terms, and conditions; and

6. Other indicators of market power, which may include growth and shifts in market share, ease of entry and exit, and any affiliation between and among alternative providers of the service(s).

It is important to note that the current rules require an indication of "market power." This is an important requirement. When a company has little market power, customers are protected from excessive rates, because they can go to alternative suppliers if one

company's rates are excessive. However, when a company has high market power, that means there is little price-restraining, effective competition, and therefore, customers are not protected by competition.

Q. UNDER THE USWC PROPOSAL, WOULD THIS SAME INFORMATION BE REQUIRED TO SUPPORT USWC'S PETITIONS FOR CLASSIFYING WIRE CENTERS AS "COMPETITIVE ZONES"?

A. No. Under USWC's proposal, the information that the Commission's Rules require would not be required to classify a wire center as a "competitive zone." Under USWC's proposal, any wire center where any competitor, including a reseller, is offering even one service would be eligible to be classified as a competitive zone. Mr. Teitzel explains his proposed criteria for a wire center to be classified as a "competitive zone" in his Direct Testimony:

> Before a competitive zone can be established, at least one of the following criteria must be met: 1) A competitor has facilities in place and is marketing or offering services in competition with U S WEST; 2) A reseller is marketing or offering services in competition with U S WEST; or 3) A competitor is marketing or offering services through the provision of unbundled network elements purchased from U S WEST.[14]

These same criteria are also found in §2.16 (B) of USWC's proposed tariff in this proceeding. Under USWC's proposal, all that would need to be demonstrated to classify an exchange as competitive is that one other company was offering at least one alternative service in that area. No indication of market power, market share, or other information which indicates that competition is effective would be required. In short,

[14]Teitzel Direct, Page 18, lines 7-11.

1 USWC could declare areas as "competitive" even where there was no effective price
2 constraining competition.
3
4 Q. CAN YOU GIVE US AN EXAMPLE OF THERE BEING A COMPETITOR IN A
5 MARKET THAT DOES NOT REALLY PROVIDE EFFECTIVE COMPETITION TO
6 USWC FOR MOST CUSTOMERS?
7 A. Yes. There are "competitors" who offer telephone service to customers who have been
8 disconnected for non-pay, or otherwise cannot obtain telephone service from USWC due
9 to credit or payment problems. The rates these competitors charge are sometimes much
10 higher than USWC's rates. In response to discovery, USWC admitted that a reseller of
11 residential basic exchange service who markets to customers with poor credit at rates
12 much higher than USWC's rates would be sufficient competition to qualify a wire center
13 as a competitive zone under the USWC proposal.[15] The existence of a very high priced
14 competitor does not constrain USWC's prices, and does not provide effective competition
15 (other than for a very limited category of customers).
16
17 Q. DOES THE AVAILABILITY OF RESELLERS PUT A "PRICE CONSTRAINT" ON
18 USWC SO THAT NO FURTHER SIGNIFICANT PRICE REGULATION (EITHER
19 TRADITIONAL OR ALTERNATIVE) BY THE COMMISSION IS REQUIRED?
20 A. No. Resellers resell service that is provided by USWC. The wholesale rate the resellers
21 pay USWC is their major cost of doing business. In addition, the USWC wholesale rate
22 is automatically increased when USWC's retail rate is increased. Therefore, if USWC
23 increased its residential rate in an area, then the wholesale rate to the resellers would also

1 increase the same percent, thereby forcing the reseller's price up as well. Specifically,
2 USWC's residential wholesale service is provided at a 12% discount from their retail rate.
3 (18% for business)[16] In addition to paying USWC the wholesale rate, the resellers must
4 cover their own costs, such as marketing, billing and collection, and uncollectible. For
5 example, if a hypothetical LEC doubled the price of its retail service, that would mean
6 that the price of the wholesale service would also double.[17] As a result, the cost that
7 makes up approximately 88% of the resellers' cost of doing business would automatically
8 double at the same time the LEC doubled its rate.[18] This cost increase would force the
9 reseller to go along with the LEC's doubling of the rate. The availability of resellers does
10 not provide the customers any significant protection from improper price increases by the
11 LEC.
12
13 Q. IS THERE ANOTHER PROBLEM WITH CONSIDERING RESALE OR EVEN UNE
14 SERVICES AS BEING "EFFECTIVE" COMPETITIION TO USWC TO JUSTIFY
15 EFFECTIVELY PRICED DEREGULATION?
16 A. Yes. It must be remembered that under both of these forms of "competition", USWC
17 actually ends up with the vast majority of the revenues paid to the "competitors".[19] If
18 USWC's price increase caused customers to leave USWC for a reseller, the majority of

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[15] USWC's response to Request WDA4-009(d) and (e).
[16] USWC response to Request WDA2-001.
[17] The hypothetical "doubling" of the rate is only to illustrate the mechanism being discussed. This section of testimony does not imply or contend that USWC intends to specifically "double" the rate.
[18] Assuming their prices are similar to USWC. If the reseller prices below USWC, then the wholesale increase would be more than 88% of their cost of doing business.
[19] For residential resale, the USWC wholesale rate is 88% of its retail rate. Therefore, USWC receives almost as much revenue from the wholesale service. Of course, USWC avoids the cost of billing and collection from individual customers, uncollectible from certain individual customers, and certain other costs.

those revenues would end up with USWC. They just take a different route in getting there.

C. USWC'S PROPOSAL WOULD INITIALLY DEREGULATED THE ** ** OF ITS BUSINESS LINES, AND ALMOST ** ** OF ITS RESIDENTIAL LINES

Q. ON PAGE 22 OF HIS DIRECT TESTIMONY, MR. TEITZEL STATES THAT USWC IS REQUESTING IMMEDIATE PRICING FLEXIBLIITY "ON A LIMITED GEOGRAPHIC BASIS." PLEASE COMMENT.

A. The wire centers that USWC proposes be immediately classified as "competitive zones" for business services are the wire centers that serve ** ** of USWC's total business access lines, and produce ** ** of USWC's total business revenue in the State of Arizona.[20] The residential "competitive" zones that USWC proposes be immediately established cover over ** ** of USWC's residential lines in service in Arizona.[21]

Q. ON PAGE 31, LINE 18 OF HIS SUPPLEMENTAL DIRECT TESTIMONY, MR. TEITZEL STATES "THE NUMBER OF 'PORTED' LOCAL TELEPHONE NUMBERS IS A ROUGH MEASURE OF THE NUMBER OF ACCESS LINES BEING SERVED BY LOCAL EXCHANGE COMPETITORS." DO YOU AGREE THAT THE NUMBER OF "PORTED" LOCAL TELEPHONE NUMBERS IS ONE OF THE BEST GAUGES WE HAVE FOR THE MAGNITUDE OF LOCAL EXCHANGE COMPETITION?

[20] USWC's response to Data Request WDA 2-13.
[21] USWC response to Request WDA 21-12, Attachments A and B.

1 A. Yes. Customers can move their existing telephone number to a different company at no
2 charge. It is much more convenient for a customer to keep their existing telephone
3 number than to change their number. It is much easier for the people who already know a
4 certain telephone number to contact that number if the existing number is kept.
5 Therefore, the tracking of ported numbers gives a good indication of the total number of
6 customers served by other companies. The "ported" figure also includes all types of
7 competitors, including resellers, companies utilizing UNE facilities, and facility based
8 competitors.
9
10 Q. DOES THE "PORTED" NUMBER DATA DEMONSTRATE THE EXISTENCE OF
11 SIGNIFICANT COMPETITION FOR RESIDENTIAL BASIC EXCHANGE
12 SERVICES IN ARIZONA SPECIFICALLY IN THE WIRE CENTERS THAT USWC
13 HAS ASKED BE IMMEDIATELY DECLARED COMPETITIVE?
14 A. No. Through April 2000, there were ** ** residential "ported" numbers in the 23
15 wire centers that USWC proposes be immediately classified as residential "competitive
16 zones."[22] This compares to the over ** ** residential telephone lines of USWC
17 in service in these 23 wire centers.[23] Therefore, the data that USWC has provided in this
18 proceeding indicates that fewer than ** ** of the residential lines in service
19 have been ported in the 23 wire centers that USWC proposes be immediately established
20 as residential "competitive zones", as is shown on Schedule WDA-16.[24]
21

[22] Teitzel Supplemental Direct, Exhibit DLT-44.
[23] USWC response to Request WDA 21-12, Attachment A.

[24] ** **.

1 Q. ARE THE AREAS WHICH USWC HAS PROPOSED BE IMMEDIATELY

2 DECLARED COMPETITIVE, COMPETITIVE?

3 A. They are not by accepted standards. As previously discussed, the Commission's rules

4 require that for an area to be considered competitive, market share information must be

5 provided, and indications of market power must be considered. This market share is

6 clearly indicative of a non-competitive area, in which USWC enjoys huge market power.

7 The standard that both the U.S. Department of Justice and the Federal Trade Commission

8 (FTC) utilize as their primary method of determining the degree of market concentration

9 is the Herfindahl-Hirschman Index (HHI). The meanings of the scores on the HHI are as

10 follows:

	HHI Score
Unconcentrated	Below 1,000
Moderately Concentrated	1,001-1,800
Highly Concentrated	Above 1,800

17 The HHI for the wire centers which USWC proposes be immediately declared

18 competitive have an HHI of over ** **.[25] USWC has huge market power in these

19 markets. A residential basic exchange market in this area is very "highly concentrated."

20 These areas are nowhere near "competitive" by accepted definitions.

21

22 Q. USWC PROPOSES THAT 49 WIRE CENTERS BE IMMEDIATELY DECLARED

23 COMPETITIVE FOR BUSINESS SERVICES.[26] DOES THE DATA USWC

[25] The HHI is calculated by squaring the market share of each company in the industry with 100% being written as 100. (** **) The total score for this market would be slightly higher than this figure, as the squared market share of the other companies in the market could also be added, but that effect would be small. **( ).**

[26] USWC response to Request WDA 21-012, Attachment A.

1 PROVIDED DEMONSTRATE THAT THESE AREAS ARE COMPETITIVE FOR
2 BUSINESS BASIC EXCHANGE SERVICES?
3 A. No. In his Supplemental Direct Testimony Exhibit DLT-38, Mr. Teitzel provided an
4 Exhibit entitled "Business Access Line Losses: April 1997 Through April 2000". On this
5 Exhibit, Mr. Teitzel is claiming that over the period April 1997 through April 2000,
6 USWC had "business access line losses" totaling ** ** in the 49 wire centers that
7 USWC proposes be immediately classified as business "competitive zones". For
8 comparison, USWC serves over ** ** business lines in service in these 49 wire
9 centers.[27] Therefore, the data USWC provided shows that USWC has "lost" only about
10 ** ** of the business lines, and is serving ** ** of the business lines, even within
11 the 49 wire centers that USWC proposes be immediately established as "competitive
12 zones", as is shown on Schedule WDA-16. The HHI for this market is therefore
13 ** **.[28] This is extremely "highly concentrated." This market is nowhere near
14 competitive by accepted standards. USWC has huge market power in these areas.
15
16 USWC's market share may even be understated. USWC admitted that this business
17 access line loss data shown on Mr. Teitzel's Exhibit "has not been adjusted to reflect
18 customers lost to competition who have subsequently returned to U S WEST."[29] USWC
19 offers a "Competitive Response" program that offers a waiver of nonrecurring charges
20 and/or two months of recurring charges to customers who have left USWC and decide to

[27]USWC's response to Data Request WDA 21-12, Attachment A.

[28] ** **.

[29]USWC's response to Data Request WDA 22-31.

1 return to USWC. ** ** of small business customers that had left USWC for a
2 competitor have subsequently returned to USWC through this program.[30]
3
4 Q. WHAT IS SCHEDULE WDA-16?
5 A. Schedule WDA-16 summarizes the competitive figures for the wire centers that USWC
6 asks be immediately declared competitive. In addition to the data discussed above, this
7 Schedule also shows the number of resold residential lines in those areas equals only
8 ** ** of the residential lines.[31]
9
10 In the areas USWC has asked be declared competitive for business services, resold lines
11 represent less than ** ** of the business lines in those areas. This Schedule also
12 shows the UNE lines in the areas USWC has asked be immediately declared competitive
13 represent less than ** ** of USWC's total access lines in those areas.
14
15 Q. ARE THE TINY COMPETITIVE FIGURES SHOWN ON SCHEDULE WDA-16
16 CONSISTENT WITH OTHER DATA USWC HAS PROVIDED?
17 A. Yes. USWC provided the results of a study conducted on USWC's behalf by a company
18 called Quality Strategies. According to this study, USWC's share of the retail local
19 exchange spending is ** ** for the "consumer" (i.e. residential) market, ** **

[30]USWC's response to Data Request WDA 24-7.

[31] It should be noted that it is not appropriate to add the "ported" numbers to the "resold" numbers, because there is significant overlap. The customers who are counted as "ported" also can be counted in the "resale" or "UNE loop" columns.

for the "small business" market, and ** ** for the "large business" market in Arizona.[32]

Q. SCHEDULE WDA-16 SHOWS THE COMPETITORS HAVE NOT OBTAINED VERY SIGNIFICANT MARKET SHARE IN ARIZONA, EVEN IN THOSE AREAS THAT USWC CLAIMS TO BE THE MOST COMPETITIVE. IS A SIMILAR STATEMENT TRUE NATIONWIDE?

A. Yes. This problem is not limited to Arizona. Competitive access providers (CAPs), competitive local exchange carriers (CLECs), resellers, and all competitive carriers have low overall market share nationwide. According to the FCC's Trends in Telephone Service report for 1998, the incumbent LECs' share of the local service revenues is 96.5% nationwide, whereas all CAPs, CLECs, resellers, and all other competitive carriers share a skimpy 3.5% share of the local service revenues.[33] This is a clear indication of the true dominance that the LECs enjoy in the local service market nationwide. A mere four-tenths of one percent of the major LECs' switched lines were sold as UNE loops nationwide.[34] One and one-half percent of all access lines were resold lines nationwide.[35]

In fact, nationwide, the wireline telephone market is far more concentrated than it has been at any time since divestiture. Currently, two companies control 66% of the access

[32] Fourth quarter, 1998, USWC response to RUCO Request 6-11, Attachment A, page 8.
[33] Trends In Telephone Service, Industry Analysis Division, Common Carrier Bureau, Federal Communications Commission, Released March 2000, Table 9.1.
[34] Trends in Telephone Service, Industry Analysis Division, Common Carrier Bureau, Federal Communications Commission, Released March 2000, Table 9.4.

[35] Trends in Telephone Service, Industry Analysis Division, Common Carrier Bureau, Federal Communications Commission, Released March 2000, Table 9.3.

1 lines in the United States.[36] These two companies are SBC (which consists of the former
2 Bell operating companies of SBC, Pacific Bell, and Ameritech), and the other company is
3 Verizon (which includes the former GTE and Bell operating companies, Bell Atlantic and
4 NYNEX).
5
6 Q. WHAT IS A MAJOR PROBLEM WITH DECLARING WIRE CENTERS TO BE
7 COMPETITIVE WHEN IN FACT THEY ARE NOT COMPETITIVE, AND USWC
8 STILL HAS SIGNIFICANT MONOPOLY MARKET POWER IN THOSE
9 EXCHANGES?
10 A. Under USWC's proposals, USWC could increase its rates as much as it wanted to, up to
11 double the current rates.[37] Even in areas where it has significant monopoly power, the
12 approval of this concept would allow the Company to as much as double most of its
13 current rates. As previously discussed, this would impact a high percent of the customers
14 in the State. In most instances, those customers do not have any independent alternative
15 provider available.
16
17 Q. IN HIS DIRECT TESTIMONY, MR. TEITZEL TRIES TO DEMONSTRATE THE
18 COMPETITION THAT USWC IS EXPERIENCING IN ARIZONA BY ATTACHING
19 SEVERAL EXHIBITS SHOWING PRICES THAT OTHER COMPANIES ARE
20 CHARGING FOR CERTAIN SERVICES. DO YOU HAVE ANY COMMENT
21 ABOUT THESE EXHIBITS?

[36] Table 20.3 "Telephone Loops by Holding Company", Trends in Telephone Service, March, 2000.
[37] Except for the $19 limit on residential basic exchange.

1 A. Yes. Mr. Teitzel's exhibits focus primarily on services for which USWC has already
2 been granted price flexibility in Arizona. For example, on his Exhibit DLT-5, Mr. Teitzel
3 has provided a copy of a price quote from an AT&T account executive to a USWC
4 business customer that compares the rates that the customer would pay under USWC's
5 rates and the rates the customer would pay under AT&T's rates. Over 70% of the saving
6 that the customer is shown to experience under the AT&T rates compared to the USWC
7 rates, is attributed to lower Centrex rates. As Mr. Teitzel indicates on page 19, line 23 of
8 his Direct Testimony, Centrex is a service that has already been deemed to be
9 "competitive" on a state-wide basis by the Commission. On his Exhibit DLT-17, Mr.
10 Teitzel has provided copies of toll service advertisements of three different companies.
11 However, message toll service (MTS) is a service that has already been deemed to be
12 "competitive" on a state-wide basis by the Commission.[38] Therefore, the evidence that
13 USWC has provided that demonstrates competition for services that have already been
14 deemed to be "competitive" services in Arizona, does nothing to demonstrate a need to
15 adopt USWC's "competitive zone" proposals. At most, all that this evidence supports is
16 maintaining the current competitive classification of these services in Arizona, which is
17 not at issue.
18
19 Q. DOES PAST EXPERIENCE INDICATE THAT USWC'S CLAIMS PERTAINING TO
20 THE LEVEL OF COMPETITION SHOULD BE REVIEWED VERY CAREFULLY?
21 A. Yes. Although this Commission has already designated the toll market as competitive,
22 and I am not rearguing that classification, USWC's own testimony can be used to
23 demonstrate the inaccuracy of USWC's market share claims. Back in USWC's 1993

[38] Page 19, Teitzel Direct.

General Rate Case in Arizona, USWC claimed that the intraLATA toll market was "very competitive", that other toll providers had made "significant inroads" and that USWC had lost intraLATA toll market share.[39] USWC's intraLATA toll witness in the 1993 case stated:

> USWC has lost 19% of the Arizona small business toll market and over 7% of the Arizona residence market based on minutes of use.[40]

However, in its testimony in this proceeding, USWC's witness Alcott states:

> As recently as 1996 U S WEST had virtually 100 percent of this market. U S WEST's share of this market has decreased significantly since that time, as the proprietary figures contained in Dave Teitzel's testimony demonstrate.[41]

The above referenced quote, Mr. Alcott states USWC had "virtually 100%" of the intraLATA toll market as recently as 1996. However, several years prior to 1996, USWC had claimed that competitors already had 7% to 19% of the toll market share. These two sets of USWC testimony are inconsistent. It is clear that either Mr. Alcott's testimony in this proceeding, or the USWC witness in the 1993 proceeding, or both, are misstating the market share of USWC.

Q. USWC IS CURRENTLY REQUESTING THAT 23 RESIDENTIAL WIRE CENTERS BE DESIGNATED AS COMPETITIVE ZONES. IF THEIR TARIFF WAS

[39]Direct Testimony of Gary A. Rees in Arizona Docket No. E-1051-93-183, July 15, 1993, page 22.

[40]Direct Testimony of Gary A. Rees in Arizona Docket No. E-1051-93-183, July 15, 1993, page 21.

[41]Alcott Direct Testimony, page 13, line 15.

ACCEPTED, WOULD THEY BE ABLE TO CONVERT A NUMBER OF OTHER WIRE CENTERS TO COMPETITIVE ZONES?

A. Yes. The requirements are so lax that there are a large number of other wire centers that would also meet their requirements for being defined as a "competitive" zone. Exhibit DLT-41 attached to Mr. Teitzel's Supplemental Direct Testimony lists ** ** wire centers with resold residential services in March, 2000. Under USWC's proposal, the presence of any reseller reselling any residential service causes that wire center to meet the definition of being a "competitive" residential wire center. Therefore, all ** ** of these wire centers could be reclassified as competitive according to USWC's proposed tariff. This same Exhibit also shows a large number of wire centers that have some resold business services. Therefore, a large number of wire centers in addition to those USWC is currently asking be immediately declared competitive could readily be reclassified as competitive under USWC's proposal.

D. ONE OF USWC'S CLAIMED "PRIMARY COMPETITORS" IN ARIZONA HAS DECLARED BANKRUPTCY, AND OTHERS ARE LOSING MONEY

Q. USWC HAS LISTED SOME "PRIMARY COMPETITORS" IN ARIZONA.[42] PLEASE COMMENT.

A. One company Mr. Teitzel listed as a "primary competitor" is GST Telecommunications. However, since the filing of Mr. Teitzel's testimony in this proceeding, GST has since

[42] Teitzel Direct, page 6.

filed for Chapter 11 bankruptcy protection.[43] The GST shareholders likely will be left holding an empty bag after the sale of its assets:

> ...because the current sale offer is for substantially less than the amount of GST's debt, a distribution to shareholders is unlikely.[44]

As Mr. Teitzel explains in his testimony, GST established operations in Tucson back in 1994.[45] However, GST has been experiencing financial woes for some time. For example, for the nine months ended September 1999, GST suffered a net loss of over $103 million on total revenues of $225 million. In discovery in this proceeding, USWC provided a copy of its own internal study report that aptly described GST as having "poor cash flow."[46] One of the causes of the GST bankruptcy was GST's inability to "secure other financing."[47]

Q. ON PAGE 15 OF HIS DIRECT, MR. TEITZEL CLAIMS THAT e.SPIRE IS A PRIMARY COMPETITOR TO USWC. ON PAGE 17 OF HIS SUPPLEMENTAL DIRECT, MR. TEITZEL INDICATES THAT e.SPIRE'S REVENUES INCREASED FROM $156.8 MILLION IN 1998 TO $244 MILLION FOR THE YEAR ENDING

[43] Telecommunications Reports, "Time Warner Telecom Sees Opportunity in GST Woes", May 22, 2000, page 23.

[44] Posted on the GST website according to published reports.

[45] Teitzel Direct Testimony, page 14, line 23.

[46] USWC's response to Data Request RUCO 6-8, Attachment A.

[47] Telecommunications Reports, "Time Warner Telecom Sees Opportunity in GST Woes", May 22, 2000, page 23.

1 DECEMBER 31, 1999. WHAT DOES MR. TEITZEL FAIL TO POINT OUT ABOUT
2 e.SPIRE?
3 A. Mr. Teitzel fails to mention the fact that e.spire's net loss for the year ended December,
4 1999 was larger than its total revenues for the year. For the year ended December 31,
5 1999, e.spires's total revenues were $244 million and its net loss for the same period was
6 $277 million. In addition, as a result of these astounding losses, e.spire's reported annual
7 earnings worsened from a negative $4.46 per share for the fiscal year ending December
8 1998 to a negative $6.38 per share for the fiscal year ending December 31, 1999.[48]
9
10 Q. MR. TEITZEL LISTS ELECTRIC LIGHTWAVE, INC. (ELI) AS ONE OF THE
11 PRIMARY COMPETITORS TO USWC IN ARIZONA. PLEASE COMMENT.
12 A. As Mr. Teitzel explains, ELI who "turned up its network in 1994" was one of the first
13 competitors in the greater Phoenix area.[49] However, in just the nine months ended
14 September 1999, ELI suffered a staggering net loss of $98 million on total revenues of
15 $133 million.
16
17 As previously discussed, it is in the LECs' interest to have their competitors be
18 unprofitable. As previously discussed, the "competitive zone" proposal of USWC would
19 allow USWC to improperly price discriminate based on the level of competition. This

[48]Mr. Teitzel lists other competitors, such as AT&T/TCG, MCI WorldCom/Brooks Fiber and COX. However, the financial reports for these companies do not separately show the financial performance of the competitive local exchange services these companies provide. For example, the primary business of AT&T and MCI is the provision of long distance toll services, and COX is mainly a provider of cable television services.

[49] Teitzel Direct, page 10.

would give them a powerful additional tool to further impede the profitability of any existing competitors, and to discourage any potential competitors.

Q. THROUGHOUT HER TESTIMONY, MS. STEWART EMPHASIZES HOW "WELL-FUNDED" SOME OF USWC'S COMPETITORS ARE.[50] EVEN IF THERE ARE SOME COMPANIES THAT ARE "WELL-FUNDED", DOES THIS MEAN THAT THESE COMPANIES WILL CONTINUE TO PROVIDE SERVICES IN COMPETITION WITH USWC, EVEN IF THEY ARE CONTINUALLY LOSING MONEY DOING SO?

A. No. It is not reasonable to expect that since a company is "well-funded", that company will continue to lose money attempting to compete with USWC. At some point, these services must be profitable, or else it is not likely that there will be competitors entering this market in the future.

Q. IN HIS TESTIMONY, MR. ALCOTT STATES:

> However, what we are seeing now is that competition is emerging in specific geographic areas within the state. It starts in one part of town and grows from there.[51]

PLEASE COMMENT.

A. To the extent that USWC or other LECs are successful in limiting the profitability, or forcing the competitors to be unprofitable, that limits their ability to grow and expand competition against USWC and other LECs. The "competitive zone" proposal of USWC

[50]For example, see Stewart Direct Testimony, pages i, iii, 4, 7 and 17.

[51]Alcott Direct Testimony, page 10, line 24.

is a powerful, additional tool that USWC could use to limit the profitability and therefore the growth of competitors, and also to discourage potential competitors.

Q. ON PAGE 36 OF HIS DIRECT, MR. TEITZEL CLAIMS THAT THERE IS NO MARKET FOR RESIDENTIAL BASIC EXCHANGE SERVICE COMPETITION, BECAUSE THE PRICES THAT USWC CHARGES ARE TOO LOW. PLEASE COMMENT.

A. Of course, as Schedule WDA-16 shows, there is also very little competition in the business markets either. First of all, competitors evaluate the total revenue opportunities, not just the revenues from only one service (basic exchange). For example, nationwide the average residential telephone bill is $55 per line per month. The bill for basic exchange service is only approximately 25% of that total.[52] A company considering offering service to a residential area would consider the revenues they would expect to receive from all services, including enhanced services, toll services, basic exchange service, switched access services to other carriers, etc. In addition, Mr. Teitzel states:

> Cox is already providing residential telephone service to over 5,000 residents of Chandler, with the potential to serve 40,000 additional subscribers there and plans to ultimately offer telephone service to all of its 600,000 subscribers in Phoenix and surrounding communities. Cox's efforts illustrate that the residential market is not immune to competition.[53]

[52] Household Telecommunications Expenditures by Type of Provider in 1998, Table 3.6, FCC Reference Book of Rates, Price Indices, and Expenditures for Telephone Service, June, 1999. The average residential rates paid directly to the LECs average $33 per month.
[53] Teitzel Direct Testimony, Page 5, lines 8-12.

1 Q. WHAT ARE THE "FLOOR" AND "CEILING" UNDER USWC'S COMPETITIVE

2 ZONE PROPOSAL COMPARED TO THE CURRENT COMMISSION RULES?

3 A. USWC's "competitive zone" proposal is a great departure from the Commission's rules on

4 both ends of the range of acceptable rates. Under Section R14-2-1109(A) of the

5 Commission's Rules, the minimum rate that USWC may charge for a competitive service

6 is USWC's total service long run incremental cost (TSLRIC) of the service.[54] However,

7 under USWC's proposal, the minimum rate for any service within "competitive zones"

8 can be set below the TSLRIC of providing the service, as Mr. Teitzel explains:

9 Prices for specific services may be offered below Total Service Long Run
10 Incremental Cost (TSLRIC) in competitive zones only as long as the total revenue
11 for the customer or group of customers is above TSLRIC.[55] (Emphasis added)
12
13 USWC's ability to set the rates so that the total for all services are not below the TSLRIC

14 would make it even more difficult for competitors to cover their costs.

15

16 It must also be remembered that in order to be profitable, competitors must cover not

17 only their TSLRICs, but also their joint and common costs as well. Mr. Thompson states:

18 U S WEST must price its services to recover the common overhead costs in
19 addition to its Total Direct and Network Support costs to remain a healthy, viable
20 and growing corporation that can continue to invest in new products and services.
21 If the firm can not receive contribution from products to help recover these
22 overhead costs, the products are not likely to be offered by the firm.[56]
23

24 The same principle also applies to USWC's competitors. Current rules require the price

25 for a "competitive" service cannot be below its TSLRIC. However, under the proposed

26 rules, the price could be below its TSLRIC. Therefore, if a customer was subscribing to a

[54] Teitzel Direct, page 31.
[55] Teitzel Direct, Page 20, lines 7-9.

profitable service, the contribution from that profitable service could be diverted to another " below cost" service, thereby further eliminating the ability of a competitor to cover their joint and common costs in those areas where they are trying to compete with USWC.

For competitive services, the Commission's current rule that the maximum rate USWC may charge is the maximum rate stated in its tariff on file with the Commission. Mr. Teitzel states the new proposal is:

> The price ceilings will be double the rates approved in this filing; or for services not treated in this case, double the existing rates, except for residence Basic Exchange Service. Residence Basic Exchange Service will have a maximum rate of $19.00 established within competitive zones. In the case of services already classified as 'competitive' on a state-wide basis, the maximum rates will also apply outside of the competitive zones.[57]

Instead of the maximum being the existing tariff rate, under the USWC proposal the maximum would be double the existing tariff rate.

The fact that many of the customers would actually have no effective choice in these areas makes this potential "doubling" of the rate, less acceptable.

[56] Thompson Direct, page 7.
[57] Teitzel Direct, Page 20, lines 11-16.

E. USWC'S "COMPETITIVE ZONE" PROPOSAL WOULD ALLOW USWC TO VIOLATE SECTION 254(K) OF THE TELECOMMUNICATIONS ACT

Q. DID THE AUTHORS OF THE TA96 ANTICIPATE THAT LECS WOULD RESPOND TO COMPETITION BY ATTEMPTING TO USE THEIR NON-COMPETITIVE SERVICE RATES TO SUPPORT COMPETITIVE SERVICE RATES?

A. Yes. The authors of TA96 anticipated that LECs like USWC would respond to competition by attempting to use their non-competitive services to support their rates for competitive services. The authors of TA96 also correctly anticipated the LECs would justify this support by allocating "more than a reasonable share of the joint and common costs of facilities used to provide those services", to the non-competitive services. The authors of TA96 anticipated this strategy by the LECs, and specifically prohibited it:

> Section 254(k)--SUBSIDY OF COMPETITIVE SERVICES PROHIBITED.--A telecommunications carrier may not use services that are not competitive to subsidize services that are subject to competition. The Commission, with respect to interstate services, and the States, with respect to intrastate services, shall establish any necessary cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services.

Q. IF APPROVED BY THE COMMISSION, WOULD USWC'S "COMPETITIVE ZONE" PROPOSAL ALLOW USWC TO VIOLATE SECTION 254(K) OF THE TELECOMMUNICATIONS ACT OF 1996?

A. Yes, in at least two ways:

1. USWC would be able to shift the recovery of joint and common costs away from competitive services, and onto monopoly ratepayers across geographic areas of the state.

Under USWC's proposal, USWC would be allowed to charge higher rates for a service in areas that are subject to little or no competition and lower rates for that service where competition does exist. As Mr. Teitzel explains:

> Offerings and prices may vary between competitive zones. With this flexibility, U S WEST will be able to effectively respond to customer and market demands in the areas subject to competition.[58]

This difference in pricing would not have to reflect a difference in cost of providing service. Therefore, pricing lower where there is competition while pricing higher where there is not competition would effectively load a higher share of the joint and common costs onto the monopoly ratepayers, while loading a lower share of those joint and common costs onto the prices of competitive services. This is contrary to the requirements of Section 254(k). The Commission must establish cost allocation rules or other safeguards which prevent such a discriminatory recovery of the joint and common costs.

2. USWC would be able to subsidize competitive services across individual services or customer groups.

USWC proposes that for those wire centers that meet USWC's criteria to become a "competitive zone" for both residence and business customers, all of the services will be allowed pricing flexibility, as Mr. Teitzel explained in his Direct Testimony.[59]

[58]Teitzel Direct, Page 19.

With the ability to drastically change prices for both business and residence services within a wire center, USWC would easily be able to drastically reduce rates for one service or customer class but increase rates of another service or customer class, depending upon the level of competition that existed for each of those services or customer classes.

The result is USWC would easily be able to place an unreasonable share of joint and common costs on those services or customer groups within the wire center that are subjected to very little or no competition. They could use this to fund reductions in the rates for those services that USWC deemed to be competitive or at least potentially competitive.

Q. WHAT DO YOU RECOMMEND?

A. First of all, I recommend that the competitive zone proposal of USWC be rejected. In addition, in any alternative regulatory structure adopted by the Commission, the Commission should include a rule that requires any "revenue neutral" restructure include residential rates that are revenue neutral only within the residential category. Any "revenue neutral" restructure of the business rates must be revenue neutral within the business category. If there is no such requirement, USWC could reduce the business rates, (if it believes it has more competition there), and offset that by increasing the rates where it has less competition, which may include residential rates. This requirement

[59]Teitzel Direct, page 19, lines 34-36.

1 would apply to all services other than those that the Commission has determined to be
2 truly competitive.
3
4 In addition, any rate structure adopted by the Commission should include reasonable
5 proposals to prevent an unreasonable share of the joint and common costs from being
6 allocated to the universal services.
7
8 **F. NEW SERVICE OFFERINGS**
9
10 Q. WHAT CRITERIA WOULD NEW SERVICE OFFERINGS HAVE TO MEET
11 BEFORE THEY ARE CLASSIFIED AS COMPETITIVE, UNDER USWC'S
12 PROPOSAL?
13 A. None. Under Mr. Teitzel's proposal, any new service offering USWC provides in the
14 future, even outside of a wire center that has been classified as a "competitive zone" will
15 be automatically classified as competitive, without having to demonstrate that any
16 competition whatsoever exists for that service. Mr. Teitzel states:
17 I am proposing that a streamlined process be adopted whereby all new services
18 will automatically be classified as 'competitive' upon introduction.[60]
19
20 My experience in other states has been that the companies will slightly modify or
21 combine existing services, and claim that this is a "new" service that is therefore
22 competitively priced. For example, if an LEC combines basic exchange service with a
23 new feature that it is not currently combined with, they would argue that is a new service,

[60]Teitzel Direct, Page 23, lines 15-16.

and therefore competitively priced. This wording could open a large "loophole", which USWC could use to have virtually any service considered "competitive", simply by creating a slightly modified form of it. It should be noted that even if the original form of the service was still available in the tariffs, that provides little protection to the consumers, since most consumers do not read the tariff to find out what service options are available. Most customers instead contact the USWC service representatives.

To be deemed truly competitive, new services should have to pass the same competitive test that other services must pass. If a "new" service includes a service that is currently not classified as competitive, that "new" service clearly cannot be classified as competitive. Likewise, I recommend that in any alternative regulatory structure adopted, the new services be subject to the same treatment of price caps as are existing regulated services, unless USWC provides the information needed to demonstrate that they are truly competitive services under Article 11, R-14-2-1108.

G. USWC'S PROPOSED TIME FRAME FOR CONSIDERING ITS FILINGS TO CLASSIFY A WIRE CENTER AS A "COMPETITIVE ZONE" IS NOT REASONABLE

Q. WHAT TIME FRAME DOES MR. TEITZEL PROPOSE FOR CHANGING A ZONE CLASSIFICATION TO "COMPETITIVE?"

A. Mr. Teitzel proposes that the Commission must object to USWC's proposal within 15 days, or the area will automatically become a "competitive zone." If objections are

raised, the Commission must issue a formal notice of the objection, and the entire process would be considered within 60 days of USWC's notice.[61]

Q. IS MR. TEITZEL'S PROPOSAL REASONABLE?

A. No. The proposed time frame for considering USWC's proposals is not acceptable. It is not reasonable to expect that any party or the Commission would have sufficient time to evaluate a USWC claim of competitiveness in a 15 day or even a 60 day period.

Q. MR. TEITZEL PROPOSES CHANGES IN THE REQUIREMENTS PERTAINING TO PROMOTIONAL OFFERINGS.[62] PLEASE COMMENT.

A. USWC should be required to make promotional offerings available on a non-discriminatory basis to customers throughout the state. For example, USWC should not be allowed to discriminate on the promotional offerings based upon the level of competition that exists in a particular area, for the reasons previously discussed.

III. USWC'S COST STUDIES

A. USWC'S CLAIMED TSLRIC COST FOR RESIDENTIAL BASIC EXCHANGE SERVICE VIOLATES THIS COMMISSION'S DEFINITION OF TSLRIC, AS WELL AS USWC'S OWN DEFINITIONS OF TSLRIC

Q. HOW DOES USWC DEFINE TSLRIC COSTS IN THIS PROCEEDING?

A. In his Direct Testimony, Mr. Thompson defines TSLRIC:

> The TSLRIC studies identify the total cost of offering the service - defined as the total costs incurred by U S WEST while offering the service, less the total costs

[61] Teitzel Direct, page 22.
[62] Teitzel Direct, page 24.

that would be incurred by U S WEST if the service were not offered.[63] (Emphasis added)

In addition, USWC's cost studies in this proceeding provide a definition of "Direct Costs", which it also refers to as TSLRIC. The USWC cost studies state the following:

> **Total Direct Costs** – Total Direct cost is the total forward-looking direct cost of providing a product or service to the total universe of U S WEST Customers. It most closely reflects the cost of replacing all the facilities directly required to provide that product or service. It does not include costs that are required but which also benefit the provision of other products and services. It reflects the forward-looking cost of the entire service provided in the most efficient manner, holding constant the production of all other services produced by the firm. This cost has frequently been referred to as TSLRIC.[64] (Emphasis added)

Q. HOW DOES THIS COMMISSION DEFINE TSLRIC COSTS?

A. The definitions section of the Arizona Corporations Commission's Rules and Regulations, Section R14-2-1102 (17), provides the following definition:

> **"Total Service Long Run Incremental Cost."** The total additional cost incurred by a telecommunications company to produce the entire quantity of a service, given that the telecommunications company already provides all of its other services. Total Service Long run Incremental Cost is based on the least cost, most efficient technology that is capable of being implemented at the time the decision to provide the service is made.

The definition of the incremental cost or TSLRIC is addressed further in the Direct testimony of Thomas Regan.

[63]Thompson Direct Testimony, page 4, line 23.

[64]Thompson Direct Testimony Exhibit JLT-1, page 7.

1 Q. DID USWC VIOLATE THE COMMISSION'S DEFINITION AND ITS OWN
2 DEFINITION OF TSLRIC WHEN IT CALCULATED THE TSLRIC COSTS OF
3 BASIC EXCHANGE SERVICE IN THIS PROCEEDING?
4 A. Yes. The loop is shared by many services, as shown on Schedule WDA-17. However,
5 USWC included 100% of the unseparated loop cost in what it claims to be the basic
6 exchange TSLRIC.[65] However, the loop facilities are required for the provision of other
7 products and services. The loop facilities would not be eliminated if basic exchange
8 service was discontinued, while all other services were still being offered. Therefore, the
9 loop cost is not part of the properly calculated TSLRIC using any or all of the above-
10 referenced definitions. It is an indisputable physical fact that the loop facility is shared
11 by several services, only one of which is basic exchange service. It is an indisputable
12 physical fact that the loop facility would still be needed even if basic exchange service
13 was not provided, but USWC continued to provide all of its other services. This means
14 the loop costs are not "caused" by basic exchange service alone.
15
16 Q. PLEASE EXPLAIN SCHEDULE WWD-17.
17 A. Schedule WWD-17 is a diagram that shows some of the facilities that are required to
18 provide USWC's major services: basic exchange service, vertical services, toll switched
19 access, and ADSL service. As the diagram clearly indicates, a loop facility[66] is required
20 to provide all of these services.
21

[65] Thompson Direct, Exhibit JLT-27, page 7.
[66] The "loop" I am referring to is the switched access line as opposed to a dedicated private line.

1 In fact, the loop is sometimes referred to as the "common line" because it is a facility that
2 is "common" to a number of services.[67]
3
4 Q. USWC'S DEFINITION OF "DIRECT COSTS" CLAIMS THAT "COSTS THAT ARE
5 REQUIRED BUT WHICH ALSO BENEFIT THE PROVISION OF OTHER
6 PRODUCTS AND SERVICES" ARE NOT INCLUDED IN THAT COST. DID USWC
7 FOLLOW ITS OWN COST STUDY PRINCIPLE IN ITS RESIDENTIAL BASIC
8 EXCHANGE SERVICE COSTS STUDY?
9 A. No. By far the most significant of the "costs that are required but which also benefit
10 other products and services" are the loop facilities costs. As Schedule WDA-17 clearly
11 demonstrates, the loop facility "benefits" services other than basic exchange service. All
12 services that are provided using the loop facilities not only benefit from, but also depend
13 upon the loop facilities.
14
15 Q. HOW DID USWC TREAT THE COST OF THE SHARED LOOP FACILITIES?
16 A. USWC placed 100% of the loop facility costs on basic exchange service. USWC placed
17 none of the loop costs on any other service that also utilizes or "benefits" from the loop
18 facility. As shown on Thompson Direct Testimony Exhibit JLT-27, page 7, USWC
19 included 100% of the costs of the loop in the "Direct Cost" of residential basic exchange
20 service - a direct violation of their claimed principle.
21

[67] The costs that are shared by more than one service are sometimes referred to as terms such as "joint", "common", or "shared." In this discussion, I will use these terms interchangeably.

1 Q. DID USWC LIKEWISE VIOLATE THE TSLRIC DEFINITIONS WHEN IT
2 CALCULATED THE COSTS OF ALL SERVICES?
3 A. No. USWC's violation of the TSLRIC definition was "selective." Although USWC
4 violated the definition of TSLRIC for residential basic exchange service, USWC did not
5 make that violation when it calculated its claimed TSLRIC costs of toll and switched
6 access services. When calculating the TSLRIC of toll and switched access services,
7 USWC properly excluded the loop costs, since the loop costs would not be avoided if one
8 of these services were discontinued while holding all other products or services offered
9 by the firm constant.[68] The result of this selective violation of the TSLRIC definition by
10 USWC is to distort beyond recognition the actual contributions from each of the different
11 services. By properly excluding the loop cost from the TSLRIC of toll and switched
12 access, USWC calculated a very low cost and therefore a high contribution.
13
14 Q. WHAT WOULD USWC'S TSLRIC OF RESIDENTIAL BASIC EXCHANGE
15 SERVICE HAVE BEEN IF USWC HAD CALCULATED THE COST OF THAT
16 SERVICE CONSISTENTLY WITH THE WAY IT CALCULATED THE TSLRIC OF
17 SWITCHED ACCESS AND TOLL?
18 A. Had USWC also properly excluded the loop cost from the TSLRIC of residential basic
19 exchange service (the same as if they excluded those costs from the TSLRIC of toll and
20 access), the result would have also been a low TSLRIC and a high contribution for
21 residential basic exchange service. Excluding the loop cost (which is how USWC
22 calculated the TSLRIC for toll and switched access), the TSLRIC of USWC's residential

[68]USWC's response to Data Request WDA 1-35.

basic exchange service is ** ** per month, using the costs otherwise exactly as calculated by USWC, as is shown on Schedule WDA-18.[69] [70]

Q. WHAT RATE DOES RESIDENTIAL BASIC EXCHANGE SERVICE HAVE TO BE SET ABOVE IN ORDER TO PREVENT IT FROM BEING SUBSIDIZED?

A. The properly calculated TSLRIC of residential basic exchange service is ** ** per month for USWC. Determining the TSLRIC is important because the TSLRIC is generally accepted as being the "floor" for a proper price. TSLRIC is also the standard for determining whether a service is receiving a subsidy, as discussed in the Direct testimony of Thomas Regan. As USWC admitted in its response to Data Request WDA 2-006, a service is not receiving a subsidy if that service is priced equal to or above its properly calculated TSLRIC.

Data Request WDA 2-6 (b):

> Is it a correct statement that if a service is priced equal to or above its properly calculated TSLRIC, that service is not receiving a subsidy? If this is not a correct statement, please provide the corrected statement, as well as copy of the economic, regulatory or other standard that your Company claims supports the corrected statement provided..

USWC's Response:

> It is not receiving a cross-subsidy.

[69] Calculated from USWC's May 2000 Residence and Business Basic Exchange Recurring Cost Study, provided by USWC in response to Data Request WDA 21-6, Attachment A, pages 25 and 31 (The figure shown is the sum of the Total Direct Costs "TSLRIC" for, Local Usage, Directory Listing and Billing & Collections for an additional residence line).

[70] This figure also excludes the cost of the first unit of postage and standard envelope, as will be discussed later in this testimony.

1 Therefore, as long as residential basic exchange service is priced above ** **, it is
2 not receiving a subsidy using the widely accepted economic principles, principles which
3 even USWC has agreed are the correct and appropriate economic principles.
4
5 **B. CONTRIBUTION ANALYSIS**
6
7 Q. IF THE SHARED COSTS ARE NOT INCLUDED IN THE TSLRIC, HOW ARE
8 THOSE COSTS RECOVERED?
9 A. Services are priced above their TSLRIC so as to recover both the direct (TSLRIC) cost as
10 well as a portion of the shared cost. This is a common practice in virtually all industries.
11 For example, consider a restaurant where the rent for the building is $10,000 per month,
12 and the incremental cost of each hamburger and each soft drink is 30¢.[71] The company
13 cannot price its products at just their incremental cost of 30¢, because that would not give
14 them funds to pay the rent. Therefore, they must price above the incremental cost, so as
15 to cover the total cost, which includes both the direct cost (TSLRIC) as well as the fixed
16 costs (i.e. rent). Even in highly competitive markets, the equilibrium pricing must be a
17 price that covers the total cost of the efficient producers, which includes the incremental
18 cost as well as the shared costs.
19
20 Q. YOU PREVIOUSLY STATED THAT THE CORRECT TSLRIC (DIRECT) COSTS
21 EXCLUDE THE COST OF THE SHARED FACILITIES. HAVE YOU CONDUCTED
22 AN ANALYSIS OF USWC'S MAJOR RESIDENTIAL SERVICE CATEGORIES

[71] In this example, I am assuming these are the only two products the restaurant sells. The principle is the same if more products are sold.

WHICH SHOWS HOW MUCH EACH OF THEM CONTRIBUTES (REVENUES IN EXCESS OF DIRECT COSTS) TO THE SHARED COST OF USWC?

A. Yes. Schedule WDA-19 is a contribution analysis that shows the actual level of contribution above TSLRIC that is currently being provided by each of these USWC major residential service categories. It also compares the contribution amounts for residential services to the unbundled loop rate that the ACC has established for USWC. The figures shown on this Schedule are "contributions." These contributions are calculated by taking the revenues for each service and deducting from that the direct cost (TSLRIC) of each service.

Q. WHAT DOES THE STAFF'S CONTRIBUTION ANALYSIS DEMONSTRATE?

A. Staff's contribution analysis demonstrates the following:

1. The current residential basic exchange service rates alone provide an average of ** ** per line, per month in contribution above TSLRIC toward the shared, joint and common costs of USWC in Arizona. This is more contribution above TSLRIC than any other service which shares the residential loop facilities. The per-line, per-month contributions from each major service category are as follows:

Intrastate	Per-Line, Per-Month Contribution (Revenue - TSLRIC)
1FR Service	** **
Residential Vertical Services	**$ **
Total Residential Local Services	**$ **
Intrastate Switched Access	**$ **
Intrastate Toll	**$ **
Interstate	
Interstate EUCL/SLC	**$ **
Interstate PICC	**$ **
Interstate CCLC	**$ **
Total Residential Contribution to Shared/Joint/Common	**$ **

2. Residential basic exchange service alone provides approximately ** ** the per-line contribution that USWC's intrastate switched access provides, and over ** ** the per-line contribution that USWC's intrastate toll services provide toward the shared, joint and common costs of USWC in Arizona.[72]

3. The unbundled loop rate that the Commission approved for USWC is $21.98. Under the FCC's Part 36 Separations requirements, 25% of the loop costs are allocated to the interstate jurisdiction and recovered in interstate rates. Therefore, the intrastate portion of the loop rate is $16.49 per month.[73] The contribution above TSLRIC provided by residential local services alone (including charges for basic exchange service and vertical services) is ** ** per line, per-month. Therefore, the contribution from residential local services alone covers over ** ** of the intrastate portion of the unbundled loop rate the Commission has established for USWC in Arizona.[74]

4. The discussion in Item 3 does not even include the additional ** ** per line, per month for the interstate EUCL charge (average of primary and additional line EUCL rate) that residential end users also must pay in order to obtain basic exchange service.[75]

Residential basic exchange service is currently contributing more toward the recovery of the joint, shared and common costs of providing telecommunications services in Arizona than is toll, switched access, or even vertical services.

---

[72] ** **

[73] $21.98 x 75% = $16.49.

[74] This contribution is conservative. I have used the UNE loop "rate" as if it were the loop "cost." But the UNE loop rate already contains a 15% contribution to USWC's overhead costs and attributed joint and common costs. (See ACC Decision 60635, page 13, dated January 30, 1998, Docket No. U-3021-96-448 et al.) Therefore, the contribution to shared costs is even higher than the figure stated above and shown on Schedule WDA-19.

[75] This uses the rates that applied during the test year. I have not adjusted this for any increase in the interstate EUCL charge that may have occurred since that time.

C. COSTS ARE NOT "CAUSED" SOLELY BY BASIC EXCHANGE SERVICE

Q. ARE THE LOOP COSTS "CAUSED" SOLELY BY BASIC EXCHANGE SERVICE?

A. No. Some parties argue that the end user or basic exchange service directly causes the cost of basic exchange service, because it is the end user that orders telephone service. However, the major investment-related costs of the loop facilities were actually incurred as a result of the telephone company's decision to install those facilities. That decision was directly made by a telephone executive. The telephone executive's decision to incur the loop investment cost was not based solely on the desire to obtain basic exchange service revenues, but instead was based on the desire to obtain the whole family of telephone revenues that the loop facility would make possible. The average residential telephone bill per line is $55 per month nationwide. The bill for basic exchange service is only approximately 25% of that total.[76] A rational telephone company executive would consider the entire family of revenues that would be generated by installing those facilities as part of the decision to install them. There is no evidence that as part of this decision, the revenues derived from the loop facilities for services other than basic exchange service are ignored. No rational analysis would ignore those revenues. Some of the revenues generated are not even revenues received from the end user. For example, an IXC terminating an interstate toll call at that location pays USWC switched access charges for the use of the loop facility to terminate toll traffic. The payment for that is received from the IXC.

[76] Household Telecommunications Expenditures by Type of Provider in 1998, Table 3.6, FCC Reference Book of Rates, Price Indices, and Expenditures for Telephone Service, June, 1999. The average residential

1 Dr. Wilcox, in her testimony in this proceeding, correctly states that the companies
2 consider more than just basic exchange revenues when they examine a particular
3 customer. They also consider switched access revenues. Dr. Wilcox states:

4 Each time U S WEST loses an existing or potentially new end-user customer to a
5 facilities-based competitive local service provider, the Company also loses the
6 ability to collect switched access charges for long distance calls going to and from
7 that end-user.[77]
8
9 and;
10
11 Quite simply, there is direct impact because the carrier that supplies local
12 exchange service to a given end-user customer also controls the switched access
13 to that customer.[78]
14

15 The concept that USWC, or other companies, would consider only basic exchange
16 service revenues when evaluating a particular customer location is incorrect, and is
17 contrary to Dr. Wilcox's above statements. In addition, when a customer orders
18 telephone service, they are not ordering just basic exchange service. They receive toll
19 service, and a variety of other services all at the same time.
20
21 Q. IS THERE AN ACCEPTED TEST TO DETERMINE WHETHER A COST IS
22 "CAUSED" BY ONE SERVICE?
23 A. Yes. As USWC admitted in discovery, if a company does not avoid certain costs in the
24 long run when a service in question is eliminated (or not offered), while holding constant
25 the production of all other services produced by the Company, those costs which are not

---

rates paid directly to the LECs average $33 per month.
[77]Wilcox Direct Testimony, page 29, line 23.

[78]Wilcox Direct Testimony, page 11, line 3.

eliminated if the service in question is eliminated are not properly considered to be "caused" by the provision of that service in question.[79]

As can be seen from the diagram on Schedule WDA-17, if USWC eliminated basic exchange service, while continuing to provide all other services which it currently provided, that would not eliminate the need for the loop facility. Therefore, the loop cost is not "caused" entirely by basic exchange service, but instead is caused by a whole family of services that share the loop facility.

D. USWC'S INCLUSION OF 100% OF THE LOOP COST ON RESIDENTIAL BASIC EXCHANGE SERVICE (WHILE PLACING NONE OF IT ON THE OTHER SERVICES THAT SHARE THE LOOP FACILITIES) VIOLATES THE REQUIREMENTS AND FINDINGS OF THE TELECOMMUNICATIONS ACT OF 1996 (TA96), THE FCC, THE U.S. SUPREME COURT AND THE COMMISSIONS IN THE VAST MAJORITY OF OTHER STATES

Q. DOES USWC'S RESIDENTIAL BASIC EXCHANGE COST STUDY IN THIS PROCEEDING VIOLATE TA96?

A. Yes. Section 254(k) states:

> Section 254(k)--SUBSIDY OF COMPETITIVE SERVICES PROHIBITED.--A telecommunications carrier may not use services that are not competitive to subsidize services that are subject to competition. The Commission, with respect to interstate services, and the States, with respect to intrastate services, shall establish any necessary cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services.

[79] USWC response to Request WDA 2-007.

In this proceeding, USWC is placing 100% of the shared loop facility costs on basic exchange service, while proposing a "free ride" on those same facilities for toll, switched access, and other services. Basic exchange service is one of the "universal services."

Q. DOES USWC'S RESIDENTIAL BASIC EXCHANGE COST STUDY VIOLATE THE ORDER OF THE U.S. SUPREME COURT?

A. Yes. Decades ago, in Smith v. Illinois Bell Telephone, the U.S. Supreme Court reviewed a telephone company cost study which placed all of the loop costs on the intrastate exchange service. The U.S. Supreme Court rejected this, and required that an "apportionment" of these loop costs be made. The Court stated that unless an apportionment is made, an "undue burden" would be placed upon the intrastate exchange services:

> The appellants insist that this method is erroneous, and they point to the indisputable fact that the subscriber's station, and the other facilities of the Illinois Company which are used in connecting with the long distance toll board, are employed in the interstate transmission and reception of messages. While the difficulty in making an exact apportionment of the property is apparent, and extreme nicety is not required, only reasonable measures being essential (citations omitted) it is quite another matter to ignore altogether the actual uses to which the property is put. It is obvious that, unless an apportionment is made, the intrastate service to which the exchange property is allocated will bear an undue burden--to what extent is a matter of controversy. We think this subject requires further consideration, to the end that by some practical method the different uses of the property may be recognized and the return properly attributable to the intrastate service may be ascertained accordingly.[80] (Emphasis added)

[80]Smith v. Ill. Bell Tel. Co., 282 U.S. 131, 150-151 (1930).

1 The Smith vs. IBT ruling is still the Supreme Court ruling in effect on this subject. This
2 ruling is regularly referred to in current orders.[81] The Supreme Court has specifically
3 looked at the cost of the loop facilities, and found that you cannot properly allocate all of
4 those costs to just one of the services that shares that facility, and "ignore altogether the
5 actual uses to which the property is put." This Supreme Court requirement is valid
6 requirement that must be met today.
7
8 Q. DOES USWC'S RESIDENTIAL BASIC EXCHANGE COST STUDY VIOLATE THE
9 REQUIREMENTS OF THE FCC?
10 A. Yes. The FCC's Part 36 Separations Rules require 25% of the costs of the shared loop
11 facilities be allocated to the interstate jurisdiction.[82] The separations procedures are the
12 result of a FCC-State Joint Board proceeding. Section 410(C) of the
13 Telecommunications Act of 1934, as amended, makes the use of the separations as
14 established in the Joint Board proceeding mandatory on both the FCC and state
15 commissions. Therefore, a 25% allocation of the loop costs to the interstate jurisdiction
16 is mandatory. However, as discussed, USWC's residential basic exchange service cost
17 study makes no allocation of these costs to the interstate jurisdiction. Rather USWC
18 places 100% of these costs on residential basic exchange, which is an intrastate service.
19 In addition, the FCC has on numerous occasions stated that the loop facility costs are
20 "common" costs, and not just costs of local service. For example,

[81]The FCC, in its recent Access Charge Reform Order dated May 8, 1997, referred to this case in Footnote 23.

[82]CC Docket No. 80-286, Notice of Proposed Rulemaking and Notice of Inquiry at 24, (FCC July 13, 1995).

> [I]nterstate access is typically provided using the same loops and line cards that are used to provide local service. The costs of these elements are, therefore, common to the provision of both local and long-distance services.[83]

Q. DOES USWC'S RESIDENTIAL BASIC EXCHANGE COST STUDY VIOLATE THE FINDINGS OF THE FCC-STATE JOINT BOARD?

A. Yes. Both the FCC-State Joint Board[84] and the FCC properly concluded that recovery of the cost which includes the loop facilities should be spread over the family of services that share those facilities:

> As the Joint Board recommended, the revenue benchmark should take account not only of the retail price currently charged for local service, but also of other revenues the carrier receives as a result of providing service, including vertical service revenue and interstate and intrastate access revenues.[85]
>
> We include revenues from discretionary services in the benchmark for additional reasons. ... Revenues from services in addition to the supported services should, and do, contribute to the joint and common costs they share with the supported services.[86] (Emphasis added)

Q. DOES USWC'S RESIDENTIAL BASIC EXCHANGE COST STUDY VIOLATE THE ORDERS OF THE COMMISSIONS IN THE VAST MAJORITY OF OTHER STATES?

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[83] ¶ 237, Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry, CC Docket No. 96-262 et al.,adopted December 23, 1996 and released December 24, 1996.

[84] The FCC-State Joint Board is made up of both state commissioners and FCC commissioners.

[85] ¶200, Report and Order, CC Docket No. 96-45, FCC 97-157, adopted May 7, 1997, released May 8, 1997 (hereinafter referred to as the *Universal Service Order*).

[86] ¶261, Universal Service Order, FCC 97-157.

A. Yes. Numerous state commissions have found that the loop is a shared/joint/common cost, and that it is not a cost of just basic exchange or local service. Here are a few examples:

In an Order dated October 28, 1998, the Indiana Utility and Regulatory Commission (IURC) specifically found that assigning 100% of the loop cost to one service would violate Section 254(k) of TA96. It found the loop was "included in the definition of common and joint costs." The IURC found that,

> For purposes of resolving 'takings' claims and 'a reasonable share of the joint and common costs of facilities used to provide those services,' the loop must, therefore, be included in the definition of common and joint costs in order to determine confiscation claims and to be in compliance with the second sentence of Section 254(k). We find that the direct assignment of 100 percent of the loop costs to any one service would be a violation of the second sentence of Section 254(k).[87]

In the State of Utah, the Commission specifically found:

> We are troubled by the Company's failure to take into account Commission past orders which deal with some of the pivotal issues and assumptions which go into the calculation of TSLRIC. One failure, in particular, is the Company's decision to assign all costs of access lines to basic residential service...The Commission has already rejected the Company's premise that the only purpose of access lines, the local loop, is for the customer to obtain a dial tone or local service. Without the local loop, the end user would not have access to switched access products or use of toll services.[88]

In the State of Iowa, the Utilities Board found:

[87]Indiana Utility Regulatory Commission Order, Cause No. 40785, Section V.(C) Common and Joint Costs, Issued October 28, 1998.

[88]US West Communications, Inc Docket No. 95-049-05, Report and Order, page 95 (Issued November 6, 1995).

> The local loop is the sine qua non of virtually all of Northwestern Bell's products and services. Equity demands that the costs associated with the local loop be allocated reasonably to all the products and services which rely upon it. Unless the costs of the local loop are equitably allocated, local service customers would be shown in cost studies as not paying sufficient amounts for their services and, thus, prime candidates for significant price increases. Just coincidentally, the great majority of local service customers demonstrate an inelastic demand for telephone service making them vulnerable to large price increases (TR 83-84). This flaw alone makes the LRIC study unacceptable.[89] (emphasis in original)

In another Order:

> Designating the access line as a separate service and allocating all of its costs to the local service customer continues to be a major problem with U S WEST's LRIC methodology.[90]

The Washington Utilities and Transportation Commission found:

> Finally, the residential cost study contains a basic flaw: USWC improperly allocates 100% of the local loop to residential service, and 0% to services that rely and depend on the use of that facility. The Commission in the past has addressed this issue and found it appropriate to allocate a portion of the loop costs to toll and other services.[91]

The Colorado Public Utilities Commission found:

> The second argument defines the local loop as a system. This system has many different users demanding service, including residential customers; small, medium and large businesses; governmental bodies; resellers; long distance companies; and others. A local loop is required and used by all of these users. Consequently, it has value to all of these users, and all should pay a portion of customer access.[92]

The New Hampshire Public Utilities Commission found:

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[89]Northwestern Bell Tel. Co., Docket No. RPU-88-9, Final Decision and Order, p. 10 (IUB Dec. 22, 1989).

[90]US West Communications, Inc., Docket No. RPU-94-1, Final Decision and Order, p. 13 (IUB Nov. 21, 1994).

[91]US West Communications, Inc. Docket No. UT-941464 et al, Fourth Supplemental Order at 39. (WUTC Oct. 1995)

> The commission is well aware of the company's claim that basic local exchange service has been and continues to be subsidized by toll. In the past, the notion of various services contributing to the support of basic exchange has been reinforced by cost studies that have served to demonstrate that the 'contribution' paid by customers of other services represents a disproportionately greater share of the company's incurred costs. These studies have served to mislead due to the company's decisions to assign NTS costs to local exchange services despite the fact that both interstate and state toll services are provided over local NTS facilities. Without local exchange facilities there would be no mechanism to connect interexchange services to the majority of customers premises. Since clearly the availability of the local network for toll use is a benefit to interexchange carriers and all toll customers, the Commission believes that assignment of NTS costs solely to local exchange services is unreasonable.[93]

Q. WHAT HAS NARUC STATED?

A. Yes. The general position of most of the state commissions is summarized by the National Association of Regulatory Commissioners' (NARUC) statement,

> Interexchange carriers should pay a portion of the NTS loop cost because they use the LECs loop to provide their services.[94]

Q. DO YOU BELIEVE THAT IT IS NECESSARY TO MAKE A SPECIFIC ALLOCATION OF THE COSTS OF THE SHARED LOOP FACILITY TO EACH OF THE SERVICES THAT SHARE THE LOOP FACILITY?

A. No. I do not believe that it is necessary to make a specific allocation of the costs of the shared loop facilities costs to each of the services that share the loop facilities. Instead, I recommend that the Commission insure that the contribution (revenues above TSLRIC) that each service is making toward the shared, joint and common costs of USWC

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[92]Page 19, Colorado Public Utilities Commission Order, I&S Docket No. 1720, dated March 20, 1987.

[93]Pages 39-40, New Hampshire Public Utilities Commission Order, Docket No. DR-89-010, dated March 11, 1991.

[94]Page 13, Initial Comments of the National Association of Regulatory Utility Commissioners, CC Docket No. 96-262, January 29, 1997.

(including the shared loop costs) is reasonable. Residential local service is clearly making a very significant contribution towards the joint, shared, and common costs. The contribution to joint, shared, and common costs that is being produced by residential basic exchange service at present rates, is clearly within the range of reasonableness for such contribution, and even appears to be on the high side of the range of reasonableness, as shown on Schedule WDA-19. Therefore, I recommend that the Commission find that the current residential basic exchange rates are making a reasonable contribution toward the recovery of the shared, joint and common costs (including the shared loop costs).

Q. IN THIS PROCEEDING, YOU ARE NOT RECOMMENDING THAT THE COMMISSION MAKE ANY ALLOCATIONS OF THE SHARED LOOP COSTS AMONG THE VARIOUS SERVICES THAT SHARE THE LOOP FACILITIES. HOWEVER, IF THE COMMISSION WANTED TO MAKE AN ALLOCATION OF THE SHARED LOOP FACILITY COSTS, CAN YOU PROVIDE ANY INFORMATION THAT WOULD SERVE AS GUIDANCE FOR A REASONABLE RANGE OF ALLOCATIONS OF LOOP COSTS TO RESIDENTIAL BASIC EXCHANGE SERVICE?

A. Yes. Although it is not necessary for the Commission to attempt to determine some specific figure as being the "reasonable" and "proportionate" share of the loop cost to be recovered from local services, there are some basic facts that allow us to narrow down the range of possible cost recovery allocations of the loop facility costs to residential basic exchange service.

1 (1) First of all, in Smith vs. IBT, the U.S. Supreme Court rejected placing all of the loop
2 costs on intrastate local service, therefore the allocation of loop costs to residential basic
3 exchange service must be less than 100% in order to comply with this requirement.
4
5 (2) Secondly, the FCC-State Joint Board Part 36 rules allocate 25% of the loop facility
6 costs to the interstate jurisdiction, and 75% to the intrastate jurisdiction.[95] The
7 Communications Act of 1934 makes the Joint Board separations allocations mandatory
8 on state commissions, as well as on the FCC. Therefore, only 75% of the loop costs can
9 be considered in an intrastate proceeding, such as this. It is important to note that in its
10 residential basic exchange service TSLRIC cost study, USWC did not even exclude the
11 25% of the loop cost that is the interstate costs.
12 For example, assume the $21.98[96] unseparated loop "rate" is used for the loop cost. Even
13 with just the 25% interstate costs removed, the highest amount that could be considered
14 the intrastate loop cost would be $16.48 (75%). In fact, the "cost" is below this figure,
15 because the UNE loop "rate" includes a 15% coverage of joint and common costs as
16 previously discussed.
17
18 (3) The portion of the loop cost that should be recovered from intrastate local service has
19 to be significantly <u>less than</u> 75%, since other intrastate services share the loop facility
20 (such as intrastate toll, intrastate switched access services, vertical services, etc.). For the
21 same reason that some portion of the loop cost is allocated to the interstate jurisdiction

[95]Part 36.154(c).

[96]This is the rate the Commission has established as the unbundled loop rate for USWC in Arizona. See USWC's response to Data Request WDA 2-35.

(i.e. because interstate toll and switched access services share the loop), some portion of the loop costs must also be recovered from intrastate toll, intrastate switched access services and vertical services since they also share the loop facilities.

Within these limits, the exact portion of the loop costs that is recovered from residential basic is judgmental. As the FCC has stated:

> A telecommunications carrier will typically provide these services, together with numerous other telecommunications service, over a single network because the total cost of providing these services on shared facilities, under shared management, is less than the combined cost of providing these services on separate facilities particularly under separate management operations. A substantial portion of these costs of shared facilities and operations are joint and common costs; it is difficult, if not impossible to approximate the actual portion of such costs for which each product or service is responsible. For these types of costs, considerations other than cost causation must prevail in determining how the costs should be allocated among various services. [97]

And,

> These costs pose particularly difficult problems for the separations process: The costs of such facilities cannot be allocated on the basis of cost-causation principles because all of the facilities would be required even if they were used only to provide local service or only to provide interstate access services. A significant illustration of this problem is allocating the cost of the local loop, which is needed both to provide local telephone service as well as to originate and terminal long-distance calls. The current separations rules allocate 25 percent of the cost of the local loop to the interstate jurisdiction for recovery through interstate charges.[98]

As the FCC has clearly stated, within these limits the recovery of the loop cost is judgmental.

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[97]Implementation of §254(k) of the Communications Act of 1934, as amended, Order adopted and released May 8, 1998, Paragraph 8.

[98]¶23, *FCC Access Charge Reform Order*, FCC 97-158.

In this proceeding, I do not believe the Commission needs to try to select any particular allocation percentage, since it is obvious that, even at present rates, the contribution that residential basic exchange service is making towards the joint and common costs is more than ample, and falls well within the range of reasonableness.

E. WHEN BILLING FOR SEVERAL SERVICES, USWC PLACES ALL OF THE COST OF THE STANDARD ENVELOPE AND FIRST UNIT OF POSTAGE ON BASIC EXCHANGE SERVICE

Q. YOU HAVE PREVIOUSLY DEMONSTRATED THAT USWC PLACES ALL OF THE LOOP COSTS ON BASIC EXCHANGE SERVICE, IN SPITE OF THE FACT THAT THE LOOP IS SHARED BY SEVERAL SERVICES. DOES USWC PLACE OTHER COSTS THAT ARE SHARED BY MORE THAN ONE SERVICE ENTIRELY UPON BASIC EXCHANGE SERVICE?

A. Yes. Take as an example a residential customer's bill from USWC which contains billing for some intrastate toll calls, some interstate toll calls, for custom calling service, and local service. In its so-called TSLRIC studies, USWC places the full cost of the standard sized envelope and first unit of postage used to send that bill entirely in the TSLRIC of basic exchange service.[99] USWC has admitted this in response to Data Requests WDA 1-44 and WDA 25-1. However, USWC includes none of the standard envelope or first unit of postage cost in its TSLRIC of toll services, or other non-basic services.

[99]The first unit of postage is the postage for one ounce (one "stamp" for those who use stamps).

This is yet another example of USWC's selective violation of the TSLRIC definition in order to disadvantage basic exchange services as compared to other services. As previously discussed, proper TSLRICs do not include the shared costs. USWC does not violate the TSLRIC definition for toll or other non-basic services. However, USWC selectively violates the TSLRIC definition by including all of these shared costs in the claimed TSLRIC of basic exchange service.

The cost of the first unit of postage and the standard envelope are shared costs of the services for which billing is occurring. These shared billing costs benefit all of the services that are being billed for, but USWC allocates all of the standard envelope and first unit of postage costs to basic exchange service.

IV. RATE DESIGN

Q. WILL YOU PLEASE PROVIDE AN OVERVIEW OF USWC'S RATE DESIGN PROPOSALS IN THIS PROCEEDING?

A. Yes. The overall revenue impacts of the major rate changes under USWC's proposed rate design are summarized below by service category:

Service	Proposed Revenue Change
Residence Basic Exchange	$43,686,364
Business Basic Exchange	$1,788,036
Market Expansion Line	($559,705)
Long Distance Services	($1,693,703)
Directory Assistance	$19,743,296
Listings	$ 9,476,737
Custom Calling	$ 7,455,163
Start-Up Package Elimination	$ 60,000

Toll Restriction Services	$ 7,955,484[100]
Switched Access	$ (5,000,000)
Private Line	$ 5,600,000
PAL	$ (7,900)
PAL Directory Assistance	$ 1,700,000[101]

A. USWC RATE PROPOSALS WHICH STAFF DOES NOT OPPOSE

Q. ARE THERE USWC RATE PROPOSALS THAT YOU DO NOT OPPOSE IN THIS PROCEEDING?

A. Yes. Below is a list of some of the USWC rate proposals that I do not oppose in this proceeding, and the page(s) of the USWC witness that discusses each of these proposed rate changes:

1. Reduce Residential Non-Recurring Charge (Teitzel Direct, page 39)
2. Eliminate Multi-Party Service for Residence and Business (Teitzel Direct, Page 40)
3. Bundle Business Dial Tone Line w/ Local Usage Components, (Teitzel Direct, Page 43)
4. Restructure Bus. Resale/Sharing Measured Local Usage, p. 45, (Teitzel Direct, Page 45)
5. Increase Business Resale Line Monthly Rate, (Teitzel Direct, Page 45)
6. Eliminate Business and Residence Zone Connection Charges, (Teitzel Direct, Page 39)
7. Reduce Market Expansion Line Monthly Rate, (Teitzel Supplemental Direct, Page 41)
8. Increase Business/Residence Internet Listings Monthly Rate, (Teitzel Direct, Page 59)
9. Increase Business E-Mail Listings Monthly Rate, (Teitzel Direct, Page 59)
10. Caller I.D. - Name/Number - Increase Res. Monthly Rate, (Teitzel Direct, Page 61)
11. Caller I.D. - Number - Increase Residence Monthly Rate, (Teitzel Direct, Page 61)
12. USWC Receptionist - Name/Number - Increase Res. Monthly Rate, (Teitzel Dir, P. 61)
13. USWC Receptionist - Number - Increase Res. Monthly Rate, (Teitzel Direct, Page 61)
14. Grandfather Business Custom Calling Packages, (Teitzel Direct, Page 63)
15. Grandfather SingleNumber Service, (Teitzel Direct, Page 64)
16. Eliminate Scoopline service (McIntyre Supplemental Direct, page 15)
17. Eliminate Scoopline Access Restriction, (Teitzel Direct, Page 66)
18. Increase NRC for 10XXX1+/10XXX011+ Block, (Teitzel Supp. Dir., Ex. DLT-47)
19. Change Monthly Rates for 911 and E-911 Service, (Teitzel Direct, Page 45)
20. Eliminate Start-Up packages (Teitzel Supplemental Direct Testimony, page 48)
21. Increase Carrier Directory Assistance (Wilcox Direct Testimony, page 11)
22. Increase some Switched Access NRCs, (Wilcox Direct, page 12)

[100]Teitzel Supplemental Direct Testimony Exhibit DLT-48.

[101]McIntyre Supplemental Direct Testimony, page 4.

23. Revise service maintenance charges and due date changes - switched access/private Line (Wilcox Dir., p.12)
24. Increase Rates for Last Call Return service (Teitzel Supplemental Direct Testimony Exhibit DLT-46)
25. Establish a $12.50 residential/business NRC for Billed Number Screening (Teitzel Supplemental Direct Testimony Exhibit DLT-47)
26. Increase Premium Listing rates (Teitzel Direct, Exhibit DLT-20)

In addition, there are other USWC proposals, or portions of USWC proposals that Staff does not oppose, as will be discussed later.

Q. IS THERE ONE OF THE ABOVE USWC RATE PROPOSALS THAT YOU STRONGLY SUPPORT?

A. Yes. Mr. Teitzel proposes to reduce the residential non-recurring charge from $46.50 to $35.00. As Mr. Teitzel points out, USWC's residential non-recurring charge in Arizona is the highest of all the states in USWC's 14-state region.[102] A high non-recurring charge can be a barrier to universal service. I support this reduction.

B. RESIDENCE BASIC EXCHANGE SERVICE

(1). 1FR, TAP AND LIFELINE RATE PROPOSALS

Q. WHAT DOES USWC PROPOSE FOR FLAT RATE RESIDENTIAL BASIC EXCHANGE SERVICE IN THIS PROCEEDING?

A. USWC proposes to increase the initial line of flat-rate residential basic exchange rate by 19% from $13.18 to $15.68 per month.[103] For additional lines, USWC proposes to maintain the current rates, in order to "reflect the manner in which U S WEST's

[102] Teitzel Direct, page 39.
[103] Teitzel Supplemental Direct Testimony, page 39.

competitors are pricing non-primary lines in Arizona, and in recognition of the fact that additional residential lines are assessed an End User Common Line (EUCL) charge of $6.07 per line, while primary lines are assessed an EUCL charge of $3.50."[104]

Q. WHAT DOES USWC PROPOSE FOR LOW INCOME TELEPHONE ASSISTANCE PROGRAM AND LIFELINE SERVICE RATES?

A. Under USWC's proposed rates, Low Income Telephone Assistance Program[105] and Lifeline service customers would experience drastic increases in their monthly rates. Under USWC's proposal, customers in the Low Income Telephone Assistance Program (LTAP) would see a 23% increase in the monthly rate for the flat rate service.

Lifeline customers[106] would see a 21% increase in the monthly rate for the flat rate service under USWC's proposal. A comparison of the current and proposed LTAP and Lifeline rates is shown below:

	Current Rate	Proposed Rate	Increase	% Increase
LTAP Flat Rate Option	$ 8.05	$ 9.92	$1.87	23%
LTAP Low Use Option[107]	$ 4.58	$ 6.44	$1.86	40%
Lifeline Flat Rate Option	$11.43	$13.93	$2.50	21%
Lifeline Low Use Option	$ 6.75	$ 9.25	$2.50	37%[108]

[104]Teitzel Supplemental Direct Testimony, page 39, line 25.

[105] Low Income Telephone Assistance Program customers only have two single party basic service options - flat rate service and a low use option.
[106] Lifeline customers also have the option of choosing between flat rate service and a low use option.
[107] Additional charges for usage also apply for both the LTAP and Lifeline Low Use options.
[108]Teitzel Supplemental Direct Testimony, page 39.

Q. DOES STAFF SUPPORT THE ABOVE-REFERENCED PROPOSALS FOR 1FR, TAP AND LIFELINE?

A. No. Staff recommends that USWC's proposed 1FR, TAP and Lifeline rate proposals be rejected for all of the following reasons:

1. USWC's proposals are based on the flawed premise that residential basic exchange service rates are priced below cost. These proposed increases are based upon USWC selectively violating the TSLRIC definition by including 100% of the common line costs in the claimed costs of residential basic exchange service. The current residential basic exchange service rates are greatly in excess of the residential basic exchange TSLRIC, when TSLRIC is properly calculated, as shown on Schedule WDA-19.

2. At current rates, residential basic exchange service is already shouldering more of the burden of contributing in excess of TSLRIC costs toward the shared, joint and common costs (including the shared loop facility costs) than is any other service which shares the residential loop facilities, as shown on Schedule WDA-19.

3. These proposed increases would damage universal service in Arizona, as will be discussed later.

The simple fact is that the current rates for residential basic exchange service are currently covering all of the direct costs, a reasonable portion of the costs of the shared facilities used to provide the services, and are making a significant contribution to the common overhead costs of USWC. By any valid measure of cost, the current rates for residential basic exchange services are reasonable.

The justification that USWC gave for the difference between the initial and additional line, that the interstate EUCL charge was different, is not a valid reason. The EUCL charge is an interstate charge imposed by the FCC. If USWC does not agree with the

1 FCC's decision, it is not appropriate to ask the state commission to effectively "offset" the
2 FCC's decision.
3
4 USWC's proposal, which is for a higher charge on the initial line than on the additional
5 lines, would tend to damage universal service. The "additional" line is not critical for
6 universal service. Customers who have one line have telephone service, and have the
7 ability to call in the event of emergencies, and otherwise interact with their community.
8 The "additional" line is not critical to universal service. In addition, the difference
9 between the residential primary line and additional lines in the EUCL charge is now
10 different than it was when USWC presented its testimony. On July 1, 2000, the
11 residential primary line EUCL charge went from $3.50 to $4.35. However, there is not a
12 similar increase in the residential additional line SLC.
13
14 **(2) STAFF PROPOSED RATE DESIGN**
15
16 Q. WHAT DOES STAFF PROPOSE FOR RESIDENTIAL BASIC EXCHANGE
17 SERVICE RATES?
18 A. Staff's proposal for these and other rates is shown on Schedule WDA-20. The rate design
19 Staff proposes are for a range of revenue requirement possibilities. At the top of page 1
20 of Schedule WDA-20, a summary of Staff's rate design proposals for services other than
21 residential and business basic exchange services is presented. I will discuss those
22 proposals later in this testimony. The bottom of page 1 of Schedule WDA-20 shows
23 Staff's proposed residential and business basic exchange service rates. Staff's proposed

residential and business basic exchange service rates would be calculated based upon the revenue requirement ordered by the Commission. Under Staff's proposal, as the first step in changing the basic exchange rates, the business basic rates would be reduced $2 from their current level. The purpose of this reduction is to modify the existing relationship that exists between residential and business basic exchange services. There are some valid reasons for a difference between business and residential basic exchange service. For example, business basic exchange service includes a valuable yellow page listing which is not included with residential basic exchange. Business basic exchange service is generally tax deductible to the customer, but residential basic generally is not. This affects the "affordability", which is an issue that must properly be considered in rate design. However, I am proposing to reduce the difference between residence and business basic exchange, by reducing the business basic exchange rate by $2 per line, with no equivalent residential reduction. As a next step after all of the rate changes previously listed on Schedule WDA-20 are accomplished, then both the residential and business basic exchange service rates would be increased or decreased by the same dollar amount per line in order to achieve the approved revenue requirement. At the bottom of Schedule WDA-20, page 1, the amount by which each residential and business basic exchange rate must be changed for each $1 million change in revenue requirement is shown.

Pages 2 and 3 of Schedule WDA-20 show Staff's proposal in more detail, with specific rates that would be produced at various revenue requirements.

1 **(3). BASIC SERVICE LOW USE OPTION**

2

3 Q. WHAT CHANGES DOES MR. TEITZEL PROPOSE FOR ALL RESIDENTIAL LOW

4 USE OPTION CUSTOMERS?

5 A. As discussed on page 38 of his originally filed Direct Testimony, Mr. Teitzel proposes to

6 convert all residential "Low Use Option" customers to a new measured service option

7 called "Budget Measured Plan." Under Mr. Teitzel's proposed plan, customers will pay

8 an increased line rate from their previous rate of $8.50 per month to a new rate of $11.00

9 per month. This is the same $2.50 per line increase USWC has proposed for flat rate

10 residential service. The line rate will include one hour of usage, with any usage

11 exceeding the hour being charged at a rate of $0.02 per minute. Under the existing Low

12 Use Option, all calls are charged at a rate of $0.20 per call.

13

14 Q. WHAT RATIONALE DOES MR. TEITZEL PROVIDE FOR HIS LOW USE OPTION

15 PROPOSAL?

16 A. Mr. Teitzel claims that he is making this proposal to "better meet the needs of the Low

17 Use Option Customer."[109] In addition, Mr. Teitzel argues:

18 > A very small percentage of customers subscribe to the service, as the $0.20 per
19 > call charge, when added to the line rate, quickly makes flat rate service more
20 > attractive.[110]

21

22 Q. IS THE RELATIONSHIP THAT MR. TEITZEL PROPOSES BETWEEN THE

23 BUDGET MEASURED PLAN AND FLAT RATE OPTIONS REASONABLE?

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[109]Teitzel Direct Testimony, page 38, line 27.

[110]Teitzel Direct Testimony, Page 38, line 20.

1 A. No. Under USWC's proposal, the line rate for the Budget Measured Plan would be $4.80
2 below the line rate for flat rate service. However, the cost of flat rate usage is much less
3 than the $4.68 difference which USWC proposes. Therefore, the difference between
4 these two rates is greater than can be explained by the fact that the flat rate includes usage
5 whereas the measured rate does. The cost for local usage at the average for that rate level
6 is ** **, as shown on Schedule WDA-18. This figure is from USWC's cost studies.
7 In the past, the excessive discount from the flat rate charge for the "low use" line was
8 made up for by the high charge for usage. However, under the new Budget Measured
9 Plan, there is an hour of free usage, and after that the usage is 2¢ per call. Under the new
10 proposal, the usage charge would not produce as large a contribution to make up the
11 excessive difference in the line rates. The low use customers only make an average of
12 about ** ** calls a month.[111] If five minutes per call is assumed, the average low use
13 customers would be making about ** ** of calls per month. The new USWC
14 proposal contains an hour of uncharged usage.
15 The above discussion uses the existing flat rate as the starting point. If the flat rate is
16 increased or decreased, as shown on the bottom of Schedule WDA-20, page 1, the
17 Budget Measured Plan line rate would increase or decrease along with it, so as to
18 maintain the above-referenced $3.00 differential. Therefore, the average Budget
19 Measured Plan customer would pay nothing for usage, and would pay a line charge of
20 $4.68 below the flat rate. Providing service to these customers at $4.68 less than the
21 service is provided to the flat rate customers, is a differential significantly greater than the
22 difference in the cost of providing the service.

[111]USWC's response to Data Request WDA 1-2, Attachment A.

1

2 Q. WHAT DO YOU RECOMMEND?

3 A. I recommend that the Budget Measured Plan line rate, with the inclusion of one hour of

4 usage, be set $3.00 below the flat rate. After the one hour of usage is exceeded, the

5 USWC proposed rate of 2¢ per minute is acceptable. This is not a rate increase for the

6 current customers. The current low use customers make an average of about ** **

7 calls per month, which at 20¢ each, would result in a ** ** per month usage charge.

8 When this is added to their $8.50 current rate, the low use customers would have an

9 average bill of ** **. Under my proposal, using the existing $13.18 as a starting

10 point, the flat rate per line charge would be $3.00 below that, which is $10.18. The

11 average low use customer would pay no usage charge (because their usage falls within

12 the one hour of usage allowance).[112]

13

14 **C. ZONE INCREMENT CHARGES**

15

16 Q. WHAT CHANGES DOES MR. TEITZEL PROPOSE TO MAKE TO THE

17 RECURRING ZONE INCREMENT CHARGES THAT APPLY CUSTOMERS

18 LOCATED OUTSIDE OF THE BASE RATE AREA?

19 A. Mr. Teitzel proposes to expand the base rate area, thereby reducing the number of

20 customers that will be required to pay the recurring zone increment charges.[113] Under the

21 current zone increment structure, ** ** residence and ** ** business

22 customer lines are charged a zone increment charge. Under USWC's proposal to expand

[112] The $11.00 rate that USWC discusses compares to the $15.68 residential flat rate proposal, which is the same difference of $4.80 between the $8.50 current rate and $13.18 current rate.
[113] Teitzel Direct, page 42, line 16.

the base rate area, the number of customer lines that will be considered outside the base rate area (and therefore charged a zone increment charge) would be reduced to ** ** for residence and ** ** for business.[114] For these customers that remain outside of the base rate area after the proposed expansion, Mr. Teitzel proposes to increase the zone increment charges. The current and USWC's proposed residence and business recurring zone increment charges are shown below:

	Current Rate	USWC Proposed Rate
Residence		
Zone 1	$1.00	$5.00
Zone 2	$3.00	$7.00
Business		
Zone 1	$1.00	$10.00
Zone 2	$3.00	$15.00[115]

Q. WHAT IS THE BASIS FOR MR. TEITZEL'S PROPOSED INCREASES FOR THE RECURRING ZONE INCREMENT CHARGES?

A. As discussed on pages 37-38 of his Supplemental Direct Testimony, Mr. Teitzel's proposed rates are in response to USWC's proposed de-averaged rates for the UNE loop in Docket No. T-00000A-00-0194.

Q. CAN YOU PLEASE PRESENT AN ANALYSIS OF THIS ZONE INCREMENT ISSUE?

[114]USWC's Recurring Priceouts 1999 Test Year, provided in response to Data Request WDA 21-3, Section E.

[115]Teitzel Supplemental Direct Testimony, page 38.

A. Yes. Nationwide, the trend has been to completely eliminate the OBRA charges. For example, the independent telephone companies, funded by the agency formerly known as the Rural Electric Administration (REA) generally have eliminated the OBRA charges.

First of all, it must be understood that the proposed OBRA charges generally apply only to certain rural customers, and do not generally apply to customers in certain urban wire centers. For example, there are no areas in the Phoenix Main wire center or Tuscon Main wire centers in which the OBRA rates would apply.

For those certain rural customers, imposing OBRA charges is effectively the same as imposing a higher basic rate on those customers than is imposed on urban customers. For example, the Zone 2 customer under USWC's proposal can be displayed as shown below:

	USWC Proposed "Urban" Basic Exchange Rate	Effective Proposed Basic Exchange Rate for Certain Rural Customers
Residential	$15.68	$15.68
OBRA Rate (Zone 2)		7.00
Total Effective Basic Exchange Rate	$15.68	$22.68

Charging higher rates to rural customers than are charged to urban customers for similar services conflicts with a number of public policy requirements. For example, Section 254(b)(3) of TA96 states:

> ACCESS IN RURAL AND HIGH COST AREAS - - Consumers in all regions of the Nation, including low-income customers and those in rural, insular, and high cost areas, should have access to telecommunications and information services, including interexchange services and advanced telecommunications and

> information services, that are reasonably comparable to those services provided in urban areas and that are available at rates that are reasonably comparable to rates charged for similar services in urban areas.[116]

Of course, "similar" is a judgement, but USWC is clearly decreasing the similarity between the urban and rural rates under their proposal. In addition, TA96 requires that the rates for service be "affordable." Section 254(b)(1) states:

> QUALITY AND RATES.--Quality services should be available at just, reasonable, and affordable rates.

Affordability is also a matter of judgement. However, USWC's proposal would make the basic exchange service rates significantly less affordable in the affected rural areas. As discussed, above, the USWC proposed rate for basic exchange plus outside base rate area for Zone 2 rural customers is $22.68. In addition to this, the customers must pay the $4.35 interstate EUCL charge. When normal taxes and surcharges are added, the rural customers are looking at a rate just to have basic exchange service in the area of $30 per line per month. In addition to the approximate $30 charge for basic exchange service, rural customers on the average already pay much higher toll bills than do urban customers, because of the difference in the local calling areas, as will be discussed later.

Q. ON PAGES 36-38 OF HIS SUPPLEMENTAL DIRECT, MR. TEITZEL DISCUSSES THE COMMISSION'S ACTION TO DE-AVERAGE UNBUNDLED LOOP RATES IN ARIZONA, AND CLAIMS THAT IN ORDER TO "MAINTAIN A REASONABLE RELATIONSHIP BETWEEN UNE LOOP PRICES AND RETAIL PRICES", THE ZONE INCREMENT CHARGES FOR BASIC EXCHANGE SERVICE SHOULD BE

[116] §254 (b) (3), Federal Telecommunications Act of 1934 (1996 Amended).

1 INCREASED. DOES UNE LOOP DE-AVERAGING PROMPT A NEED TO
2 INCREASE THE ZONE INCREMENT CHARGES?
3 A. No. In order to determine whether or not a "reasonable relationship" exists between UNE
4 loop prices and retail rates, you must compare the retail revenues obtained from all of the
5 services that share the loop facilities to the costs of providing all services that share the
6 loop facilities (including the cost of the UNE loop). Since the loop facility is shared by a
7 number of different services, a study that compares the total contribution over and above
8 direct cost derived from the family of services that share the loop facilities should be
9 conducted to determine if a "reasonable relationship" exists between the UNE loop prices
10 and retail prices.
11
12 Due to Mr. Teitzel's erroneous view of the loop facility as a cost of providing only basic
13 exchange service, Mr. Teitzel has improperly linked a change in the price for the
14 unbundled loop with a proposal to change the retail price for just one of the services that
15 shares the loop facility - basic exchange service, via the zone increment charge. In reality
16 it is the retail rates that are charged for the whole family of services that share the loop
17 facilities that must be considered when determining whether or not a "reasonable
18 relationship" exists between UNE loop rates and retail rates.
19
20 Q. IS USWC'S ARGUMENT THAT THE BASIC EXCHANGE RATES MUST BE
21 ADJUSTED TO CONFORM TO THE UNE RATES VALID?
22 A. Not entirely. USWC's argument is based upon their misconception that the loop cost (as
23 identified by the UNE rates) is directly a cost of only basic exchange service. As

1 previously demonstrated, and as shown on Schedule WDA-17, that is an incorrect
2 concept. The loop facilities are used by a whole family of services. Therefore, UNE
3 costs cannot be directly related to just basic exchange service rates, or to any one of the
4 family of services that share the loop facilities.
5
6 Twenty-five percent of the loop costs are separated to the interstate jurisdiction. In those
7 areas where the loop costs are higher, that means the dollar amount per loop allocated to
8 the interstate jurisdiction is higher than in other areas where the loop cost is lower. The
9 remaining costs must be recovered over the family of intrastate services that share the
10 facilities.
11
12 In addition, the higher rural intrastate costs must be compared to the total intrastate
13 revenues being derived. In general, the intrastate revenues under present rates are already
14 much higher for the average rural line than for the average urban line, primarily because
15 of the higher levels of toll and switched access, as discussed below. Therefore, USWC
16 has presented no evidence that an additional increase in the rural areas' total charge is
17 required.
18
19 Q. WHY ARE THE RURAL REVENUES HIGHER ON AVERAGE THAN THE URBAN
20 REVENUES FOR THE AVERAGE RESIDENTIAL CUSTOMER, EVEN WITHOUT
21 AN ADDITIONAL OBRA CHARGE?
22 A. Rural customers generally have a more limited local calling area than do urban
23 customers. As a result, rural customers pay toll rates for calls for which an urban

customer pays local rates. As a result, the average rural customers' toll bills are generally significantly higher than the urban customers' toll bills. Without an analysis of the total revenues between rural and urban customers, it is not possible to determine that there is a need to increase rates on the rural customers. It is true that the loop cost per line in certain rural areas may be higher than in urban areas, but it is also true that the existing total revenues per line in the rural areas are also higher than the existing revenues in the urban areas. Staff attempted to obtain a breakdown of the difference in toll revenues between rural and urban customers from USWC, but USWC would not provide that information.[117]

Q. IS THERE EVIDENCE THAT USWC'S RURAL CUSTOMERS IN ARIZONA HAVE HIGHER TOLL BILLS THAN DO USWC'S URBAN CUSTOMERS?

A. Yes. In discovery, USWC provided the dial equipment minutes (DEM) minutes of use for a number of wire centers throughout USWC's service territory in Arizona. This data clearly demonstrates that a much greater percent of customer's minutes of use in rural areas is intraLATA toll or access minutes than is true for urban areas.

For example, in USWC's urban "Phoenix Main" wire center, only about ** ** of the total intrastate minutes of use are intrastate toll and intrastate switched access minutes.[118] Since the "Phoenix Main" wire center is part of the "Phoenix Metropolitan" exchange that

[117] USWC response to Request WDA23-001.

[118] USWC's response to data Request WDA 28-2, Attachment A, CLLI code "PHNXAZMADS4". Switched access minutes occur when a toll carrier other than USWC originates or terminates a toll call over USWC facilities. Therefore, these two figures combined is a measure of the total intrastate toll usage.

1 includes local calling to many access lines, it is not surprising to find that only a small
2 percentage of the total intrastate minutes of use are from intrastate toll and intrastate
3 switched access in the "Phoenix Main" exchange.
4
5 However, customers in the USWC rural Whitlow exchange can call only ** ** lines
6 as their local calling area.[119] Any call outside of these few lines is a toll call. For
7 customers in USWC's rural Whitlow exchange, an incredible ** ** of the total
8 intrastate minutes of use are for intrastate toll and intrastate switched access.[120] The
9 average customer in this rural USWC exchange are obviously incurring much higher toll
10 bills, and generating much higher toll and switched access revenues per line for USWC,
11 than is the average customer in the Phoenix exchange. Another example is the rural
12 "Payson" wire center, where over ** ** of the total intrastate minutes of use are
13 from intrastate toll and intrastate switched access minutes. Customers in the Payson
14 wire center can call a total of ** ** lines as their local calling area.[121]
15
16 In USWC's rural "Casa Grande" wire center, over ** ** of the total intrastate
17 minutes of use are from intrastate toll and intrastate switched access minutes.[122] The
18 "Casa Grande" wire center is in the rural Casa Grande exchange, which does not have a
19 local calling area that includes a major urban or metropolitan area. Customers in the

[119]USWC's response to Data Request WDA 32-1, Attachment A.

[120]USWC's response to data Request WDA 28-2, Attachment A.

[121]USWC's response to Data Request WDA 32-1, Attachment A.

[122]USWC's response to data Request WDA 28-2, Attachment A.

1 "Casa Grande" exchange can call fewer than ** ** lines as part of their local
2 calling area.[123] Any calls outside of these ** ** lines is a toll call.
3
4 In many rural areas, USWC is collecting much higher toll and switched access revenue
5 per line than is true for urban areas. Even if the cost of providing facilities are higher in
6 rural areas, the revenues per line are also higher. Therefore, there is no evidence at this
7 time that an additional increase in the total rates charged to rural customers as compared
8 to urban customers is needed at this time.
9
10 Q. WHAT DO YOU RECOMMEND WITH RESPECT TO USWC'S ZONE INCREMENT
11 CHARGE?
12 A. I accept the expanded base rate area as USWC has proposed. I recommend maintaining
13 the current recurring charges for both Zones 1 and 2.
14
15 Q. THE COMMISSION, IN THE UNE PROCEEDING, DID NOT APPROVE
16 EXPANDING THE BASE RATE AREAS AS PART OF THE INTERIM UNE RATE
17 CHANGE. WILL THAT CAUSE SIGNIFICANT CUSTOMER CONFUSION?
18 A. No. End user customers have no interaction with the UNE tariffs. Only certain
19 customers, such as CLECs, deal with UNE rates.
20

[123] According to Section 5.1.1 of USWC's Exchange and Network Services Tariff, the Casa Grande Exchange has local calling to Casa Grande, Coolidge, Eloy, Florence and Maricopa. The lines for these exchanges were obtained from USWC's response to Data Request RUCO 27-4, Attachment A.

On the other hand, the rates that are being set in this case will be the retail rates that may be in effect, or may form the basis for the rates in effect, for many years in the future. In addition, many customers may have been aware that the Company was proposing to expand the base rate areas, thereby relieving them of paying the OBRA charges. Staff sees no valid reason to prevent that expansion.

D. BUSINESS BASIC EXCHANGE SERVICE

Q. WHAT DOES USWC PROPOSE FOR BUSINESS BASIC EXCHANGE SERVICE?

A. Overall, USWC proposes to increase business basic exchange service revenues annually by $1,788,036.[124] Included in USWC's proposal was a revenue-neutral collapse of the currently separate dial tone line and usage elements into a single flat business line rate.

Q. WHAT DOES STAFF PROPOSE FOR BUSINESS BASIC EXCHANGE SERVICE RATES?

A. Staff does not oppose the above-referenced revenue neutral collapse of the two elements. As previously discussed, Staff proposes to reduce the differential that currently exists between residential basic exchange and business basic exchange service. As a first step, Staff proposes reducing the business basic exchange rate by $2.00 per line per month. All of the other business basic exchange rates (PBX trunk, etc.) are also reduced by $2.00 per line per month. Following that change in the business basic exchange service rates, Staff proposes that the business basic exchange service rates be increased or decreased by

[124]Teitzel Supplemental Direct Testimony Exhibit DLT-48.

the same dollar amount per line that the residential basic exchange service rates are increased or decreased. This is shown on the bottom of page 1 of Schedule WDA-20. The specific rates at various assumed revenue requirements are shown on the other pages of that Schedule. The change in the per line rate for business basic exchange service includes all forms of business basic exchange service, such as single line flat rate business rates, PBX trunk rates, etc.

E. INTRALATA TOLL SERVICES

Q. WHAT DOES USWC PROPOSE FOR INTRALATA TOLL SERVICES?

A. USWC is proposing to make the following intraLATA toll rate changes:

1. Reduce the business and residence standard MTS rates;
2. Increase the Speech/Hearing impaired discount from 35% to 50%;
3. Eliminate the Simple Calling Plan for Residence and convert to MTS;
4. Eliminate Arizona Value Calling Plan I for Residence/Business - convert to MTS;
5. Eliminate Arizona Value Calling Plan II and convert to Super Savings
6. Eliminate Volume Discount Plans - convert Business to Simple Value Plan and Residence to MTS
7. Grandfather MetroPac Calling Plan[125]

The annual revenue impact of these USWC intraLATA toll proposals is a decrease of $5,106,829.[126]

Q. DOES USWC NEED THE COMMISSION'S APPROVAL IN THIS PROCEEDING TO REDUCE ITS TOLL RATES?

[125]Teitzel Supplemental Direct Testimony Exhibit DLT-45.

[126]Teitzel Supplemental Direct Testimony Exhibit DLT-45.

A. No. The Commission has already determined that the toll services are competitive, and that they are flexibly priced.[127] In response to discovery in this proceeding, USWC stated the following:

> With the pricing flexibility currently afforded toll services, U S WEST could certainly reduce its toll rates outside of this rate case without Commission approval.[128]

Q. IF USWC CAN REDUCE ITS TOLL RATES OUTSIDE OF THIS PROCEEDING WITHOUT COMMISSION APPROVAL, WHAT IS USWC ACTUALLY SEEKING BY PLACING THESE REDUCTIONS IN THIS PROCEEDING?

A. USWC is actually seeking an offsetting increase in the rates for other (primarily non-competitive) services to support the $5 million reduction in the rates for competitive toll services. Increasing the rates for non-competitive services to offset a reduction in the rates for competitive services violates the entire concept of designating these services as competitive. In a competitive market, the Company has the freedom to adjust its prices as needed (within limits), but does not have the right to ask the customers of non-competitive services to support the revenue changes that result from the change in prices in the competitive market.

Q. WHAT DOES STAFF RECOMMEND PERTAINING TO THE CHANGE IN TOLL RATES?

A. The intraLATA toll service has been classified by this Commission as competitive. USWC has the flexibility to reduce its toll rates without Commission approval. Staff

[127] ACC Decision No. 59637.
[128] USWC's response to Data Request WDA 2-21 (b).

1 does not, in any way, oppose the reductions deemed appropriate by USWC (providing
2 they fall within the Commission allowed ranges, which Staff does not believe is an issue
3 at this time). However, Staff does oppose the USWC concept that the rates for other
4 services, primarily non-competitive services, should be increased to offset the change in
5 revenues resulting from the change in price for a competitive service. That would be
6 requiring the non-competitive services to support USWC in the competitive market,
7 which is inappropriate and a violation of the concept of treating the competitive services
8 separately from the non-competitive services. The Commission has given USWC the
9 freedom to compete in those markets the Commission has deemed to be competitive.
10
11 Competition is supposed to drive prices down by forcing companies to become more
12 efficient. If competition drives prices down by forcing greater efficiency, then customers
13 have benefited. However, Mr. Teitzel proposes an effective shift of cost recovery away
14 from the services that have already been classified as competitive and onto other services
15 that are not competitive. Customers would not gain any benefit from reducing toll rates
16 by shifting the costs onto non-competitive services.
17
18 Q. IS USWC'S REVENUE IMPACT CALCULATION FOR TOLL CREDIBLE?
19 A. No. The premise of the USWC proposed price change is that USWC would be more
20 successful in the toll market at the new prices than they would at the existing prices. If
21 that is true, that means USWC will generate as much or more revenues at the new prices
22 than they would at the current prices (or else the change in price would not be
23 reasonable). In short, if the change in price will improve USWC's position in the

1 competitive markets, then that change does not result in a reduction of revenues, it results
2 in the same, or if anything, an increase in revenues. The USWC revenue impact
3 calculation, which pretends that the revenue impact of the change would be to decrease
4 revenues by $5 million, is therefore inconsistent with their testimony.
5
6 Q. USWC CLAIMS THAT THE TOLL REDUCTIONS IT PROPOSES WOULD
7 POSITION THEM BETTER IN THE MARKET THAN ITS CURRENT RATES.[129]
8 PLEASE RESPOND.
9 A. USWC is free to make the rate changes it proposes. USWC management may believe
10 that as a result of price reductions, USWC's market share will be higher than it otherwise
11 would have been to offset the revenue losses that result from the price reductions.
12 USWC would be better off in the market after the price reductions than if they had not
13 made these price reductions. If management chooses to make those rate changes which
14 better position them in the market, there is no associated revenue loss. (Management
15 would have made these changes only because they thought they would be better off than
16 if they had not made them.) On the other hand, if management does choose to make rate
17 changes in this competitive market that do cause a revenue loss, that is a result of the
18 management's decision. The result of a management decision in a competitive market is
19 not something that should be recovered from the non-competitive services. The revenue
20 impact to be recovered from non-competitive services is zero. This does not imply in any
21 way that Staff is opposing USWC choosing to make price reductions, which the
22 Commission has allowed them to do within the flexible pricing guidelines.
23

1 Q. MR. TEITZEL CLAIMS THAT USWC'S TOLL "IS PRICED MANY TIMES ABOVE
2 ITS TSLRIC AND SHARED COST."[130] DOES THE "SHARED COST" THAT MR.
3 TEITZEL REFERS TO INCLUDE ANY PORTION OF THE SHARED LOOP
4 FACILITY COSTS?
5 A. No. The major shared cost associated with the provision of USWC's intraLATA toll
6 services is the shared cost of the loop facilities. However, USWC has included no
7 portion of these major shared costs in its claimed "TSLRIC and Shared cost." Therefore,
8 Mr. Teitzel's claim that USWC's intraLATA toll services are priced many times the
9 "TSLRIC and Shared cost" is based upon a distortion of the costs that excludes the major
10 shared cost of providing the service.
11
12 Q. ON PAGE 49 OF HIS DIRECT TESTIMONY, MR. TEITZEL CLAIMS THAT
13 USWC'S INTRALATA TOLL RATES SUBSIDIZE RESIDENTIAL BASIC
14 EXCHANGE SERVICE. MR. TEITZEL STATES:

15 With the move to price residence Basic Exchange Service towards cost, U S
16 WEST can then coincidentally eliminate a portion of the subsidies represented by
17 the contribution in Long Distance Services.[131]
18

19 IS THIS A VALID CLAIM?
20 A. No. Mr. Teitzel's claim that intraLATA toll rates subsidize residential basic exchange
21 service rates is based upon a distortion of residential basic exchange costs that includes
22 the full cost of the shared loop facilities. Despite the fact that several services share the

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[129] Teitzel Direct, page 49.
[130] Teitzel Direct Testimony, page 50, line 23.

[131] Teitzel Direct Testimony, page 49, line 29.

1 loop facilities, USWC chooses to unreasonably place the full cost of the shared loop
2 facilities on residential basic exchange service. When this improper distortion is
3 removed from the analysis, it is clear that residential basic exchange service covers its
4 TSLRIC, plus makes a reasonable contribution to the shared costs of providing the
5 service, including the shared loop facility costs.
6
7 Q. DOES INTRALATA TOLL PROVIDE AS MUCH CONTRIBUTION AS BASIC
8 TOWARD THE SHARED, JOINT AND COMMON COSTS OF USWC?
9 A. No. At current rates, intraLATA toll services provide a mere ** ** per line per
10 month contribution toward the shared costs of providing telecommunications services,
11 including the shared loop facility costs, as shown on Exhibit WDA-19. As shown on
12 that Schedule, the current residential basic exchange service rates provide over **
13 ** more contribution per-line toward the shared, joint and common costs of
14 providing telecommunications services. USWC's claim that intraLATA toll is providing
15 a "subsidy" to residential basic exchange service is nothing more than a distortion of the
16 facts. Supporting a small portion of the costs of the loop facility that toll services share is
17 not a "subsidy" to any other service, it is simply supporting a small portion of the cost of
18 the facility that is needed to provide, among other things, toll service.
19
20 The above discussion of costs and contribution demonstrates that there is no valid reason
21 for the rates of other customers to be increased to support toll services' price reduction.
22 The toll services are not currently being burdened with any disproportionate share of the
23 joint and common costs. In fact, the toll services' contribution to the joint and common

1 cost is much lower than the contribution being received from basic exchange service
2 rates.
3
4 **F. OPERATOR SURCHARGES**
5
6 Q. WHAT DOES USWC PROPOSE FOR OPERATOR SERVICES?
7 A. As indicated on his Supplemental Direct Exhibit DLT-45, Mr. Teitzel proposes to
8 increase the rates for a number of Operator Service Surcharges.
9
10 Q. WHAT ARE OPERATOR SERVICE SURCHARGES?
11 A. Operator Service Surcharges apply when a customer requests an operator (either
12 mechanized or human) to provide assistance with a call.
13
14 Q. ARE USWC'S PROPOSED OPERATOR SERVICE RATE INCREASES COST-
15 BASED?
16 A. No. Of USWC's total proposed revenue increase of $3,413,126 for Operator Services, all
17 but ** **[132] of that increase is for Operator Services whose current rates are
18 already above the costs that USWC has filed in this proceeding (both the TSLRIC "Total
19 Direct" and the "Total Direct Plus Network Support" costs).[133]

[132]Mechanized calling Card is the only Operator Service whose current rate is below USWC's claimed costs. The revenue impact of USWC's proposed rate change for Mechanized calling Card is an annual increase of ** **, as shown in Section C6.2.1 of USWC's USWC's Recurring Priceouts 1999 Test Year, provided in response to Data Request WDA 21-3.

[133]The current and proposed rates for USWC's Operator Service Charges are shown on Exhibit DLT-45 of Mr. Teitzel's Supplemental Direct Testimony and the costs are shown on Exhibit JLT-1 of Mr. Thompson's Supplemental Direct Testimony.

In addition, a number of the operator surcharges that USWC proposes rate increases for already have current rates that are far in excess of USWC's claimed costs. For example, as shown on Mr. Teitzel's Supplemental Direct Exhibit DLT-45, the current rate for "Connect to Directory Assistance" service is $1.50 and USWC's proposed rate is $2.25. However, as shown on page 14 of Mr. Thompson's Supplemental Direct Exhibit JLT-1, USWC's claimed cost of this service is ** ** per call.

Q. WHAT DO YOU RECOMMEND FOR OPERATOR SERVICES?

A. Some of these charges are very high and greatly exceed costs. Some of the USWC proposed operator assistance rates are $6.00 or more for one call. For most operator services, I have proposed some increases, although the increases I propose are not as high as the Company has proposed. The changes which I propose produce a revenue impact of ** **, as shown on Schedule WDA-20.

G. DIRECTORY ASSISTANCE

Q. WHAT DOES USWC PROPOSE FOR DIRECTORY ASSISTANCE (DA) SERVICES?

A. USWC has made the following proposals for DA in this proceeding:

1. Eliminate the monthly call allowance for DA;

2. Increase the rate for "traditional" DA from $0.47 per call to the National DA rate of $0.85 per call;

3. Include "Complete-A-Call" for the $0.85 per call rate.[134]

[134]Teitzel Direct Testimony, pages 54-57.

4. Increase the current PAL DA rate of $0.15 per call to $0.60 per call[135].

5. Increase the rate for carrier DA from $0.22 to $0.35 per call.[136]

Q. ARE USWC'S DA AND NATIONAL DA NOW CLASSIFIED AS "COMPETITIVE" SERVICES IN ARIZONA?

A. Yes. In its December 18, 1997 Order (Decision No. 60545) in Docket No. T-1051-97-369, the Commission classified USWC's National Directory Assistance (National DA) services as "competitive" services. In its December 14, 1999 Order (Decision No. 62129) in Docket No T-01051B-99-0362, the Commission classified USWC's Directory Assistance (DA) services competitive. In that proceeding, USWC was requesting an increase in the DA rates, however, the Commission deferred the proposed rate changes to this rate proceeding.

Q. IF DA IS NOW FLEXIBLY PRICED, WHY DOES USWC NEED THE COMMISSION'S APPROVAL TO INCREASE THESE DA RATES?

A. In this proceeding, USWC is asking for changes that are outside the scope of what they can accomplish without Commission approval under price flexibility. The DA rate increase that USWC proposes for "traditional" DA would go above the ceiling price that applies to the flexibly priced range. Therefore, USWC needs the Commission's specific approval to change that ceiling price.

[135]Wilcox Direct Testimony, page 22, line 7.

[136]Wilcox Direct Testimony, page 11.

1 Q. WHAT DO YOU RECOMMEND?

2 A. Staff does not oppose raising the cap to $0.85 for DA, nor does Staff oppose the
3 elimination of the one call monthly call allowance, and the other proposed changes listed
4 above. The addition of the "completed call" service at no charge will provide an
5 additional benefit to customers.

6

7 Q. IS THERE A PROBLEM WITH THE COMPANY FILING ON THIS ISSUE?

8 A. Yes. The Company admitted in discovery that it had miscalculated the revenue impacts,
9 shown on Schedule WDA-21. USWC stated that the $18.3 million revenue impact they
10 originally calculated should in fact have been $23.5 million. USWC stated it would
11 update its rate case to reflect this change.[137] The Company's current filing still includes
12 the above-referenced error. Based upon the 1999 test year data, the correct annual
13 revenue impact of the Company's proposal is ** **, as shown on Schedule
14 WDA-22. This compares to the $19,743,296 incorrect figure that is shown on Exhibit
15 DLT-48 of Mr. Teitzel's Supplemental Direct testimony. The primary error appears to be
16 in USWC's incorrect handling of the elimination of the free call allowance. This
17 elimination of this allowance results in a revenue increase because calls that are currently
18 free, will be charged for under this proposal.

19

20 Q. DOES USWC PROPOSE ANY OTHER CHANGES TO DIRECTORY ASSISTANCE
21 OTHER THAN THOSE YOU HAVE JUST DISCUSSED?

22 A. Yes. As discussed on page 22, line 7 of her Direct Testimony, Dr. Wilcox proposes to
23 increase the current PAL DA rate of $0.15 per call to $0.60 per call. The PAL DA would

1 be expanded to include access to national as well as local numbers. According to Dr.
2 Wilcox, these proposals are based on her claim that the present $0.15 per call rate is
3 below cost.[138]
4
5 For alternatively billed DA calls such as calling card and third number, Dr. Wilcox
6 proposes to offer DA with the addition of call completion for a rate of $0.85 per call.
7
8 Q. WHO PURCHASES PAL DIRECTORY ASSISTANCE SERVICE?
9 A. As Dr. Wilcox explains on page 22, line 8 of her Direct, this service is purchased by
10 payphone providers for resale to their end user customers.
11
12 Q. WHAT DOES USWC CHARGE PAYPHONE USERS FOR DIRECTORY
13 ASSISTANCE AT USWC-OWNED PAYPHONES IN ARIZONA?
14 A. USWC charges its payphone customers $0.35 for direct dialed calls to Directory
15 Assistance.[139]
16
17 Q. WHAT DO YOU RECOMMEND FOR PAL DIRECTORY ASSISTANCE SERVICE?
18 A. To be competitive with USWC's 35¢ payphone DA charge, competitive payphone
19 providers could not be expected to charge their customers more than 35¢ for a direct
20 dialed DA call. However, under USWC's proposal, those competitive payphone
21 providers would have to pay USWC 60¢ per DA call. This would force the competitive

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[137] These are the numbers that were based upon the test year ending June, 1998.
[138] Wilcox Direct Testimony, page 22, line 16.

[139] USWC's response to Data Request WDA 26-6.

1 payphone providers to provide service at a loss. Obviously, USWC is engaging a "price
2 squeeze" on those that compete against USWC payphones. Such a price squeeze is anti-
3 competitive. Therefore, Staff recommends that PAL rate for direct-dialed DA cannot
4 exceed the current charge of USWC, which is 35¢.
5
6 **H. PRIVACY LISTING SERVICES**
7
8 Q. WHAT DOES USWC PROPOSE FOR PRIVACY LISTING SERVICES?
9 A. USWC is proposing to increase Non-Published Service monthly rates by 66% (from
10 $1.80 to $3.00) for business customers and by 57% (from $1.90 to $3.00) for residence
11 customers. For Non-Listed Service, USWC proposes to increase the monthly rate 37%
12 (from$1.45 to $2.00) for business and 29% (from $1.55 to $2.00) for residence
13 customers.[140]
14
15 Q. IS THERE ANY COST REASON FOR INCREASING THESE RATES?
16 A. No. According to the costs presented by Mr. Thompson in this proceeding, the cost to
17 provide Non-Published and Non-Listed service is ** **.[141]
18
19 Q. DO YOU BELIEVE THAT NON-LISTED AND NON-PUBLISHED SERVICES ARE
20 PROPER TARGETS FOR EXTRACTING HIGH LEVELS OF CONTRIBUTION?

[140]Teitzel Direct Testimony, page 58, line 16.

[141]Thompson Supplemental Direct Testimony Exhibit JLT-1, page 15.

1 A. No. An indeterminate number of these customers have themselves been targets of
2 harassment or worse. These particular customers depend on restriction of access to their
3 telephone numbers as a form of protection. Under the USWC rate proposal, these
4 particular customers are a captive market. They must pay the higher rate to maintain the
5 protective shield of their private telephone numbers.
6
7 Q. WHAT IS ONE ARGUMENT USWC MAKES?
8 A. On page 58 of his testimony, Mr. Teitzel says,

9 These rates should be increased because Privacy Listings are discretionary
10 services which serve to devalue the public switched network over time. As more
11 customers make their telephone number unavailable for others through the use of
12 such services, telephone service for other customers is devalued.
13
14 Q. ARE ADDITIONAL RATE INCREASES NEEDED TO CURB THE GROWTH OF
15 PRIVACY LISTINGS?
16 A. No. The percent of residential listings omitted from the directories because of these
17 services is declining. The percent of residential lines omitted from the directories as a
18 result of these services is now ** ** lower than it was in the test year USWC utilized
19 in the 1993 general rate case. Less than ** ** of business lines are omitted from the
20 published directory due to privacy listing services.[142]
21
22 Q. WHAT DO YOU RECOMMEND CONCERNING THE RATES FOR THESE
23 SERVICES BY USWC?
24 A. I recommend the current non-published and non-listed rates continue. They are
25 producing a large contribution over the costs of providing these services.

[142]USWC's response to Data Request WDA 2-27 and WDA 21-12 (c).

I. PREMIUM LISTING SERVICES

Q. BEGINNING ON PAGE 58 OF HIS DIRECT TESTIMONY, MR. TEITZEL PROPOSES RATE CHANGES FOR SEVERAL PREMIUM LISTINGS. DO YOU OPPOSE THESE PROPOSED PREMIUM LISTING RATE CHANGES?

A. No. An example of a premium listing service is if a customer wishes their E-mail address to appear along with their listing in the directory.

Q. WHAT IS THE ANNUAL REVENUE IMPACT OF THE RATE PROPOSALS FOR PREMIUM LISTINGS?

A. The annual revenue impact of these proposals is an increase of approximately ** **.[143]

J. CUSTOM CALLING SERVICES

Q. WHAT DOES MR. TEITZEL PROPOSE FOR CUSTOM CALLING SERVICES?

A. For residence Custom Calling services, USWC proposes to increase the Caller Identification (Caller ID) -Name and Number monthly rate from $5.95 to $6.95 and an increase for Caller ID - Number from $5.50 to $6.95 per month. In addition, USWC

[143]Calculated from USWC's Recurring Priceouts 1999 Test Year, provided in response to Data Request WDA 21-3.

1 proposes to increase U S WEST Receptionist - Name and Number from $10.95 to $11.95
2 per month and U S WEST Receptionist - Number from $10.50 to $11.95 per month.[144]
3
4 In addition, USWC proposes to increase the monthly and "Pay Per Use" rates for Last
5 call Return Service for both business and residence customers. For residence, USWC
6 proposes to increase the monthly rate from $2.95 to $3.95 and for business, USWC
7 proposes a rate increase from $3.00 to $4.00. USWC proposes to increase the "Pay Per
8 Use" rate from $0.75 to $0.95 per use.[145]
9
10 Q. ARE THESE CUSTOM CALLING RATE INCREASE PROPOSALS SUPPORTED BY
11 USWC'S CLAIMED COSTS FOR THESE SERVICES?
12 A. No. According to USWC's cost studies for these services, USWC's claimed TSLRIC
13 (Total Direct) cost to provide Caller ID - Name and Number is only ** ** per
14 month; USWC's total monthly cost to provide Caller ID -Number is ** ** per
15 month and USWC's total monthly cost for Last call Return service is ** **.[146]
16 Therefore, USWC's current rates for these services already greatly exceed USWC's
17 claimed costs.
18
19 Q. WHAT DO YOU CONCLUDE WITH RESPECT TO USWC'S RESIDENTIAL
20 CUSTOM CALLING PROPOSALS?

[144]Teitzel Direct Testimony, page 61, lines 16-27, and also Teitzel Supplemental Direct Testimony Exhibit DLT-46.

[145]Teitzel Supplemental Direct Exhibit DLT-46.

[146]Thompson Supplemental Direct Testimony Exhibit JLT-1, page 21.

1 A. There is no valid cost-based reason to increase these rates. However, these services are
2 discretionary in nature. It is better to generate revenues from such discretionary services
3 than raising rates for universal services, such as basic exchange service.
4
5 Q. WHAT DOES MR. TEITZEL PROPOSE FOR BUSINESS CUSTOM CALLING
6 SERVICES?
7 A. Mr. Teitzel proposes to grandfather all existing packages of Custom Calling services with
8 the exception of SMARTSET, SMARTSET PLUS and Call Manager Connection. As
9 indicated on Mr. Teitzel's Supplemental Direct Testimony Exhibit DLT-46, these
10 services are found in Section 105.4.3, pages 3-5 of USWC's Exchange and Network
11 Services tariff.
12
13 Q. DO YOU OPPOSE THIS PROPOSAL?
14 A. No.
15
16 Q. WHAT IS THE REVENUE IMPACT OF THESE RESIDENTIAL CUSTOM CALLING
17 RATE PROPOSALS?
18 A. The total annual revenue impact of the proposed custom calling rate proposals is an
19 increase of $7.4 million. Of this total increase, ** ** is for residential custom
20 calling services, and ** ** for business, as shown on Schedule WDA-20.
21
22
23

K. SCREENING SERVICES

Q. WHAT CHANGES DOES USWC PROPOSE FOR TOLL RESTRICTION SERVICES?

A. As shown on Exhibit DLT-47 of his Supplemental Direct Testimony, Mr. Teitzel proposes the following changes for Toll Restriction/Screening services:

1. Increase the residential non-recurring charge (NRC) for Toll Restriction Service;
2. Establish a $12.50 residential/business NRC for Billed Number Screening;
3. Withdraw ScoopLine Access Restriction;
4. Establish a $12.50 residential/business NRC for 900 Service Access Restriction;
5. Increase the residential/business NRC for 10XXX1+/10XXX011+ Blocking

Q. DO YOU OPPOSE ANY OF THESE PROPOSED CHANGES?

A. Yes. I oppose Mr. Teitzel's proposal to increase the residential Non-Recurring charge for Toll Restriction Service from $6.00 to $12.50.[147] As Mr. Teitzel admits, the rationale behind this proposal is to generate increased revenues for USWC. Mr. Teitzel states:

> An increase in the residence nonrecurring charge is designed to generate additional revenue in this case.[148]

However, Toll Restriction service may be subscribed to by customers who have trouble controlling their toll usage or the toll usage of others who have access to their telephone. Therefore, when a customer subscribes to toll restriction, they are making an effort to keep their telecommunications service bills affordable. In addition, USWC's proposal to increase the non-recurring rate from $6.00 to $12.50 is not cost-based. According to

[147]Teitzel Supplemental Direct Testimony Exhibit DLT-47.

[148]Teitzel Direct Testimony, page 66, line 6.

1 USWC's residential non-recurring cost studies, the cost is ** ** at the most.[149] I
2 believe it would be inappropriate to extract large contribution from residential customers
3 who are making an effort to keep their telephone bills more affordable. For all of these
4 reasons, I recommend that the current residential non-recurring charge of $6.00 be
5 maintained for residential toll restriction service.
6
7 In addition, Staff believes that USWC's proposed $12.50 non-recurring charge for 900
8 Service Access Restriction is excessive. Staff believes that many of the customers who
9 are subscribing to 900 Service Access Restriction, similar to subscribers of Toll
10 Restriction service, are making an effort to keep their telecommunications service bills
11 affordable by preventing household members or other users of their telephone from
12 making costly telephone calls that can greatly inflate the monthly telecommunications
13 bill. Staff recommends that a non-recurring charge of $6.00 be established for 900
14 Access Charge Restriction. This rate is above USWC's claimed cost of ** ** shown
15 on page 21 of Mr. Thompson's Supplemental Direct Testimony Exhibit JLT-1.
16
17 Q. DO YOU OPPOSE ANY OF THE OTHER TOLL RESTRICTION/SCREENING
18 PROPOSALS ADVANCED BY USWC?
19 A. No. I do not oppose any of USWC's proposals for the other Toll Blocking and
20 Restriction Services. The revenue impact of the remaining proposed changes is a revenue
21 increase of approximately ** **.
22

[149]Thompson Supplemental Direct Testimony Exhibit JLT-1, page 21.

L. SWITCHED ACCESS SERVICE

Q. WHAT CHANGES DOES USWC PROPOSE TO THE SWITCHED ACCESS RATES?

A. USWC proposes a number of changes. The major impacts are a proposed reduction in the IC.[150] This reduces annual revenues by approximately ** **. The reduction of the carrier common line charge (CCLC) rate reduces annual revenues by approximately ** **. USWC proposes increases in the local switching rates and net decreases in switched transport rates. The total effect is an overall proposed decrease of approximately $5 million in switched access.

Q. ON PAGE 6, LINE 20 OF HER DIRECT TESTIMONY, DR. WILCOX CLAIMS:

> The carrier common line (CCL) charge today provides revenue contribution in support of basic telephone service for end-users. There are no direct access costs associated with this price element since it is generally related to the recovery of U S WEST's non-traffic sensitive (NTS) costs associated with the ubiquitous provision of basic telephone service.

IS DR. WILCOX'S DISCUSSION OF THE CCL CHARGE ACCURATE?

A. No. While Dr. Wilcox is correct that the CCL charge is the switched access rate element that is associated with the recovery of a portion of the non-traffic-sensitive loop facilities costs, Ms. Wilcox is incorrect that this represents a support for basic telephone service. Since switched access shares the loop, it should support a share of the loop costs. Dr. Wilcox is correct that the TSLRIC of switched access does not include the non-traffic sensitive (NTS) costs, such as loop costs, because the loop is a shared cost. However, for the same reason, the TSLRIC of basic exchange service also does not include the shared loop cost. However, proper prices must cover not only the TSLRIC (direct cost), but also

must cover the shared costs as well. If all costs, including the shared costs, are not covered, companies will go out of business. A portion of those shared costs should be borne by the switched access CCLC, as this Commission has properly found in the past.

In addition, in a current USWC general rate case in the State of New Mexico, Dr. Wilcox stressed the fact that the CCLC is merely a charge to the IXCs to contribute toward the network that the IXCs depend upon:

> Elimination of the CCL would mean that long distance carriers would no longer help pay for the local loop or help support the ubiquitous local network, which end-users and carriers alike depend upon.[151]

Switched access supporting a portion of the facilities that it depends upon, benefits from, and shares is not payment in support of another service. As discussed elsewhere in this testimony, residential basic exchange service costs is ** ** per line per month, if its cost is calculated in the same way that USWC has done for switched access service, which is to exclude all of the shared loop costs, and joint billing costs (standard envelope and first unit of postage). Basic exchange service and switched access service are both part of the group of services which share the loop, and both should properly contribute toward the recovery of the shared cost of the loop. Of course, switched access service, toll service, basic exchange service, and other services should be priced above their TSLRIC so as to contribute to the shared costs.

[150] The IC is sometimes referred to as the TIC, or the residual interconnection charge (RIC).
[151] Rebuttal Testimony of Barbara M. Wilcox, New Mexico Utility Case No. 3008, May 19, 2000.

1 Q. DO THE CURRENT SWITCHED ACCESS RATES MAKE AN UNREASONABLY
2 LARGE CONTRIBUTION TO THE SHARED, JOINT AND COMMON COSTS OF
3 PROVIDING TELECOMMUNICATIONS SERVICES IN ARIZONA?
4 A. No. As shown on Schedule WDA-19, the current intrastate switched access rates
5 (including the intrastate CCLC) make a contribution of ** ** per line above their
6 direct cost, toward the shared, joint and common costs of providing telecommunications
7 services in Arizona. For purposes of comparison, the current residential basic exchange
8 service rates make over ** ** more contribution per-line above direct
9 cost toward the shared, joint and common costs of USWC.
10
11 Q. ON PAGE 7, LINE 1 OF HER DIRECT, DR. WILCOX CLAIMS THAT USWC'S
12 INTERCONNECTION CHARGE (IC), WHICH WAS CREATED AS A RESULT OF
13 LOCAL TRANSPORT RESTRUCTURE, IS A SUPPORT FOR BASIC TELEPHONE
14 SERVICE. IS THIS AN ACCURATE CLAIM?
15 A. No. First of all, as discussed above, residential basic exchange service is not receiving a
16 subsidy or support from other services. In addition, as Dr. Wilcox indicates in her Direct
17 Testimony, in the last general rate case, USWC's switched access rates underwent a
18 Local Transport Restructure that aligned USWC's transport rates with the interstate rates
19 and rate structure.[152] The application of the IC was part of that restructure which copied
20 the interstate rate structure. In the interstate jurisdiction, the FCC intentionally set the
21 charge for the tandem switch rate element at 20% of its costs, and put the remainder of

[152]Wilcox Direct Testimony, page 5, line 5; Also see page 108, Decision No. 58927.

1 the tandem switch revenue requirement into the IC (sometimes referred to as the TIC).

2 The FCC stated:

3 The charge for the tandem switch was initially set to recover 20 percent of the
4 Part 69 tandem revenue requirement. Finally, to make the restructure revenue
5 neutral initially, we required incumbent LECs to establish a non-cost based
6 transport interconnection charge (TIC), to recover the revenue difference between
7 what the LECs would have realized under the equal charge rate structure and what
8 they would realize from the interim facility-based transport rates, including the
9 remaining 80 percent of the tandem revenue requirement.[153] (Citations omitted)
10
11
12 Q. ARE THE CURRENT SWITCHED ACCESS RATES PRODUCING AN
13 UNREASONABLE LEVEL OF CONTRIBUTION TOWARDS JOINT AND
14 COMMON COSTS?
15 A. No. As Schedule WDA-19 shows, switched access services are not producing an
16 unreasonable level of contribution to the joint and common costs, including the shared
17 loop costs.
18
19 Q. WHAT DO YOU RECOMMEND FOR USWC'S SWITCHED ACCESS SERVICES?
20 A. I propose the Commission allow a revenue neutral restructure of the switched access rates
21 by USWC. If USWC objects to the level of specific rates, such as the level of the IC,
22 their concern can be accommodated by a revenue neutral restructure. However, if the
23 intent is to transfer the support of joint and common costs away from switched access
24 onto other services, that concept is inappropriate and should be rejected. Switched access
25 services are not providing an unreasonable level of support to the joint and common
26 costs.

[153]FCC Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry, CC Docket No. 96-262 et. al., Released December 24, 1996, ¶82.

1

2 **M. ALTERNATIVES TO USWC'S SWITCHED ACCESS SERVICE**

3

4 Q. ON PAGE 28, LINE 19 OF HER DIRECT, DR. WILCOX SUGGESTS THAT THERE
5 ARE "MANY CASES" WHERE PRIVATE LINE CIRCUITS ARE REPLACING
6 SWITCHED EXCHANGE PBX TRUNKS AND 1FB LINES. ARE PRIVATE LINE
7 SERVICES A COMPETITIVE THREAT TO USWC'S SWITCHED ACCESS
8 SERVICES, OTHER THAN FOR VERY HIGH VOLUME LOCATIONS?

9 A. No. To connect to the average customer, switched access is a much more economical
10 alternative than a private line for carrying toll traffic. The average USWC intrastate
11 switched access revenues per line are ** ** per month, as shown on Schedule
12 WDA-19.[154] This represents the average switched access charges paid by IXCs to
13 USWC. A private line would require a separate loop. The monthly rate for just a
14 dedicated loop portion of private line service would be many times the charge for
15 switched access. Therefore, for the average customer location, it will not be an
16 economical alternative to pay the private line rates compared to paying switched access
17 rates.

18

19 Q. WOULDN'T MOST CUSTOMERS FOR WHOM PRIVATE LINE SERVICE IS AN
20 ECONOMICAL ALTERNATIVE, ALREADY BE USING PRIVATE LINE SERVICE
21 TO CARRY THEIR TOLL TRAFFIC?

[154]Calculated from USWC's responses to Data Requests WDA 21-13, Attachments A and C.

1 A. Yes. For those customers who originate and terminate extremely high volumes of toll
2 traffic, private line services like special access is an economical alternative. However,
3 the majority of those customers would already be using private line services to carry their
4 toll traffic. There may be a small percentage of customers whose level of usage is on the
5 borderline between making switched access and private line the more economical choice.
6 In these instances, a change in one of these service's rates may have an impact on a
7 customer's decision between the two services, however, this situation would be limited,
8 certainly not typical or average.
9
10 Q. WHAT IS USWC'S SHARE OF THE SWITCHED ACCESS MARKET IN ARIZONA?
11 A. USWC has a virtual monopoly of the switched access services in Arizona. For example,
12 according to the information provided by Dr. Wilcox in this proceeding, USWC's
13 competitors' share of the switched access minutes of use in Phoenix is less than
14 ** **.[155]
15
16 **N. INTRASTATE PRIVATE LINE**
17
18 Q. HAVE YOU DETERMINED THE REVENUE REQUIREMENT FOR USWC'S
19 INTRASTATE PRIVATE LINE SERVICES?
20 A. Yes. In response to discovery, USWC provided its Part 36 Separations Studies for the
21 year 1999.[156] These separations studies prepared by USWC separately show the

[155]Wilcox Direct Testimony Exhibit BMW-15 and Attachment L of USWC's response to Data Request WDA 1-15.

[156]USWC response to Requests WDA 23-7, 24-1 and 24-2.

intrastate interLATA and intrastate intraLATA private line revenue requirements. The local private line revenue requirement can also be determined from the figures that underlie that study. Data from USWC's own separations studies show that USWC's 1999 test year revenue requirement for its intrastate private line services is ** **, as is shown on Schedule WDA-23.

Q. WHAT WERE USWC'S INTRASTATE PRIVATE LINE REVENUES FOR ITS 1999 TEST YEAR?

A. USWC's intrastate private line revenues totaled ** ** for its 1999 test year.[157] Therefore, USWC's intrastate private line services have a ** ** annual revenue deficiency.

Q. WHAT DOES USWC PROPOSE FOR PRIVATE LINE SERVICES?

A. USWC has proposed the following for Private Line services:

1. Increase the recurring two-wire/four-wire Network Access Channel (NAC) Rates;
2. Increase some and reduce other Channel Performance rates;
3. Grandfather Local Area Data Service (LADS);
4. Increase fixed and per-mile transport mileage rates;
5. Increase some and reduce other Optional Features and Functions;
6. Increase some and reduce other Private Line NRCs;
7. Increase Digital Data Service (DDS) rates; and
8. Increase E911 Transport Rates.[158]

Q. WHAT IS THE REVENUE IMPACT OF USWC'S PRIVATE LINE AND E911 TRANSPORT SERVICE PROPOSALS LISTED ABOVE?

[157]USWC's response to Data Request WDA 30-3, Attachment A.

[158]McIntyre Supplemental Direct Testimony, pages 6-13.

1 A. The annual revenue impact is an increase in revenues of $5.6 million for the Private Line
2 service proposals, and an annual increase of $109,972 for the E911 transport proposals.[159]
3
4 Q. HAS THE COMMISSION DETERMINED THAT PRIVATE LINE SERVICES ARE
5 COMPETITIVE?
6 A. The Commission has classified the interexchange private line services as competitive and
7 flexibly priced.[160] The Commission has not classified the local private line services as
8 competitive or flexibly priced. In discovery, USWC was unable to separate the private
9 line revenues between the private line services the ACC has classified as competitive, and
10 the private line services the ACC has not classified as competitive.[161] It is reasonable to
11 expect that the majority of the private line revenues are in the category that the
12 Commission has classified as competitive. USWC contends that all private lines are
13 competitive, but the Commission Order which granted competitive status specifically
14 referenced "interexchange" private line services.
15
16 Q. WHAT DO YOU RECOMMEND?
17 A. I propose that USWC's proposal for E-911 and 911 services be granted as filed without
18 additional increases allowed. I recommend that the customers of USWC monopoly
19 services not be required to support USWC's pricing of their private line services below
20 cost. To allow this would be requiring the customers of what are primarily non-
21 competitive services to support USWC's competitive services. Therefore, I recommend

[159]McIntyre Supplemental Direct Testimony, pages 12-13.

[160] Paragraph 7, ACC Decision No. 59637.
[161] USWC response to Request WDA 16-002.

1 this Commission authorize USWC to increase its private line rates such as to produce an
2 additional ** ** in revenues.
3
4 Since at least a major portion of this service is flexibly priced, the Commission Order will
5 not mandate the USWC management to increase the price for these competitively priced
6 services, since that discretion has been given to management. However, the additional
7 revenues will be imputed in the revenue analysis in this proceeding, regardless of whether
8 the USWC management chooses to increase the private line rates or not. The revenue
9 requirement that is being considered in this case includes in excess of ** ** in
10 private line revenue requirement. However, the private line revenues are only **
11 **. Therefore, if the rates are not increased, or a revenue imputation is not made,
12 that will mean the rates for non-competitive services will have to be priced to cover
13 approximately ** ** of private line competitive service revenue requirement.
14 If USWC chooses to price its competitive services at a loss, that is a USWC management
15 decision which they are allowed to make under flexible pricing. However, in no event
16 should the rates for other non-competitive services be set to remove the private line
17 revenue requirement that the USWC management has elected to not recover in the private
18 line rates.
19
20 In short, the revenue impact calculation should include a ** **[162] annual
21 revenue increase for private line services, with the permission to make those increases

[162] The E911 increase of $109,972 is included in this proposal. Therefore, the increase for other services would be the stated amount less the E911 transport increase.

granted to USWC. That revenue impact should be used regardless of whether USWC chooses to take advantage of that permission or not.

Q. IF YOU DO NOT SPECIFICALLY ADDRESS A RATE DESIGN PROPOSAL OF USWC IN THIS TESTIMONY, DOES THAT MEAN YOU DO NOT OPPOSE THAT RATE PROPOSAL?

A. No. If I do not specifically address a rate design proposal of USWC in this testimony, that does not necessarily mean I do not oppose that rate proposal. I recommend that the rates shown on Schedule WDA-20 be implemented in this proceeding. I recommend that no other rate changes be made in this proceeding other than those shown on Schedule WDA-20.

V. UNIVERSAL SERVICE ISSUES

A. ARIZONA'S PENETRATION RATE IS BELOW AVERAGE. USWC'S PROPOSED RATE INCREASES FOR RESIDENTIAL BASIC EXCHANGE SERVICE WOULD HARM UNIVERSAL SERVICE.

Q. DOES ARIZONA ALREADY HAVE A BASIC LOCAL SERVICE PENETRATION PROBLEM?

A. Yes. Arizona lags behind most states in the USWC region and the majority of the states in the country in telephone service penetration rates. Only two states in USWC's 14-state region (New Mexico and South Dakota) have penetration rates that are below Arizona's current penetration rate of 93.2%. The average penetration rate for USWC's 14-state region is 94.9%. In addition, Arizona lags behind 33 states nationwide in penetration.

1 The current nationwide average penetration rate is 94.2%, leaving Arizona well below the
2 average for both USWC's region and the nation as a whole.[163]
3
4 Q. IS USWC'S PROPOSAL TO DRASTICALLY INCREASE THE RATES FOR LOW
5 INCOME AND LIFELINE CUSTOMERS IN THE PUBLIC INTEREST?
6 A. Absolutely not. USWC's proposal drastically increases the basic exchange service rates
7 for the customers that Mr. Teitzel admits are least able to pay for these services.[164] This
8 undermines the benefit of having assistance programs. USWC's proposal to drastically
9 increase these rates will jeopardize the ability of these needy customers to obtain
10 telephone service, is not in the public interest, and should be rejected by the Commission.
11
12 Q. ON PAGE 37 OF HIS DIRECT TESTIMONY, MR. TEITZEL CLAIMS THAT THERE
13 ARE APPROXIMATELY 160,000 CUSTOMERS THAT ARE ELIGIBLE FOR STATE
14 AND/OR FEDERAL ASSISTANCE IN PAYING FOR TELEPHONE SERVICE IN
15 ARIZONA. HOW MANY CUSTOMERS ACTUALLY RECEIVE ASSISTANCE IN
16 ARIZONA?
17 A. Only a small portion of those who Mr. Teitzel claims "qualify" for assistance actually
18 receive assistance. For example, USWC indicates that the average number of USWC's
19 customers that subscribe to Lifeline service in Arizona is 4,447 and the total number of
20 subscribers who receive assistance from USWC's Low Income Telephone Assistance

[163]Data for annual 1999 unit penetration. FCC's Monitoring Report, CC Docket No. 98-202, December 1999, Table 6.3.

[164]Teitzel Direct Testimony, page 37, line 14.

1 Program (TAP) is 3,835.[165] The fact is that programs such as Lifeline and TAP, which
2 provide assistance to low income consumers are helpful, however, such need-based plans
3 are not the full answer. Many of the customers that would qualify for such programs, for
4 a number of different reasons do not receive assistance from these programs. For
5 example, they may not be aware of these programs, may not be willing to go through the
6 administrative procedures required to qualify or may for personal reasons be unwilling to
7 accept assistance on the basis of their income.
8
9 Such programs do help some customers, but in the interest of universal service it is also
10 necessary that the residential basic exchange rates, which are available without requiring
11 the customer to declare and prove that they have low income, should be as reasonably
12 priced as possible.
13
14 Q. ON PAGE 35, LINE 33 OF HIS DIRECT, MR. TEITZEL CLAIMS THAT HIS
15 PROPOSED RESIDENTIAL BASIC EXCHANGE INCREASES WILL HAVE A
16 "NEGLIGIBLE" IMPACT ON SUBSCRIBERSHIP LEVELS IN ARIZONA. ARE
17 THERE MANY CUSTOMERS IN ARIZONA THAT ARE BEING PRICED OFF THE
18 NETWORK AT THE CURRENT RATES?
19 A. Yes. At USWC's current rates, USWC initiates the disconnection of over ** **
20 residential customers for non-payment per year.[166] This represents nearly ** ** of

[165]USWC's Response to Data Request WDA 21-12 (b), which is an updated response to USWC's response to Data Request WDA 2-16.

[166]According to Section E2.2.9 of USWC's Non-Recurring Priceouts 1999 Test Year, provided in response to Data Request WDA 21-3, USWC initiates the termination of an average of ** ** residential services per month.

1 USWC's total residential lines in service in the State of Arizona.[167] Many residential
2 customers are having trouble paying the phone bill even at current rates. Clearly,
3 drastically increasing the rates for residence basic local exchange service would make
4 these situations even worse.
5
6 Q. WHAT SHOULD BE DONE TO PROMOTE AN INCREASE IN PERCENT
7 PENETRATION IN ARIZONA?
8 A. In order to promote an increase in percent penetration in Arizona, the non-recurring and
9 recurring residential basic exchange rates must be kept as low as possible. USWC's
10 proposal to reduce the non-recurring residential basic exchange rates is a step in the right
11 direction, but the USWC proposal to greatly increase the recurring rates will have a
12 negative impact on penetration.
13
14 **B. UNIVERSAL SERVICE SHOULD BE AFFORDABLE FOR ALL**
15 **CUSTOMERS, NOT JUST "MOST CUSTOMERS"**
16
17 Q. ON PAGE 36 OF HIS DIRECT, MR. TEITZEL ARGUES THAT "MOST
18 CUSTOMERS" WILL BE ABLE TO AFFORD THE RESIDENTIAL BASIC
19 EXCHANGE RATE INCREASES THAT HE PROPOSES IN THIS PROCEEDING.
20 DO YOU BELIEVE THAT A BASIC EXCHANGE RATE INCREASE IS
21 WARRANTED AS LONG AS "MOST CUSTOMERS" CAN AFFORD TO PAY IT?
22 A. No. First of all, the current residential basic exchange service rates are not only already
23 well above the relevant residential basic exchange service TSLRICs, but also residential

[167] According to USWC's ARMIS Report 43-08 for the year 1999, Row 130, USWC has 2,009,298 residential lines in service in Arizona.

basic exchange service makes the largest contribution of any major service category to the joint, shared and common costs, as shown on Schedule WDA-19. Secondly, residential basic exchange service is one of the services included in the definition of universal service. Due to the importance of this foundational service, residential basic exchange service should be universally affordable to all of those who wish to subscribe to it, not just affordable for what USWC calls "most customers."

C. CHARGING EXCESSIVE RATES IN AREAS WHERE LITTLE OR NO COMPETITION EXISTS WILL NOT "ATTRACT" COMPETITORS

Q. ON PAGE 43, LINE 9 OF HIS DIRECT TESTIMONY, MR. TEITZEL CLAIMS THAT USWC'S PROPOSED RATE INCREASES FOR RESIDENTIAL BASIC EXCHANGE SERVICE "WILL INCENT COMPETITIVE GROWTH." WILL THESE PROPOSED RATE INCREASES PROMOTE COMPETITIVE GROWTH IN ARIZONA?

A. No. USWC is claiming that it is pro-competitive to reduce rates in those areas where they may face competition, while increasing rates in those areas where little or no competition exists. USWC is arguing that such a policy may attract competition to the areas or services where there is currently little or no competition. First of all, it is obvious that USWC would not propose a strategy that would actually result in increasing competition to itself. It is not in USWC's interest to propose a price structure that would attract competition for itself.

USWC lowering the prices where they face competition forces the competitors to lower their prices, which lower competitors' earnings. This does not benefit the competitors.

USWC charging higher prices where they have monopoly power does not attract competitors, as will be discussed below. The high monopoly rates would attract competitors only if those competitors knew that those high monopoly rates would continue to exist once the competitors arrived in the area. However, from their past experience with LECs like USWC, the competitors know very well that those high "monopoly" rates cease once the competitors enter the market. The competitors know very well that once they started competing in an area or service, USWC would drop their high "monopoly" rates and replace them with their low "anti-competitive" rates in those areas and for those services where competition existed.

By pricing competitive services to produce little or even negative earnings, the LECs can make the competitors unprofitable, limit their growth, and send a message to the potential competitors that their profits will be low or non-existent wherever it is they choose to compete with that LEC.

D. RELATIONSHIP BETWEEN UNBUNDLED NETWORK ELEMENTS AND RETAIL SERVICES

Q. ON PAGE 33 OF HIS DIRECT TESTIMONY, MR. TEITZEL ARGUES THAT THERE MUST BE A LOGICAL RELATIONSHIP BETWEEN THE PRICES FOR UNBUNDLED NETWORK ELEMENTS AND THE RATES CHARGED FOR INDIVIDUAL SERVICES. IN TELECOMMUNICATIONS, IS IT COMMON FOR THE APPROPRIATE RATE FOR AN INDIVIDUAL SERVICE TO BE LESS THAN

1 THE CHARGE FOR THE UNBUNDLED NETWORK ELEMENTS THAT ARE
2 NEEDED TO PROVIDE THAT SERVICE?
3 A. Yes. In telecommunications, nearly all services are provided over shared facilities.
4 When it is USWC that is providing the services to its end-users using those shared
5 facilities, the proper rate design for those services is to price each service at a level that
6 contributes to the recovery of the cost of the shared facilities.
7
8 When these facilities are rented to a competitor, these facilities are referred to as
9 "unbundled network elements." When a competitor rents unbundled network elements
10 from USWC, it is up to the competitor to properly price each of its services that it
11 provides using these elements at a level that contributes to the recovery of the shared cost
12 of renting those facilities from USWC.
13
14
15 **E. WIRELESS SERVICES ARE NOT A PRACTICAL ALTERNATIVE TO**
16 **LANDLINE TELECOMMUNICATIONS SERVICES**
17
18 Q. MR. TEITZEL DEDICATES SEVERAL PAGES OF HIS SUPPLEMENTAL DIRECT
19 TESTIMONY TO A DISCUSSION OF WIRELESS SERVICE PROVIDERS. ON
20 PAGE 25 OF HIS TESTIMONY, HE REFERENCES A SURVEY THAT FOUND 45%
21 OF PHOENIX HOUSEHOLDS AND 43% OF TUCSON HOUSEHOLDS SUBSCRIBE
22 TO WIRELESS SERVICE. ON HIS SUPPLEMENTAL DIRECT TESTIMONY
23 EXHIBIT DLT-43, HE PROVIDES DATA SHOWING AN INCREASE IN
24 CELLULAR MINUTES OF USE IN ARIZONA. DOES THIS INFORMATION

1 DEMONSTRATE THAT CELLULAR SERVICE IS REPLACING LANDLINE
2 TELECOMMUNICATIONS SERVICES?
3 A. No. At best, this information demonstrates that cellular services are a form of
4 telecommunications that are a supplement to landline telecommunications services, not a
5 replacement for them. As discussed elsewhere, the household penetration rate for basic
6 exchange service in Arizona is 93.2%.[168]
7
8 Q. HAVE USWC'S LINES IN SERVICE BEEN INCREASING OVER TIME, DESPITE
9 THE FACT THAT WIRELESS SERVICES HAVE BEEN AROUND FOR SOME
10 TIME?
11 A. Yes. Despite the fact that wireless services have been around and growing for many
12 years now, USWC's number of access lines in service in Arizona has grown year after
13 year. In addition, in response to discovery, USWC provided its forecast of residential
14 lines in service through the year 2003. This forecast shows that USWC anticipates the
15 number of both residential main lines and additional lines to **
16 **.[169] In addition, nationwide the number of access lines (landline) has grown
17 year after year, at the same time cellular service was also rapidly growing. Clearly, the
18 growth of wireless service is not resulting in the decline of landline telephone service.
19

[168]FCC's Monitoring Report, CC Docket No. 98-202, December 1999, Table 6.3.

[169]USWC's response to Data Request WDA 3-22, Attachment A.

1 Q. ON PAGE 26 OF HIS SUPPLEMENTAL DIRECT TESTIMONY, MR. TEITZEL
2 CLAIMS THAT THE RATES FOR WIRELESS SERVICES ARE "EXTREMELY
3 COMPETITIVE WITH WIRELINE SERVICES." DO YOU AGREE?
4 A. No. One of the key determinants of the price of a cellular service package is the number
5 of minutes that are included in the package. According to USWC, the average monthly
6 residential basic exchange service flat-rate local usage on a USWC line is ** **
7 outgoing minutes.[170] Nationwide, the percent of households that have telephone service
8 (landline) has grown over the last ten years, even while cellular service was rapidly
9 growing.[171] Of course, a call that is outgoing on one line is incoming on another line, so
10 the total usage for landline telephone service is approximately in excess of ** **
11 minutes per line. Cellular service generally charges separately for incoming as well as
12 outgoing minutes.[172] In his Supplemental Direct Testimony Exhibit DLT-30, Mr. Teitzel
13 provided a comparison of some of the wireless service packages that are offered in
14 Arizona. Under the wireless plans shown on Mr. Teitzel's Exhibit, a wireless plan that
15 included 1,000 minutes of use would cost a minimum of about $49.99 per month.[173] This
16 is over 3.5 times the USWC charge for landline residential basic exchange service, which
17 is $13.18 per month.[174]
18

[170]USWC's response to Data Request WDA 1-32 (A).

[171] FCC's Monitoring Report.

[172] Some PCS allows the first incoming minute at no charge, but then charges after that.

[173]Of the plans shown on Exhibit DLT-30, VoiceStream Wireless Get More 2000 Service would be the closest reasonable charge. Under this plan, the customer is charged $39.99 per month for 500 "anytime" minutes and an additional $10.00 for 500 "weekend" minutes. Therefore, the total charge would be $49.99.

[174]Teitzel Direct Testimony, page 28.

VI. CONCLUSION

Q. WHAT DO YOU RECOMMEND?

A. Staff recommends the rate design as shown on Schedule WDA-20. The Staff recommendation is a reasonable proposal that balances the Company interest with the public interest. The Staff's recommendations are based upon proper rate design principles and requirements, including those included in TA96.

Staff recommends that the Commission deny the USWC "competitive zone" proposal. Staff recommends that any regulatory structure that is adopted should include a specific requirement that prices in different geographic areas may not vary by an amount that is greater than the variation that is justified by any variation in the cost of providing service. If the regulatory structure allows price flexibility or "revenue neutral" restructuring, any such restructure should not increase the rate differential between geographic areas that is incorporated in the specifically approved ACC rates, without specific Commission approval.

USWC's "competitive zone" proposal has not been supported by the evidence that the Commission rules require it to provide to show a service or area is competitive. Many of the services in many areas that USWC considers to be competitive will not meet the requirements of the Commission rule, and are not competitive by standard criteria. The data that USWC has provided in this proceeding indicates that fewer than **

** of the residential lines in service have been ported in the 23 wire centers that USWC proposes be immediately established as residential "competitive zones". The data USWC provided shows that USWC has "lost" only about ** ** of the business lines, and is serving ** ** of the business lines, even within the 49 wire centers that USWC proposes be immediately established as "competitive zones".

In addition, USWC's "competitive zone" proposal would allow USWC to violate Section 254(k) of the TA96. The proposal would allow USWC to shift the recovery of joint and common costs away from competitive services, and onto monopoly ratepayers across geographic areas of the state. Under USWC's proposal, USWC would be allowed to charge higher rates for a service in areas that are subject to little or no competition and lower rates for that service where competition does exist. This difference in pricing would not have to reflect a difference in cost of providing service. This is contrary to the requirements of Section 254(k). The Commission must establish cost allocation rules or other safeguards which prevent such a discriminatory recovery of the joint and common costs.

USWC's claims that residential basic exchange service is "below cost" and is receiving a "subsidy" from other services, is based upon a direct violation of the proper calculation of direct costs/TSLRICs. The accepted definition of TSLRIC dictates that only costs that are directly caused by one service are to be considered as the direct costs of that service. The loop facility is shared by several services, but USWC improperly included 100% of the loop cost in its claimed direct cost/TSLRIC for basic exchange service. However, for

1 the other services that share the loop facility, which include toll, switched access, and
2 vertical services, USWC included no portion of the loop facility costs. When the direct
3 cost/TSLRIC of residential basic exchange service is calculated using the accepted
4 TSLRIC definition, the direct cost of residential basic exchange service is ** **. If
5 USWC ceased providing residential basic exchange service, while continuing to provide
6 all other services, USWC would lose an average of $13.18 per month, per line in revenue,
7 but would save only ** ** per line per month in costs, even in the long run. USWC
8 is clearly better off with residential basic exchange service than without it. Residential
9 basic exchange service makes the largest contribution toward the residential shared joint
10 and common costs of any residential service.
11
12 Q. DOES THIS CONCLUDE YOUR RATE DESIGN TESTIMONY?
13 A. Yes.

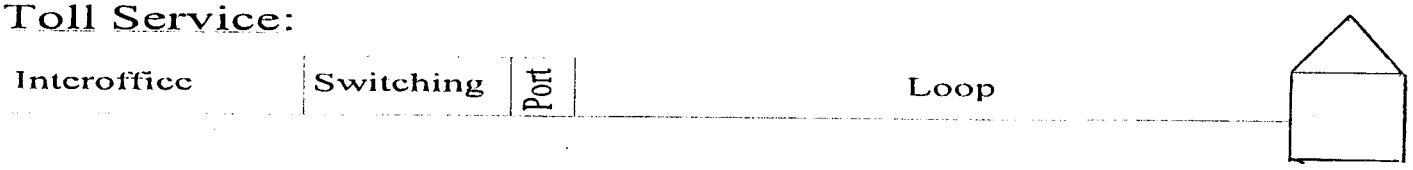
SCHEDULE WDA-16 CONTAINS INFORMATION

CLAIMED TO BE PROPRIETARY BY USWC.

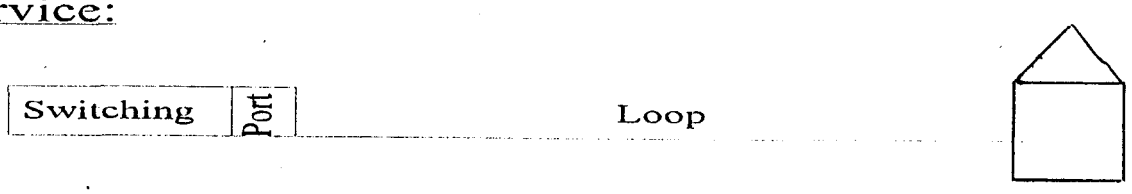
THEREFORE, IT HAS BEEN DELETED

FROM THIS TESTIMONY.

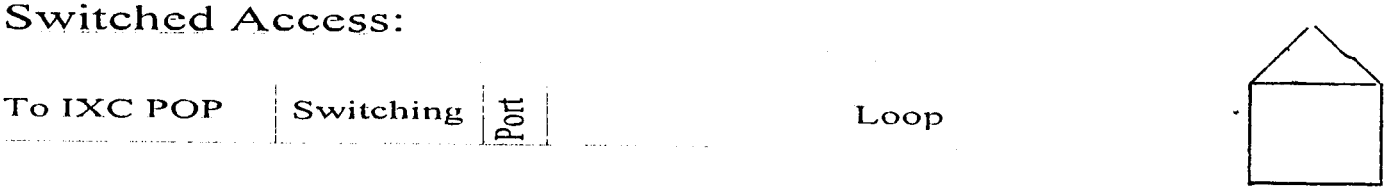
Toll Service:



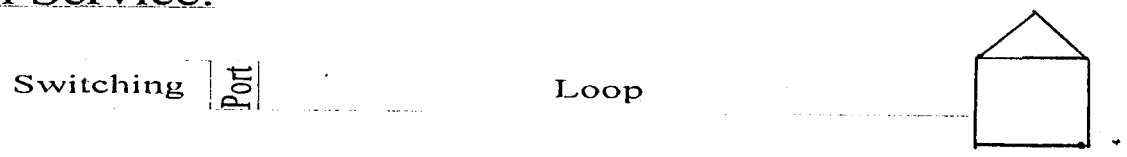
Vertical Service:



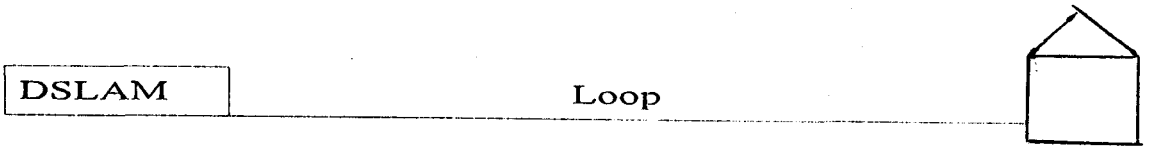
Switched Access:



Basic Local Service:



ADSL:



SCHEDULE WDA-18 CONTAINS INFORMATION

CLAIMED TO BE PROPRIETARY BY USWC.

THEREFORE, IT HAS BEEN DELETED

FROM THIS TESTIMONY.

SCHEDULE WDA-19 CONTAINS INFORMATION

CLAIMED TO BE PROPRIETARY BY USWC.

THEREFORE, IT HAS BEEN DELETED

FROM THIS TESTIMONY.

SCHEDULE WDA-20 CONTAINS INFORMATION

CLAIMED TO BE PROPRIETARY BY USWC.

THEREFORE, IT HAS BEEN DELETED

FROM THIS TESTIMONY.

Arizona
Docket No. T-1051B-99-105
WDA 19-005

INTERVENOR: Arizona Corporation Commission Staff (Dunkel)

REQUEST NO: 005

With reference to USWC's June 28, 1999 petition to classify its Directory Assistance Service as competitive, USWC requested that the Commission allow USWC to implement a $1.50 maximum rate for DA service and to eliminate the one call allowance for DA.

A. Please provide USWC's estimated annual revenue impact of its proposed changes for DA. The revenue impact provided should show all present quantities, proposed quantities, present rates and proposed rates for DA.

B. Please provide a breakdown of the revenue impact provided in response to part (a) to separately show the revenue impact that results from the proposed rate increase and the revenue impact that results from the elimination of the one-call allowance for DA.

RESPONSE:

a. On December 7, 1999, the Commission approved U S WEST's petition to classify its DA service as competitive. However, the Commission did not approve the proposed pricing changes included in the petition, stating that the price changes and associated revenue impact would be addressed in the rate case. The original revenue impact of U S WEST's pricing proposal in the rate case was $18.261 million, as stated in the Direct Testimony of David Teitzel. However, since that time, the Company has received updated information indicating that the revenue impact should have been shown as $23.538 million. The Company is preparing an update to its rate case filing to reflect this change.

b. The revenue impact associated with the Company's revised rate case DA proposal is shown on Confidential Attachment A. Confidential Attachment A is being provided pursuant to the terms of the Protective Agreement in this proceeding.

SCHEDULE WDA-22 CONTAINS INFORMATION

CLAIMED TO BE PROPRIETARY BY USWC.

THEREFORE, IT HAS BEEN DELETED

FROM THIS TESTIMONY.

SCHEDULE WDA-23 CONTAINS INFORMATION

CLAIMED TO BE PROPRIETARY BY USWC.

THEREFORE, IT HAS BEEN DELETED

FROM THIS TESTIMONY.

QWEST (US WEST COMMUNICATIONS)

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ARIZONA CORPORATION COMMISSION

DOCKET NO. T-01051B-99-105

DIRECT TESTIMONY

OF

STEPHEN G. HILL

ON BEHALF OF

THE

ARIZONA CORPORATION COMMISSION STAFF

August 9, 2000

DIRECT TESTIMONY

OF

STEPHEN G. HILL

QWEST (US WEST COMMUNICATIONS)

DOCKET NO. T-01051B-99-105

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INTRODUCTION / SUMMARY

Q. PLEASE STATE YOUR NAME, OCCUPATION AND ADDRESS.

A. My name is Stephen G. Hill. I am self-employed as a financial consultant, and principal of Hill Associates, a consulting firm specializing in financial and economic issues in regulated industries. My business address is P. O. Box 587, 4000 Benedict Road, Hurricane, West Virginia, 25526 (e-mail: sghill@compuserve.com).

Q. BRIEFLY, WHAT IS YOUR EDUCATIONAL BACKGROUND?

A. After graduating with a Bachelor of Science degree in Chemical Engineering from Auburn University in Auburn, Alabama, I was awarded a scholarship to attend Tulane Graduate School of Business Administration at Tulane University in New Orleans, Louisiana. There I received a Master's Degree in Business Administration. More recently, I have been awarded the professional designation "Certified Rate of Return Analyst" by the Society of Utility and Regulatory Financial Analysts. This designation is based upon education, experience and the successful completion of a comprehensive examination. A more detailed account of my educational background and occupational experience appears in Appendix A.

Q. HAVE YOU TESTIFIED BEFORE THIS OR OTHER REGULATORY COMMISSIONS?

A. Yes, I have appeared previously before this Commission. In addition, I have testified on cost of capital, corporate finance and capital market issues in over 175 regulatory proceedings before the following regulatory bodies: the West Virginia Public Service Commission, the Texas Public Utilities Commission, the Oklahoma State Corporation Commission, the Public Utilities Commission of the State of California, the Pennsylvania Public Utilities Commission, the State of Maine Public Utilities Commission, the Minnesota Public Utilities Commission, the Ohio Public Utilities Commission, the Insurance Commissioner of the State of Texas, the North Carolina Insurance

Commissioner, the Rhode Island Public Utilities Commission, the City Council of Austin, Texas, the Missouri Public Service Commission, the South Carolina Public Service Commission, the Public Utilities Commission of the State of Hawaii, the Maryland Public Service Commission, the Public Service Commission of Utah, the Illinois Commerce Commission, the Kansas Corporation Commission, the Indiana Utility Regulatory Commission, the Virginia Corporation Commission, the Montana Public Service Commission, the New Mexico Public Service Commission, the Public Service Commission of Wisconsin, the Vermont Public Service Board, the Federal Communications Commission and the Federal Energy Regulatory Commission. I have also testified before the West Virginia Air Pollution Control Commission regarding appropriate pollution control technology and its financial impact on the company under review and have been an advisor to this Commission on matters of utility finance.

Q. ON BEHALF OF WHOM ARE YOU TESTIFYING IN THIS PROCEEDING?

A. I am testifying on behalf of the Staff of the Arizona Corporation Commission (Staff).

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I have been requested by the Staff to present a cost of capital analysis for the Arizona local exchange operations of Qwest, formerly US WEST Communications, Inc. (USWC[1], the Company). As part of my analysis, I will recommend and testify to the overall rate of return that should be utilized in determining the revenue requirement for the Company in this proceeding. In addition, I will comment on the cost of capital testimony submitted by Company witness Peter Cummings.

Q. HAVE YOU PREPARED AN EXHIBIT IN SUPPORT OF YOUR TESTIMONY?

A. Yes. I have prepared an Exhibit, entitled Exhibit__(SGH-1), consisting of 12 Schedules. This Exhibit was prepared by me and is correct to the best of my knowledge and belief.

[1] Qwest's local exchange operations will be referenced in this testimony as USWC-Arizona or USWC-AZ, and due to the recent name change, Qwest will be referred to as US WEST Communicaions in this testimony.

Q. PLEASE SUMMARIZE YOUR TESTIMONY AND FINDINGS CONCERNING THE RATE OF RETURN WHICH SHOULD BE ALLOWED IN ESTABLISHING A REVENUE REQUIREMENT FOR THE ARIZONA LOCAL EXCHANGE TELEPHONE OPERATIONS OF US WEST COMMUNICATIONS IN THIS PROCEEDING.

A. My testimony is organized into four sections. First, I review the current macro-economic environment in which my equity return recommendation is made and show that current economic indicators support the reasonableness of that recommendation. Second, I review the Company's requested capital structure and determine an appropriate ratemaking capital structure.

Third, I evaluate the Company's cost of equity capital using Discounted Cash Flow (DCF), Modified Earnings-Price Ratio (MEPR), Market-to-Book Ratio (MTB) and Capital Asset Pricing Model (CAPM)) analyses. It is not possible to directly analyze the equity capital cost of a local exchange telecommunications firm like USWC-Az because no firms exist which engage only in those operations. Therefore, I determine the cost of equity using proxy groups that bracket the operating risk of USWC-Az. That is, the equity capital cost rates of firms that have similar-but-lower risk as well as firms that have similar-but-higher risk than USWC-Az are analyzed, and provide an indication of the upper and lower bound of the cost of equity for a local exchange telephone company.

In the fourth section of my testimony, I discuss the shortcomings contained in Company witness Cummings' equity capital cost analysis. Mr. Cummings' analysis improperly focuses only on firms that have higher operating risk than USWC-Arizona. The Company witness' analysis uses telecommunications holding companies as well as a sample of fully-competitive firms to estimate the cost of equity. However, information relative to the level of competition experienced in Arizona (provided by the Company in response to Staff data requests) indicates that competition has made only very small inroads into the Company's local exchange operating revenues, and net profits are up strongly during the past few years. Therefore, the Company's own operating data confirms that USWC-Az remains a near-monopoly provider of local exchange service—a relatively lower-risk enterprise. Therefore, Mr. Cummings' exclusive focus on fully-competitive

firms produces an equity cost estimate which overstates that appropriate for the Company's local exchange operations in Arizona.

I have estimated the equity capital cost of local exchange telephone operations of similar risk to US WEST Communications to be in the range of 11.0% to 12.5%. Within that range, a reasonable point estimate of the cost of equity capital for the Company is at the mid-point of that range, or 11.75%. Utilizing an 11.75% equity cost rate with the cost of debt and capital structure requested by the Company produces an overall cost of capital range for US WEST Communications of 9.55% (see Exhibit_(SGH-1), Schedule 12). I recommend that the Commission rely on that overall return for the purpose of setting rates for USWC-Arizona in this proceeding.

Q. WHY SHOULD THE COST OF CAPITAL SERVE AS A BASIS FOR THE PROPER ALLOWED RATE OF RETURN FOR A REGULATED FIRM?

A. The Supreme Court of the United States has established, as a guide to assessing an appropriate level of profitability for regulated operations, that investors in such firms are to be given an opportunity to earn returns that are sufficient to attract capital and are comparable to returns investors would expect in the unregulated sector for assuming the same degree of risk. The Bluefield and Hope cases provide the seminal decisions [Bluefield Water Works v. PSC, 262 US 679 (1923); FPC v. Hope Natural Gas Company, 320 US 591 (1944)]. These criteria were restated in the Permian Basin Area Rate Cases, 390 US 747 (1968). However, the Court also makes quite clear in Hope that regulation does not guarantee profitability and, in Permian Basin, that, while investor interests (profitability) are certainly pertinent to setting adequate rates, those interests do not exhaust the relevant considerations.

As a starting point in the rate-setting process, then, the cost of capital of a regulated firm represents the return investors could expect from other investments, while assuming no more and no less risk. Since financial theory holds that investors will not provide capital for a particular investment unless that investment is expected to yield their opportunity cost

of capital, the correspondence of the cost of capital with the Court's guidelines for appropriate earnings is clear.

I. ECONOMIC ENVIRONMENT

Q. WHY IS IT IMPORTANT TO REVIEW THE ECONOMIC ENVIRONMENT IN THE PROCESS OF DETERMINING AN EQUITY COST ESTIMATE?

A. The cost of equity capital is an expectational, or *ex ante*, concept. In seeking to estimate the cost of equity capital of a firm, it is necessary to gauge investor expectations with regard to the relative risk and return of that firm, as well as that for the particular risk-class of investments in which that firm resides. Because this exercise is, necessarily, based on understanding and accurately assessing investor expectations, a review of the larger economic environment within which the investor makes his or her decision is most important. Investor expectations regarding the strength of the U.S. economy, the direction of interest rates and the level of inflation (factors that are determinative of capital costs) are key building blocks in the investment decision. They should be reviewed by the analyst and the regulatory body in order to assess accurately investors' required return—the cost of equity capital.

Q. IN LIGHT OF THE CURRENT FINANCIAL AND ECONOMIC ENVIRONMENT IN THE U.S., WHY DO YOU BELIEVE AN 11.75% RETURN ON EQUITY CAPITAL IS REASONABLE FOR A LOCAL EXCHANGE TELEPHONE COMPANY IN TODAY'S CAPITAL MARKET?

A. Although there was a strong upward movement in interest rate levels during 1999 and the first half of 2000, the overall level of fixed-income capital costs continues to remain relatively modest by historical standards. Also, there are examples in the marketplace for equities that indicate that investor return requirements continue to remain relatively low.

For example, recent investor service reports regarding the utility industry indicate that investment return expectations in that industry are relatively modest. As this

Commission is well aware, the energy utility is changing dramatically as restructuring occurs in both the electric and gas businesses. Therefore, while carrying less risk than telecommunications companies generally, gas utilities face many of the same kinds of competitive (i.e., bypass) risks faced in the local exchange telephone industry, and, thus, provide an indicator of the lower end of investors' return expectations for local exchange telephone companies.

A recent A.G. Edwards report on the gas utility industry[2] indicates that market-based return expectations for gas utility stocks are well below historical earned returns. That investor service publication reports that, for a sample of 19 large and small gas distributors, the median total return expectation (dividend yield plus expected growth—a DCF-type calculation) is approximately 9.5%. That total equity return expectation is far below the lower end of the range of equity returns I recommend in this proceeding for USWC-Arizona—11.0%.

A.G. Edwards also reviews the estimated total return for "integrated" gas utilities, and energy merchant companies. Those firms, unlike gas distribution operations (and similar to telephone companies), have significant non-utility operations and, as a result, have a higher overall investment risk. A.G. Edward's median market return expectation for all the gas industry companies it reviews is 10.1%. Therefore, even for gas operations that engage in significant unregulated operations (exploration, production, gas marketing), investors' equity return expectations, as exhibited by that recent A.G. Edwards publication, are below the lower end of the range I recommend for USWC-Arizona in this proceeding. Those data confirm that my 11.75% equity return recommendation for telecommunications companies is conservative.

Another indication of the reason investors are willing to buy and hold stocks that offer relatively low returns is shown in Exhibit__(SGH-1), Schedule 1, page 1, which depicts Moody's A-rated utility bond yields from 1984 through May, 2000. Page 1 of Schedule 1 shows that interest rates and capital costs, even with the recent yield increases, remain low relative to the interest rate levels that existed in the mid-1980s. Also, page 2 of

[2] A.G. Edwards, "Gas Utilities Quarterly Review," March 31, 2000.

Schedule 1 (Exhibit__(SGH-1)), which presents the year-average Moody's A-rated bond yields for each year over the past 30 years (1968-1999), shows that the last time debt cost rates were as low as they were during 1998 was roughly thirty years ago. In 1999, A-rated bond yields were considerably higher than the average yield established in 1998 (approximately 7.6% versus 7% in 1998) but that level is still similar to average bond yield levels last seen in the U.S. in the late 1960s and early 1970s (prior to the 1974 oil embargo). Even the most recent average A-rated utility bond yield, 8.2%[3], falls in the lower range of interest rates that have existed over the past 30 years.

The above data indicate that capital costs, even with the recent credit tightening by the Federal Reserve, remain at relatively low levels and generally support the efficacy of my range of equity capital costs. However, it is important to note here that equity capital cost rates and bond yields do not move in lock-step fashion over time. In fact, the variability of that return differential is a fundamental reason why risk premium type analyses—which attempt to quantify the additional return over bond yields required by equity investors—are not reliable as primary indicators of equity capital cost. Therefore, it is necessary to perform an independent cost of equity capital analysis, rather than to simply "index" the cost of capital to current interest rates.

Q. PLEASE BRIEFLY DESCRIBE THE INTEREST RATE CHANGES THAT HAVE OCCURRED IN THE U.S. ECONOMY OVER THE PAST FEW YEARS AND HOW THEY IMPACT CAPITAL COST RATE EXPECTATIONS FOR THE FUTURE.

A. The interest rate trough that existed in 1986 and early 1987, mentioned above, spurred increased economic activity in the U.S. The rate of growth in the U.S. Gross Domestic Product (GDP) increased rapidly by the end of 1987 and showed signs of continuing to gain strength. That increased economic activity, in turn, led to increased inflation expectations (a rapid rate of economic growth can create shortages in labor and materials, driving up the price of those factors of production which ultimately results in higher prices

[3] Value Line *Selection & Opinion*, most recent six weekly editions (4/28/00-6/2/00, inclusive), A-rated utility bond yield averages.

in all sectors of the economy). That expectation of increased inflation caused the Fed to act aggressively to slow down what was widely believed to be an overheating economy. The very sharp interest rate rise that followed in late 1987 and 1988, shown on Exhibit__(SGH-1), page 1 of Schedule 1, succeeded in damping down the economy, reducing inflationary pressures, and allowing interest rates to fall again.

Since that time, the "cat and mouse" game between the Fed and nascent inflation has continued to be a primary influence in the U.S. macro-economy and the level of interest rates. Overall, as inflation has remained calm, interest rates have trended downward, but that general downward direction has been interrupted when investors (and/or the Fed) believed that falling interest rates would spur rapid economic growth. Rapid economic growth has, historically, created unwanted inflation. Investors therefore, anticipating that higher inflation and interest rates might be the result of rapid economic expansion, have reacted to positive economic news (e.g., increasing GDP growth rates, lower unemployment) or negative inflation news (e.g., increasing commodity prices, factory capacity or labor shortages) by bidding down debt prices and driving up interest rates. That is precisely the economic situation that fueled the more recent interest rate peaks from 1994 through the 1999/2000 period (see Exhibit__(SGH-1), Schedule 1, page 1).

As I noted previously, single-A rated utility debt yielded about 7.6%, on average, in 1999, while, more recently, equivalently-rated debt has been priced to yield 8.2%. That cost rate increase is due, primarily, to investors' concerns regarding the continued strength of the U.S. economic expansion (now the longest peacetime expansion U.S. in history) and the potential for increased inflation caused by that rapid level of growth. As Value Line noted in its most recent Quarterly Review regarding economic growth, inflation and the interest rate environment, the current expectation is that the Federal Reserve's credit tightening will, in the latter half of 2000 begin to slow down the economy. Moreover, Value Line predicts that while interest rate increases will be volatile for a time, they will continue in the future at relatively moderate levels preserving a favorable capital cost environment:

"**Economic Growth**: As noted, growth surged late in 1999 and in the early part of this year. Moreover, we look for just a modest reduction in activity this quarter, with GDP rising by at least 4.0%-4.5% [chart omitted]. A further slowing in the pace of activity is then likely in the third and fourth quarters, as past and prospective tightening moves by the Fed start to finally clip the sails of the housing, retail, labor, and industrial markets [chart omitted]. Continued moderation in growth, to the 3.0%-3.3% level, would then seem likely in 2001. Thereafter, assuming no major miscalculations by the Fed, or exogenous shocks on the U.S. or international stage, GDP growth would likely hold near that level over the next 3 to 5 years. We caution, however, that deviations from such a growth path—indeed, even a recession—are possible within this several-year projection period.

Inflation: On balance, the rate of price inflation remains modest. For example, producer prices fell in the latest month and consumer prices were unchanged, reflecting a brief, early spring decline in oil prices. More recently, however, oil quotations have rebounded to around the $30-a-barrel level. That uptick, coupled with a rise in both wage and benefits costs, is spreading fear through the financial markets for its potential implications on the interest-rate front. Our sense, though, is that barring a further surge in oil prices or an unexpected flareup elsewhere on the pricing spectrum, producer (or wholesale) prices will probably average a still-manageable 3% this year, while the less volatile Consumer Price Index should hold in the 2.5% area. Slower growth should then allow these inflation gauges to moderate in 2001 [chart omitted].

Interest Rates: Currently, in contrast to the expected gradual moderation in growth and inflation over the course of the next few quarters, we see no such decline, or even stability, on the interest rate front. Indeed, it appears likely that short-term rates may head higher before they go lower, with one or more rate increases likely before the Fed is finished with its monetary tightening initiatives later this year. The right side of all this is that once the lead bank has accomplished its objective (i.e., to reduce growth and keep price inflation at bay), long-term rates, which largely reflect inflationary expectations, should decline. That, in turn would help to set the stage for further growth out to the middle years of this decade [chart omitted]" (The Value Line Investment Survey, *Selection & Opinion*, June 2, 2000, pp. 4879, 4880)

In that most recent Quarterly Economic Review, Value Line projects long-term Treasury bond rates will average 6.2% through 2000 and 5.8%-5.9% each year through

2004. The recent six-week average 30-year T-bond yield is 5.92% (data from Value Line, *Selection & Opinion*, six weekly editions, April 28, through June 2000), with the yield falling to 5.8% in the most recent week. Therefore, the indicated expectation with regard to interest rates is that they are likely to fluctuate somewhat during the remainder of this year, but will remain within a relatively narrow range over the next few years. These data indicate that the current environment of relatively low capital costs is likely to continue into the future.

II. CAPITAL STRUCTURE

Q. WITH WHAT CAPITAL STRUCTURE HAS US WEST COMMUNICATIONS REQUESTED RATES BE SET IN THIS PROCEEDING?

A. As discussed in Company witness Cummings' Supplemental Direct Testimony, page 2, US WEST Communications is basing its rate request on the book value capital structure of USWC as reported to the Federal Communications Commission and as allocated to the Company's Arizona operations. That is, the dollar amounts of the capital used to establish the weights used in the Company's requested weighted cost of capital are based on the values that appear on its balance sheet as reported to the FCC. Some portion of those amounts is then allocated to the Company's Arizona operations to produce the capital amounts shown in Mr. Cummings Exhibit PCC-02. The Company's allocated capital structure consists of 52.4% common equity, and 47.6% total debt (long-term and short-term debt). It is important to note that this capital structure is more leveraged (i.e., contains more debt and less equity) that the capital structure originally filed[4]. Because of that fact, the Company's updated capital structure request would more cost-effectively finance its Arizona operations.

[4] The Company originally requested a ratemaking capital structure consisting of 58.76% equity and 41.24% debt.

Q. IS THE CAPITAL STRUCTURE ON WHICH MR. CUMMINGS RELIES IN THIS PROCEEDING THE CAPITAL STRUCTURE THAT US WEST PRESENTS TO INVESTORS?

A. No, it is not. Exhibit_(SGH-1), Schedule 2, page 1 contains the capital structures that US WEST presents to investors and the investment community in its Investor Handbook and its Securities and Exchange Commission reports. In its publications targeted to investors US WEST presents "consolidated" (total operations including directory publishing, wireless, enhanced phone services, etc.) and "telephone operations only" capital structures which are quite different than the allocated capital structure on which the Company relies for ratemaking purposes in this proceeding.

The upper half of page 1 of Schedule 2 shows US WEST's consolidated capital structure over the past five years, as reported in the Company's 1998 Investor Handbook and its January 26, 2000 S.E.C. Form 8-K. Those data indicate that, absent consideration of short-term debt, US WEST's consolidated equity ratio averaged between 39% and 46% from 1995 through 1997. If short-term debt were included in the calculation of those capital structures the equity ratios would be lower. More recently, at year-end 1998 and 1999, US WEST's consolidated equity ratio fell dramatically, comprising only 8% to 10% of capital (again, excluding consideration of short-term debt). That recently published equity ratio is only a fraction of that requested by the Company for ratesetting purposes in this proceeding.

The lower half of page 1 of Schedule 2 depicts US WEST's "telephone operations only" capital structure as reported to investors over the past five years. That presentation of the Company's capitalization indicates an equity ratio ranging from approximately 37% to 44% of total equity over the 1995-1999 period. Over that five-year period the average year-end equity ratio for the "telephone operations only," according to the Company's own published data, averaged approximately 40% of total capital. It is important to note, these data are taken from a handbook designed especially for investors and published by US WEST.

Therefore, in presenting its balance sheet and capitalization to the investment community, the Company indicates a substantially different capitalization than that reported to the FCC and utilized by Mr. Cummings to determine the overall cost of capital. The capital structures presented to investors indicate a more highly leveraged company (a firm which is capitalized with more debt and less equity) than the capital structure requested by the Company in this proceeding. All else equal, a firm financed with less debt and more equity will impart lower financial risk to the equity holder and investors will require a lower return for due to that additional cushion. This is a widely-accepted tenet of modern corporate finance.

Q. DO THE OTHER TELECOMMUNICATIONS HOLDING COMPANIES EXHIBIT SIMILAR CAPITAL STRUCTURES TO THAT PUBLISHED BY US WEST's TELEPHONE OPERATIONS?

A. Yes. Page 2 of Schedule 2 shows the most recent available capital structure for the telecommunications holding companies studied in this testimony and published in Value Line (*Ratings & Reports*, April 7, 2000). Absent consideration of US WEST's consolidated capital structure (which contains a very low equity ratio), the telecommunications holding companies are currently capitalized with approximately 44% equity and 56% fixed-income capital (preferred stock, long- and short-term debt). Those recent-average equity and fixed-income percentages for the telecommunications holding companies indicate that those firms (which include riskier, competitive operations) are capitalized with less equity and more debt, on average, than the Company requests in this proceeding.

It is important to note that the equity ratio implicit in the capital structure requested by the Company in this proceeding falls within the range exhibited by the telecommunications holding companies. Absent consideration of US WEST's capitalization, the equity percentage of the capital structures exhibited by the larger telecommunications holding companies currently ranges from approximately 32% (GTE

Corp.) to 55% (SBC Corp.). The Company's requested ratemaking capital structure, which contains 52.4% common equity, falls near the top end of that range.

Q. HOW DOES THE COMPANY'S REQUESTED CAPITAL STRUCTURE COMPARE TO THE CURRENT CAPITALIZATION OF GAS AND ELECTRIC UTILITY OPERATIONS?

A. The June 2000 edition of CA Turner's Utility Reports indicates that the current average equity ratio in the electric industry (81 electric and combination electric and gas utilities) is 39% of total capital. For the gas distribution and integrated natural gas industry, that same publication indicates that those firms are currently capitalized with an equity ratio of 43%. The Company's requested equity ratio, 52.4%, is well above the equity ratios which exist, on average, in the utility industry.

Q. WHAT IS YOUR RECOMMENDATION, THEN, WITH REGARD TO THE CAPITAL STRUCTURE AND EMBEDDED COST RATES THAT SHOULD BE USED IN DETERMINING THE OVERALL COST OF CAPITAL IN THIS PROCEEDING?

A. Schedule 2, page 3 shows that, for purposes of determining an overall rate of return in this proceeding I have elected to rely on the capital structure and embedded cost rates requested by the Company in this proceeding. That capital structure consists of 52.43% equity and 47.57% debt. As I noted above, that ratemaking capital structure contains an equity ratio which is above that employed, on average, by telecommunications holding companies and utility operations and falls at the upper end of the range of capital structures exhibited by those firms. Therefore, that capital structure will impart less financial risk, on average, than that employed by either the telecommunications holding companies or utilities. In that way, the capital structure that I recommend recognizes the potential for increased operating risk in local exchange telephone operations. The embedded cost of debt used in my recommended capital structure is that requested by the Company—7.39%.

III. METHODS OF EQUITY COST EVALUATION

DISCOUNTED CASH FLOW MODEL

Q. PLEASE DESCRIBE THE DISCOUNTED CASH FLOW (DCF) MODEL YOU USED TO ESTIMATE THE COST RATE OF COMMON EQUITY CAPITAL FOR THE COMPANY'S LOCAL EXCHANGE TELECOMMUNICATIONS OPERATIONS.

A. The DCF model relies on the equivalence of the market price of the stock (P) with the present value of the cash flows investors expect from the stock, providing the discount rate equals the cost of capital. The total return to the investor, which equals the required return according to this theory, is the sum of the dividend yield and the expected growth rate in the dividend.

The theory is represented by the equation,

$$k = D/P + g \ , \qquad (1)$$

where "k" is the equity capitalization rate (cost of equity, required return), "D/P" is the dividend yield (dividend divided by the stock price) and "g" is the expected sustainable growth rate.

Q. WHAT GROWTH RATE (g) DID YOU ADOPT IN DEVELOPING THE COST OF COMMON EQUITY FOR THE COMPANY?

A. The growth rate variable in the traditional DCF model is quantified theoretically as the dividend growth rate investors expect to continue into the indefinite future. The DCF model is actually derived by 1) considering the dividend a growing perpetuity, that is, a payment to the stockholder which grows at a constant rate indefinitely, and 2) calculating the present value (the current stock price) of that perpetuity. The model also assumes that the company whose equity cost is to be measured exists in a steady state environment, i.e., the payout ratio and the expected return are constant and the earnings, dividends, book value and stock

price all grow at the same rate. As with all mathematical models of real-world phenomena, the DCF theory does not exactly "track" reality. Payout ratios and expected equity returns do change over time. Therefore, in order to properly apply the DCF model to any real-world situation and, in this case, to find the long-term sustainable growth rate called for in the DCF theory, it is essential to understand the determinants of long-run expected dividend growth.

Q. CAN YOU PROVIDE AN EXAMPLE TO ILLUSTRATE THE DETERMINANTS OF LONG-RUN EXPECTED DIVIDEND GROWTH?

A. Yes, an example, which illustrates the determinants of long-run expected dividend growth, is provided in detail in Appendix B.

Q. DID YOU USE THE SUSTAINABLE GROWTH RATE APPROACH TO DEVELOP AN ESTIMATE OF THE EXPECTED GROWTH RATE FOR THE DCF MODEL?

A. Yes. The objective of this proceeding is to determine rates for USWC's local exchange operations in Arizona. One important part of that determination is an estimate of the cost of equity capital to the company. Direct market data regarding USWC-Arizona's equity capital is not available. Therefore, I have calculated both the historical and projected sustainable growth rate for a sample of telecommunications firms with sizeable local exchange operations, which was also used by Company witness Cummings in his Direct Testimony. That sample of companies is comprised of the remaining former Bell Regional Holding Companies (RHCs) and GTE. In addition, and in order to more accurately assess the equity capital cost rate of USWC-Az's local exchange operations, I have estimated the equity capital cost a sample of property/casualty insurance companies and natural gas distribution companies. To supplement the sustainable growth rate analysis, I have also analyzed published data regarding both historical and projected growth rates in earnings, dividends, and book value for all the companies under study.

Q. WHY HAVE YOU USED THIS TECHNIQUE OF ANALYZING THE MARKET DATA OF SEVERAL COMPANIES?

A. In addition to the fact that USWC-Arizona's common equity is not publicly traded, I have used the "similar sample group" approach to cost of capital analysis because such an analysis yields a more accurate determination of the cost of equity capital than does the analysis of the data of one individual company. Any form of analysis in which the result is an estimate, such as growth in the DCF model (or any other equity cost estimation model), is subject to measurement error, i.e., error induced by the measurement of a particular parameter or by variations in the estimate of the technique chosen. When the technique is applied to only one observation (e.g., estimating the DCF growth rate for a single company) the estimate is referred to, statistically, as having "zero degrees of freedom." This means, simply, that there is no way of knowing if any observed change in the growth rate estimate is due to measurement error or to an actual change in the cost of capital. The degrees of freedom can be increased and exposure to measurement error reduced by applying any given estimation technique to a sample of companies rather than one single company. Therefore, by analyzing a group of companies with similar characteristics, the estimated value for the growth rate and the resultant cost of capital is more likely to equal the "true" value for the parameters being measured for a utility of that type.

Q. WHY WERE THE REMAINING RHCs AND GTE SELECTED FOR YOUR ANALYSIS OF THE COST OF EQUITY CAPITAL OF US WEST'S ARIZONA OPERATIONS?

A. Although there are significant changes occurring in the telecommunications industry that make the RHCs and GTE more risky and their equity costs higher than local exchange telephone operations such as USWC-Arizona, I believe an equity cost analysis of those firms can offer useful information in estimating the equity capital cost of a telephone utility operation. Of course, the RHCs and GTE have stepped up diversification efforts and local exchange operations now comprise less than half of all revenues collected by those companies. That significant diversification into unregulated, competitive operations has increased the investment risk of those firms and the concomitant higher return expectation

is impounded in their stock prices and investor-expected returns. Therefore, while local exchange operations remain a profit center for those firms and, as a result, their market data provide some indication of the cost of equity of that type of firm, those companies also have invested in riskier operations which will raise the market required return above that of a local exchange telephone company. For those reasons, the market-based equity cost of the telecommunications holding companies should be considered to provide an indication of the upper end of a reasonable range of equity capital costs for USWC-Az's local exchange operations.

It is important to note also that some of the firms included in the telecommunications sample group are in the process of merging (e.g., US WEST/Qwest, Bell Atlantic/GTE) and, because of that fact, the determination of an accurate cost of equity estimate for local exchange operations, using those firms as proxies, has become more problematic. The telecommunications companies included in my equity capital cost rate analysis are: Bell Atlantic Corporation (BEL), Bell South Corporation (BLS), GTE Corp. (GTE), SBC Communications (SBC), and US WEST Communications (USW). [Note: The stock ticker symbols are referenced here because that is the manner in which the companies are identified in Exhibit_(SGH-1).]

Q. YOU INDICATED THAT YOU HAVE ALSO ANALYZED THE MARKET DATA OF A SAMPLE OF PROPERTY/CASUALTY INSURANCE COMPANIES. PLEASE EXPLAIN WHY THAT MARKET INFORMATION IS USEFUL IN INDICATING A PROPER EQUITY COST RANGE FOR A LOCAL EXCHANGE TELEPHONE OPERATION.

A. As I noted above, there is no direct market-based, or "pure-play" proxy for local exchange telephone operating companies. The telecommunications firms I have selected have the advantage of actually having some local exchange operations as part of their business mix—that fact makes them a reasonable proxy in our task of isolating the cost of equity of that type of operation. However, those companies are expanding rapidly into other, riskier endeavors and are also consolidating and merging operations. In my view, those facts

make the cost of equity result based on the market data of those firms a less robust indicator of the upper limit of the cost of equity of local exchange telecommunications operation like USWC-Arizona. For that reason, I have elected to also analyze the cost of equity of a group of property/casualty insurance companies followed by Value Line.

My inclusion of property/casualty insurance companies in my analysis in this proceeding is designed to provide a more reliable upper bound to the cost of equity range appropriate for a local exchange telephone operation. The insurance industry is highly competitive. It is a relatively simple process to change one's insurance provider, and no one firm has a franchise operation in any locale or is a provider through which other insurance must be accessed (like local exchange service).

The use of insurance firms as a determinant of the upper end of a range of equity cost, then, recognizes the potential for eventual competition (and the cost of equity which results from that situation) in the local exchange business. Moreover, in some states insurance companies are rate-regulated. While the regulation is not as detailed as is utility regulation, it is similar, and that aspect adds to the usefulness of these companies as proxies to establish the upper-end of a reasonable range of equity capital costs for local exchange operations.

In selecting a sample of insurance firms to analyze, I screened all the property and casualty and diversified insurance firms followed by Value Line. I selected companies that had a continuous financial history (i.e., currently paying a dividend, and had no dividend reductions or erratic earnings over, at least, the most recent five years) and had revenues generated by private property insurance. The data for the sample group regarding the writing of property insurance (fire, homeowners, farmowners and allied lines) were obtained from Best's Aggregates and Averages, 1998 edition[5].

The companies included in the sample group are W. R. Berkley Corp. (BKLY), Chubb Corporation (CB), Cincinnati Financial Corp. (CINF), NAC Re Corp. (NRC), Ohio Casualty Corp. (OCAS), RLI Corp. (RLI), SAFECO Corporation (SAFC), St. Paul

[5] Best's Aggregates and Averages is a widely-utilized source for current and historical data on the property/casualty insurance industry. The data presented in the 1998 edition, is the most recent available. The 1999 edition of Best's will not be published until the Fall of 2000.

Companies (SPC), Selective Insurance Group, Inc. (SIGI), Transatlantic Holdings (TRH), American Bankers Insurance Group (ABI), American International Group, Inc. (AIG), and Unitrin (UNIT).

Q. YOU INDICATED THAT YOU HAVE ALSO ANALYZED THE MARKET DATA OF A SAMPLE OF GAS DISTRIBUTION COMPANIES. PLEASE EXPLAIN WHY THAT MARKET INFORMATION IS USEFUL IN INDICATING A PROPER EQUITY COST RANGE FOR A LOCAL EXCHANGE TELEPHONE OPERATION.

A. As I noted above, the telecommunications and insurance firms studied in my analysis carry higher investment risk that a local exchange telephone operation like USWC-Az, due to their competitive operations. Therefore, an analysis of the market data of those firms will provide a cost of equity capital estimate that is greater than that appropriate for a local exchange telephone operation. In order to balance the analysis, it is necessary to also analyze a group of companies that are somewhat similar in risk to local exchange telephone operations, but have somewhat *lower* overall risk. Natural gas distribution operations fulfill that requirement. By estimating the cost of equity of all three sample groups, the cost of equity capital for a local exchange telephone utility operation can be more accurately estimated, being bracketed above by the equity capital cost of the telecommunications holding companies and insurance firms and below by the equity capital cost of gas distributors.

While gas distribution operations are generally considered to carry less investment risk than telephone operations, there are many similarities between the local exchange telephone industry and the gas distribution industry. Like the telephone industry, the gas industry underwent massive structural changes in the 1980s. Due to regulatory changes at the Federal level and pressures in the marketplace, the gas utility system in the U.S. was split into a transportation industry and a distribution industry. In broad terms, that bifurcation of the gas industry was similar to the separation of the telephone industry into long distance and local exchange operations. In addition, gas distributors have faced the "bypass" problem that telephone company representatives have, for years, touted as a

major risk to the security of their income stream. Gas distributors are bypassed due to the ability of pipelines to supply gas directly to customers, as well as the ability of customers in some portions of the U.S. to purchase gas supplies directly from producers or other marketers, or in gas-rich areas of the country, to drill their own wells. Finally, the operational risk of the marketing function (securing a reliable supply of gas for a particular customer base), which was once borne solely by the pipelines, has been shifted forward to the distributors. Gas distribution operations, then, face operational risks similar to local exchange telephone operations, and market-based indicators of capital costs for gas distributors are useful in identifying the lower end of the range of appropriate capital costs for local exchange telephone operations.

In selecting a sample of gas distribution firms to analyze, I screened all the gas distribution firms followed by Value Line. I selected companies from that group that had a continuous financial history, had at least 70% of revenues generated by gas distribution operations, and had investment-grade bond ratings of "A" or below. In addition, I eliminated companies that were in the process of merging or being acquired and had realized a stock price shift due to that activity. The data for the sample group regarding the percent of revenues generated by gas distribution operations were obtained from CA Turner Utility Reports, June 2000 edition.

The companies included in the similar-risk sample group in this proceeding are AGL Resources (ATG), Atmos Energy Corporation (ATO), Cascade Natural Gas Corporation (CGC), New Jersey Resources (NJR), Northwest Natural Gas (NWNG), Piedmont Natural Gas Company (PNY), and South Jersey Industries (SJI).

Q. REGARDING YOUR USE OF GAS DISTRIBUTORS AS A LOWER-RISK PROXY FOR LOCAL EXCHANGE TELECOMMUNICATIONS, HAS THE COMPANY PROVIDED ANY EVIDENCE IN THIS PROCEEDING THAT SUPPORTS YOUR USE OF THOSE COMPANIES AS A PROXY FOR LOCAL EXCHANGE TELEPHONE OPERATIONS?

A. Yes, the Company has provided evidence in response to Staff Data Requests that indicates that the use of a gas distribution equity cost estimate as a lower bound of the cost of equity appropriate for USWC-AZ is a reasonable procedure. When asked in Staff-SGH-01-09 to, "... provide any and all data available to quantify the dollar impact of competition on the revenue stream of the Company's Arizona telephone operations, each year, since 1993," the Company provided a confidential response which showed which indicated a very small impact on its revenues. Based on the most recent annualized data, the Company's response to SGH-01-09 indicates that competition in USWC-Arizona's local exchange operations currently amounts to a cumulative impact of less than 1% of the Company's 1999 local exchange revenues. Therefore, while there appears to be some impact to the Company's revenue stream from competition, it is quite small in relation to total local exchange revenues.

In addition, the Company's response to SGH-01-11 shows that the revenues and net income generated for USWC-Az shows strong, unimpeded upward movement. Exhibit__(SGH-1), Schedule 3, page 1, is a graphical representation of USWC-Az's local service and total jurisdictional revenues from 1989 through 1999. Over that period, USWC-Az's local service revenues have increased very steadily, have nearly doubled and have averaged 6.4% growth, annually over the period. The Company's total jurisdictional revenues have grown a bit slower on average—5.5% annually versus 6.4% annually for the local service revenues—but in the most recent three of four years, the Company's total jurisdictional revenues have increased more rapidly. The Company's income statements reveal that the increased rate of total revenue growth has come from the recent increases in "Miscellaneous" revenues. Therefore, during a period in which competition is supposedly creating greater operating risk for USWC-Az, the Company's total revenues are increasing at an increasing rate.

Also, page 2 of Schedule 3 is a graph that shows the Company's jurisdictional net income since 1993—the time of USWC-Az's last rate case. That graph shows a very strong upward trend in net income for this Company—an increase from $40.7 Million in 1993 to $164.6 Million in 1999.

In sum, the data provided by the Company to support its claim that its operating risk has increased markedly due to the amount of competition in Arizona does fulfill that requirement. The only tangible data that the Company is able to provide indicates that any revenue impact that might have occurred from competition in Arizona is very small, indeed. Moreover, the Company's operating data (revenues and net income) show very strong upward trends during a period in which the Company implies that it is exposed to "significant competition"[6]. The data that I have reviewed, which are provided by the Company, indicate that USWC continues to operate in an environment that, while no longer fully monopolistic, certainly imparts less risk than one which is fully competitive. For that reason, it is clear that 1) the operating risk of USWC-Az is well below that of the telecommunications holding companies or any fully-competitive firm, and 2) gas distribution utility operations offer a reasonable proxy for the determination of the lower end of a reasonable range of equity capital cost for this Company.

Q. HOW HAVE YOU CALCULATED THE DCF GROWTH RATES FOR THE SAMPLE OF COMPARABLE COMPANIES?

A. Schedule 4, pages 1 through 9, shows the retention ratios, returns on equity, sustainable growth rates, book values per share and number of shares outstanding for the comparable companies for the past five years. Also included in the information presented in Schedule 4, are Value Line's projected 2000, 2001 and 2003-2005 values for equity return, retention ratio, book value growth rates and number of shares outstanding.

I review these data as well as other growth rate information published by investor services for each company in my sample group, arriving at a growth rate estimate for each individual company. Those individual growth rate estimates are then combined with their respective dividend yields for each company and the results are averaged to reach the DCF equity cost estimate for the sample group. In describing the process of growth rate estimation below, I utilize my analysis for Piedmont Natural Gas as an example of the procedure I follow for each company in the sample group.

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[6] Cummings Direct Testimony, p. 9, l. 8.

In evaluating the growth rate parameters shown in Schedule 4, I first calculate the five-year average sustainable growth rate, which is the product of the earned return on equity and the ratio of earnings retained within the firm. For example, Schedule 4, page 8, shows that the five-year average sustainable growth rate for Piedmont Natural Gas (PNY) is 3.81%. However, I seldom use that simple five-year average sustainable growth value as the investor-expected sustainable growth in the DCF model. Instead, that value is used as a benchmark against which I measure the company's growth rate trends. It is reasonable to believe that growth rate trends tend to be more investor-influencing than simple historical averages. Continuing to focus on Piedmont Natural Gas, page 8 of Schedule 4 shows that PNY's sustainable growth rate began the historical period at about a 2.8% rate. However, the Value Line data indicate that over the last couple of years PNY's "b times r" growth rate increased to over 4%, before dropping back to a 3% level of growth in the most recent year (1999). Value Line projects that by the 2003-2005 period sustainable growth for this company will rise to 5.25%. These data would indicate that investors expect PNY to grow at a rate in the future above that, which has existed, on average, over the past five years.

At this point I should note that, while the projected data are given full consideration in estimating a proper growth rate because they are available to and are used by investors, they are not given sole consideration. Value Line readily acknowledges to its subscribers the subjectivity necessarily present in estimates of the future:

> "We have greater confidence in our year-ahead ranking system, which is based on proven price and earnings momentum, than in 3- to 5-year projections." (Value Line Selection and Opinion, June 7, 1991, p. 854).

Another factor to consider is that PNY's book value growth is expected to remain stable at a 6.5% level, after increasing at that same rate, historically. However, that company's dividend growth rate, which was 6% historically, is expected to decline to 4.5% in the future. As shown on Schedule 5, page 2, Value Line projects PNY's dividend growth rate to be below the sustainable growth rate projections. That information would tend to moderate investor expectations regarding increased growth in the future. Projected

earnings growth rate data available from Value Line indicates that investors can expect a slightly higher growth rate in the future (7%) than has existed over the past five years (6%). However, an investor advisory service (Multex.com) that polls institutional analysts for growth earnings rate projections projects lower earnings growth rate for PNY—5.57%—over the next five years.

PNY's projected sustainable growth, as well as institutional analysts' and Value Line's projected earnings growth indicates that investors can expect higher growth than has occurred, on average, in the past. Those projections are moderated somewhat by an expectation of lower dividend growth. A long-term sustainable growth rate of 5.25% is a reasonable expectation for PNY.

Q. DOES THE TYPE OF GROWTH RATE ESTIMATION PROCESS YOU HAVE JUST DESCRIBED PRODUCE THE FINAL DCF GROWTH RATE YOU USE TO ESTIMATE THE COST OF EQUITY CAPITAL?

A. No. An investor's sustainable growth rate analysis does not end upon the determination of an internal growth rate from earnings retention. Investor expectations regarding growth from external sources (sales of stock) must also be considered and examined.

For PNY, page 8 of Schedule 4 shows that the number of outstanding shares increased at a 2.07% rate over the most recent five-year period. Value Line expects the number of shares outstanding to increase more slowly through the 2003-2005 period, bringing the share growth rate down to a 1.06% rate by that time. An expectation of share growth of 1.5% is reasonable for this company.

Because a goal of regulation is to allow a utility to recover no more than its cost of capital, it is also reasonable to assume that investors would expect the market price/book value ratio to have a tendency toward unity. However, the price/book ratio is unlikely to reach 1.0 overnight and, on average, utilities will continue to issue stock at prices above book value. I believe that a reasonable estimate of investors' expectations for utility price/book ratios is that it will range between current levels and 1.0. I have used the average as an estimate of investors' expectations for the future. At the time of this analysis

(June 2000), PNY's market price is 172% of its year-end 2000 book value (M/B = 1.72). The result of combining expected internal (b x r = 5.25%) and external growth rates (1.5%) yields an investor-expected long-term growth rate of 5.79% for PNY (see Exhibit__(SGH-1), Schedule 5, page 5 of 6). [I have included the details of my growth rate analyses for PNY as an example of the methodology I use in determining the DCF growth rate for each company in the industry sample. I have also included, in Appendix C, a similar discussion of the growth rate analysis of each of the companies under study. Schedule 5, pages 1, 3 and 5, show the internal, external and resultant overall growth rates for all the companies included in the similar-risk sample group.]

Q. PLEASE DESCRIBE YOUR COMPARISON OF YOUR DCF GROWTH RATE ESTIMATES WITH OTHER, PUBLICLY AVAILABLE, GROWTH RATE DATA.

A. Pages 2, 4 and 6 of Schedule 5 shows the results of my DCF growth rate analysis for the telecommunications, insurance and gas distribution companies under study, respectively, as well as 1) 5-year historic and projected earnings, dividends and book value growth rates from Value Line, 2) earnings growth rate projections from institutional analysts, 3) the averages of those data, and 4) the 5-year compound growth rates for earnings, dividends and book value for each company under study.

The average sustainable growth rate estimate for the telecommunications companies determined in my growth rate analysis is 10.12%. This figure is closely approximates Value Line's projected average growth rate in earnings, dividends and book value for those same companies (10.13%). My average DCF growth rate estimate for the telcos (10.12%) is slightly below the average projected Analyst's earnings growth rate for those companies (10.96%) but well above Value Line's projected dividend growth for the telcos (2.30%). Also, the growth rate average used in my analysis is much higher than either historical growth rate series shown in Schedule 5, page 2, which indicates that my analysis in not based merely on historical data, but takes into account the RHC's increased future growth expectations. In addition, those data indicate that investors expect higher growth from their telephone company investments that they have achieved in the past.

My average sustainable growth rate estimate for the insurance company sample group is 9.33%, as shown on page 4 of Schedule 5. This figure is exceeds Value Line's projected average growth rate in earnings, dividends and book value for those same companies (7.53%). My average DCF growth rate estimate for the insurance companies (9.33%) is below the average projected Analyst's earnings growth rate for those companies (10.84%) but more than 150 basis points above Value Line's projected dividend growth (7.80%). Also, the growth rate average used in my analysis is somewhat below Value Line's historic average earnings, dividends and book value growth, but higher than the compound growth rate averages of those same parameters.

As shown on page 6 of Schedule 5, the average sustainable growth rate estimate for all the gas distribution companies included in my analysis is 5.17%. This figure is higher than Value Line's projected average growth rate in earnings, dividends and book value for those same companies (4.79%) and is well above the five-year historical average earnings, dividend and book value growth rate reported by Value Line for those companies (3.52%). My growth rate estimate for the companies under review is slightly lower than Analyst's earnings growth projection for those companies, 5.55%. The growth rate projections published by investor services indicate that investors expect increased growth in the future from these companies. Those data also confirm the reasonableness of my growth rate estimate for the sample of gas utilities.

Q. DOES THIS CONCLUDE THE GROWTH RATE PORTION OF YOUR DCF ANALYSIS?

A. Yes, it does.

Q. HOW HAVE YOU CALCULATED THE DIVIDEND YIELDS?

A. I have estimated the next quarterly dividend payment of each firm analyzed and annualized them for use in determining the dividend yield. If the quarterly dividend of any company were expected to be raised in the next quarter following the analysis (i.e., the second or third quarter of 2000), I increased the current quarterly dividend by (1+g). Because most of

the companies had either recently raised dividends or were not expected to increase dividends at all in 2000, only two companies required an adjustment of the dividend: Bell Atlantic (BEL), and SAFECO Corporation (SAFC).

The next quarter annualized dividends were divided by a recent six-week daily closing average stock price to obtain the DCF dividend yields. I use the most recent six-week period to determine an average stock price in a DCF cost of equity determination because I believe that period of time is long enough to avoid daily fluctuations and recent enough so that the stock price captured during the study period is representative of current investor expectations. Schedule 6 contains the market prices, annualized dividends and dividend yields of the gas companies under study. Schedule 6 indicates that the average dividend yields for the sample group of telecommunications, insurance and gas distribution companies are 2.59%, 3.15% and 5.69%, respectively.

Q. IN DERIVING THE DIVIDEND YIELDS PRESENTED IN YOUR SCHEDULE 6, DID YOU ADJUST THE DIVIDEND YIELD TO ACCOUNT FOR QUARTERLY COMPOUNDING OF THE DIVIDEND?

A. No. Such an adjustment results from an improper interpretation of the theory on which the DCF model is based and serves only to inflate a DCF-determined equity capital cost estimate. The DCF model may be derived under two alternative mathematical assumptions: discrete compounding and continuous compounding. Under the assumption of continuous compounding, the dividend is paid continuously and the DCF model takes on the following exponential form[7]:

$$P_0 = \int_0^{\infty} D_t e^{-kt}\, dt. \qquad (2)$$

Carrying out the integration indicated above, the resulting DCF model may be written as:

[7]Gordon, M.J., The Investment, Financing, and Valuation of the Corporation, R.D. Irwin, Inc., Homewood, Ill., 1962, p.45.

$$k = D_0/P_0 + g. \qquad (3)$$

The dividend variable is defined as "D_t = dividend per share paid by the corporation *during* t" and the price variable is defined as "P_t = the price of a corporation's share of stock *at the end* of period t" (Gordon, p. 44, emphasis added). Therefore, under the continuous compounding assumption, the resultant DCF model indicates that the cost of equity capital, "k", equals the dividend paid during the preceding period divided by the current stock price, plus expected growth. For example, if the dividend were paid continuously and the proper "period" was one year, the dividend yield portion of the DCF model would be determined by dividing the current stock price into the dividend yield paid out during the immediately preceding year. In other words, it would be last year's dividend divided by the current stock price.

In actuality, dividends are not paid continuously but in a discrete, usually quarterly, fashion. When the DCF is derived under these assumptions, the result is:

$$k = D_1/P_0 + g. \qquad (4)$$

Some analysts automatically (and mistakenly) assume that the relevant "period" for the above DCF model is one year and proceed to "adjust" the quarterly dividend to account for one year's growth. Dr. Gordon, in his own testimony before Federal regulators has argued against such treatment:

> "D_1 is the forecast dividend for the coming year if dividends are paid annually. Common practice, however, is to pay dividends quarterly, in which case D_t in [the following equation], the fundamental expression for share price, is a quarterly dividend.
>
> $$P_0 = \frac{D_1}{(1+k)} + \cdots + \frac{D_t}{(1+k)^t} + \cdots + \frac{D_\infty}{(1+k)^\infty}$$
>
> Because it is customary and convenient to think in terms of annual and not quarterly figures for rate of return and growth statistics, annualized figures will be used here. Annualized

> figures are simply four times quarterly figures. ...Hence, in arriving at the cost of equity capital, the correct figure for the dividend yield term in Eq.[4] is the annualized value of the forecast dividend for the coming quarter divided by the current price." (Testimony of M.J. Gordon, F.C.C. Docket No. 79-63, pp. 63–64)

Additionally, as Dr. Gordon noted in his text, The Cost of Capital to a Public Utility (Ibid., p. 81),

> "[S]ince dividends are paid quarterly, the relevant difference [between D_0 and D_1] is in the quarterly dividend."

Therefore, the DCF model is a quarterly model not an annual model because the dividends are paid quarterly rather than annually. The proper dividend yield to use in the DCF model is based on the expected next quarter dividend, annualized, as I have done and as Professor Gordon has done in his equity capital cost testimony before Federal regulators. The DCF model, then, implicitly recognizes the quarterly payment of dividends and does not require any "adjustment" to account for one year's expected growth.

Q. DOES USWC WITNESS CUMMINGS USE QUARTERLY COMPOUNDING IN HIS DCF COST OF EQUITY ESTIMATES IN THIS PROCEEDING?

A. Yes, and his DCF estimates are overstated as a results of his use of quarterly compounding. Mr. Cummings' Exhibits PCC-03 and PCC-04 attached to his Supplemental Direct Testimony in this proceeding indicates that dividend compounding increased his equity cost estimate for US WEST by about 15 to 20 basis points.

Q. WHAT IS YOUR COST OF EQUITY CAPITAL ESTIMATE FOR THE SAMPLE GROUP OF TELECOMMUNICATIONS FIRMS AND GAS DISTRIBUTION UTILITIES, USING THE DCF MODEL?

A. Schedule 6, pages 1 through 3 shows that the average DCF cost of equity capital for the group of diversified telecommunications firms is 12.71%, and 12.48% for the

property/casualty insurance firms, while the DCF result for the gas distribution utility companies studied is 10.86%.

CAPITAL ASSET PRICING MODEL

Q. PLEASE DESCRIBE THE CAPITAL ASSET PRICING MODEL (CAPM) YOU USED TO ESTIMATE THE COST RATE OF EQUITY CAPITAL FOR US WEST COMMUNICATIONS.

A. The CAPM states that the expected rate of return on a security is determined by a risk-free rate of return plus a risk premium which is proportional to the non-diversifiable (systematic) risk of a security. Systematic risk refers to the risk associated with movements in the macro-economy and, thus, cannot be eliminated through diversification by holding a portfolio of securities. The beta coefficient (β) is a statistical measure which is an attempt to quantify the non-diversifiable risk of the return on a particular security against the returns inherent in general stock market fluctuations. The formula is expressed as follows:

$$k = r_f + \beta(r_m - r_f), \qquad (5)$$

where "k" is the cost of equity capital of an individual security, "r_f" is the risk-free rate of return, "β" is the beta coefficient, "r_m" is the average market return and "$r_m - r_f$" is the market risk premium. The CAPM is used in my analysis as one of several checks of the DCF cost of equity estimate. Although I believe the CAPM is generally useful in estimating the cost of equity capital, certain theoretical shortcomings of this model (when applied in cost of capital analysis) reduce its usefulness as a stand-alone analytical technique and should be made clear.

Q. CAN YOU EXPLAIN WHY THE CAPM ANALYSIS SHOULD BE APPLIED WITH CAUTION IN REACHING AN ESTIMATE OF THE COST OF EQUITY CAPITAL?

A. Yes. The reasons why the CAPM should be used in cost of capital analysis with caution (i.e., as a corroborative methodology, not as a primary determinant of the cost of capital) are detailed in Appendix D. It is important to understand that my caution with regard to the use of CAPM results in cost of equity capital analysis does not indicate that the model is not a useful description of the capital markets. Rather, it is simply the recognition that in the practical application of the CAPM to cost of capital analysis there are problems which cause the results of that analysis to be less reliable than other, more widely accepted models such as the DCF. Moreover, regulators apparently echo this view of the CAPM. According to the National Association of Regulatory Utility Commissioners' annual survey of regulation[8], the number of utility regulatory commissions in the U.S. and Canada that list the CAPM as one of the equity cost estimation methodologies considered is 11, whereas, the DCF is utilized by nearly every single regulatory body.

Q. WHAT VALUE HAVE YOU CHOSEN FOR A RISK-FREE RATE OF RETURN?

A. As the CAPM is designed, the risk-free rate is that short-term rate of return investors can realize with certainty. The nearest analog in the investment spectrum is the 13-week U. S. Treasury Bill. Although longer-term Treasury bonds have equivalent default risk to T-Bills, those longer-term government securities carry maturity risk, which the T-Bills do not have. When investors tie up their money for longer periods of time, as they do when purchasing a long-term Treasury, they must be compensated for future investment opportunities forgone as well as the potential for future changes in inflation. Investors are compensated for this increased investment risk by receiving a higher yield on T-Bonds.

In early 1996 and 1997, T-Bill rates moved upward slightly in response to investor concerns regarding the possible recurrence of higher levels of inflation. When that inflation did not occur, T-Bill rates receded in 1998. However, as I noted in my previous discussion of the macro-economy, although there is a current expectation that inflation may increase in the future, very little inflation currently exists and interest rates have increased from the

[8] Utility Regulatory Policy In The United States And Canada, Compilation 1994-1995, National Association of Regulatory Utility Commissioners, pp. 264, 520, 588.

very low interest rate levels established in 1998. Over the most recent six-week period, T-Bills have produced an average yield of 5.92% (data from Value Line *Selection & Opinion*, six most recent weekly editions—4/28/00 to 6/2/00, inclusive). In the CAPM analysis, I average T-Bill futures rates with the current 13-week T-Bill rate to arrive at a time-adjusted risk-free rate. Currently, T-Bill futures dated December 2000 are trading at a price that produces a yield of 6.17% (*Wall Street Journal*, June 8, 1999, p. C18). For purposes of analysis in this proceeding, 6.05% represents a reasonable estimate of the risk-free rate for use in a CAPM equity cost estimate [5.92% current average T-Bill yield + 6.17% T-Bill futures yield / 2 = 6.05%].

Q. DO YOU BELIEVE THE USE OF A LONG-TERM TREASURY BOND RATE IS APPROPRIATE IN THE CAPM?

A. No. The selection of a long- or short-term Treasury security as the risk free rate of return to be used in the CAPM is one of the areas of contention in applying the model in cost of capital analysis, however, I believe the use of a short-term T-Bill rate is preferable.

First, the long-term T-Bond does not represent the lowest-risk security available in the market today and, thus, cannot be considered "risk free." The reason why long-term Treasuries most often have yields higher than shorter-term U.S. Government instruments is maturity risk, an element of risk investors do not face with the purchase of T-Bills. When investors tie up their money for longer periods of time, as they do when purchasing a long-term Treasury, they must be compensated for future investment opportunities forgone as well as the potential for future changes in inflation. Investors are compensated for this increased investment risk by receiving a higher yield on T-Bonds. Thus, maturity risk causes T-Bonds to carry a level of risk that is necessarily higher than that of T-Bills, which represent a better approximation of the risk-free rate called for in the CAPM.

Second, the use of a long-term T-Bond yield as the risk-free rate violates one of the fundamental tenets of the CAPM -- its exclusive reliance on systematic risk. As I noted above, the only risk of concern to investors in the CAPM paradigm is risk that cannot be diversified away. That risk is called systematic risk. The degree of systematic risk inherent

in any stock or portfolio investment is captured (again, according to the CAPM theory) by beta. One risk that contributes to the overall systematic risk of investing is the risk of unexpected changes in the long-term inflation rate. According to the CAPM, then, that risk is captured by (i.e., is included in) beta. Therefore, if one utilizes a long-term T-Bond yield in the CAPM analysis, an interest rate measure which, as I noted above, impounds investors' return requirements for unexpected changes in the long-term inflation rate, then that risk is accounted for twice -- once with beta and once with the long-term T-Bond yield. The use of a long-term T-Bond in the CAPM improperly double-counts investors' return requirement for long-term inflation and, thus, produces overstated results.

The fact that the long-term T-Bond rate contains a level of risk and return which should not be attributed to the risk-free rate called for in the CAPM is supported in the financial literature. Brealey & Meyers in The Principles of Corporate Finance, 4th Ed. (a text cited by USWC witness Cummings) indicate that if one uses a T-Bond rate in the CAPM rather than the T-Bill rate, the former must be adjusted to remove the average maturity risk premium of T-Bonds over T-Bills:

> "The risk-free rate could be defined as a long-term Treasury bond yield. If you do this, however, you should subtract the risk premium of Treasury bonds over bills, which we gave as 1.1 percent in Table 7-1 [a replication of the Ibboston Associates data, currently that differential is 1.4%]. This gives a rough-and-ready estimate of the expected yield on short-term Treasury bills over the life of the bond: [equation omitted]. This figure could be used as an expected average future r_f [risk-free rate] in the capital asset pricing model." (Brealey & Meyers, The Principles of Corporate Finance, 4th Ed., McGraw-Hill, New York, p. 194)

Q. WHAT HAVE YOU CHOSEN AS THE MARKET RISK PREMIUM FOR THE CAPM ANALYSIS?

A. In their 1999 edition of Stocks, Bonds, Bills and Inflation, R.G. Ibbotson Associates indicates that the average market risk premium between stocks and T-Bills over the 1926–1998 time period is 9.4% (based on an arithmetic average), and 7.4% (based on a geometric average). I have used these values to estimate the market risk premium in the

CAPM analysis. The geometric mean is based on compound returns over time and the arithmetic mean is based on the average of single-period returns.

Q. CAN YOU EXPLAIN THE DIFFERENCE BETWEEN ARITHMETIC AND GEOMETRIC MEANS IN COST OF CAPITAL ANALYSIS?

A. Yes. The geometric mean is based on compound returns over time and the arithmetic mean is based on an average of single-period returns. A numerical example will simplify the explanation. Suppose, for example, in a world of no inflation, an investor purchased for $50 a security which paid no dividend. During the first year after the purchase, the price of the security rises to $100 (a gain of 100%), but during the second year, the price falls back to $50 (a decrease of 50%).

A geometric (compound) average measure of the investors' return would divide the ending value by the beginning value ($50/$50 = 1) and take the *n*th root of that quotient (where *n* is the number of periods). In this case there are two periods, so $n = 2$. Subtracting 1 from the result we find, what the investor knew intuitively, he made no money. He started out with $50, and wound up with $50. His investment had shown a return of 0% per year over the period.

Under arithmetic averaging, we find a 100% return in the first period ($50 rises to $100) and a -50% return in the second period ($100 falls to $50), for an arithmetic average return over the two periods of 25% (100%+(-50%)/2). It would be most difficult to convince our investor, with $50 in hand at the end of two years when $50 was invested at the beginning of that period, that the return over that period was 25%, according to an arithmetic average.

In addition, the arithmetic average of an historical return series assumes that the investment is bought and sold every period (without transaction costs) while the geometric average assumes that investors buy and hold their investments. While the monthly selling and re-buying of all investments could characterize the investment behavior of a portion of the market, I believe it is unreasonable to assume that sort of investment pattern is apropos for all investors. Therefore, consideration of both the arithmetic and geometric averages

provides a more rational approximation of investor expectations than consideration of only the arithmetic mean in a CAPM analysis.

Nevertheless, some rate of return practitioners (such as USWC witness Cummings) elect to rely only on an arithmetic market risk premium in a CAPM analysis, ignoring a historical geometric market risk premium which is roughly 200 basis points lower. Also, because geometric mean return data is published by the same source (i.e., Ibbotson Associates), on the same page as the arithmetic mean, investors have access to both and, it is reasonable to assume, make use of both in determining their return requirements.

Q. IS THERE SUPPORT IN THE LITERATURE OF FINANCIAL ECONOMICS FOR THE USE OF GEOMETRIC AVERAGES OF HISTORICAL RETURNS AS THE BEST REPRESENTATION OF THE MARKET RISK PREMIUM IN THE CAPM?

A. Yes.

> "**Determining the market risk premium** The market risk premium (the price of risk) is the difference between the expected rate of return on the market portfolio and the risk free rate, $E(r_m) - r_f$. We recommend using a 5 to 6 percent market risk premium for U.S. companies. This is based on the long-run geometric average risk premium for the return on the S&P 500 versus the return on long-term government bonds from 1926 to 1992 [footnote omitted]....
>
> • We use a geometric average of rates of return because arithmetic averages are biased by the measurement period. An arithmetic average estimates the rates of return by taking a simple average of the single period rates of return.... We believe that the geometric average represents a better estimate of investors' expected returns over long periods of time....
>
> Also, the arithmetic average depends on the interval chosen. For example, an average of monthly returns will be higher than an average of annual returns. The geometric average, being a single estimate for the entire time interval, is nonvariant to the choice of interval. (Copeland, T., Koller, T., Murrin, J., Valuation, Measuring and Managing the Value of Companies, 2nd Ed., Wiley & Sons, New York, 1994, pp. 260-1)

In addition, one of the financial publications on which investors and cost of capital analysts often rely, Value Line, advises its subscribers that the geometric mean provides an unbiased measure of historical growth while the arithmetic mean is biased upward:

> "The arithmetic average has an upward bias, though it is the simplest to calculate. The geometric average does not have any bias, and thus is best to use when compounding (over a number of years) is involved." (The Value Line Investment Survey, *Selection & Opinion*, May 7, 1997, pp. 6844-5)

Therefore, both the arithmetic and the geometric mean are recognized in the financial literature and in the financial media as measures of historical returns. I recognize that there is merit to the position on the use of the arithmetic mean, and I, too, use the arithmetic average market risk premiums published by Ibbotson Associates. However, I also use the geometric mean and, in so doing, I recognize that both are available to investors and both have theoretical merit. As a result, I believe my CAPM analysis presents a more balanced estimate of the cost of capital than that offered by USWC's witness Mr. Cummings, which considers only the high-end results produced by the arithmetic mean.

Q. IS THERE EVIDENCE IN THE FINANCIAL LITERATURE THAT THE HISTORICAL RISK PREMIUMS PRESENTED IN THE IBBOTSON STUDY MAY OVERSTATE INVESTOR EXPECTATIONS?

A. Yes. There is evidence published relatively recently which studies market risk premiums over a very long-term period (dating back to the early 1800s). That study shows that the risk premiums obtained from the time period studied by Ibbotson Associates (i.e., starting in the late 1920s or early 1930s) are exaggerated. Moreover, those studies show that a more "normal" risk premium between stocks and bonds ranges from 2% to 3% (Siegel, J., Stocks for the Long Run, 1994, Irwin, Chicago IL, p. 20). That evidence indicates that the Ibbotson risk premiums may be substantially overstated as examples of investors' long-term return expectations.

Q. WHAT VALUES HAVE YOU CHOSEN FOR THE BETA COEFFICIENTS IN THE CAPM ANALYSIS?

A. I have used beta coefficients published by Value Line in my analysis. Value Line reports beta coefficients for all the stocks it follows. Their beta is derived from a regression analysis between weekly percentage changes in the market price of a stock and weekly percentage changes in the New York Stock Exchange Composite Index over a period of five years. The average beta coefficients of my sample group of telecommunications holding companies, insurance and gas distribution companies are 0.81, 0.90 and 0.57, respectively.

Q. WHAT ARE THE RESULTS OF YOUR CAPITAL ASSET PRICING MODEL ANALYSIS OF THE COST OF EQUITY FOR THE TELECOMMUNICATIONS FIRMS AND THE GAS DISTRIBUTORS?

A. Exhibit_(SGH-1), Schedule 8, pages 1 through 3, shows a mid-point estimate of 12.85% for the telecommunications holding companies and 13.61% for the insurance companies. For the gas distribution sample group, the CAPM analysis produced a range of equity cost estimates from 10.28% to 11.42%, with a mid-point of 10.85%.

MODIFIED EARNINGS-PRICE RATIO (MEPR) ANALYSIS

Q. PLEASE DESCRIBE THE MANNER IN WHICH YOU USE THE EARNINGS-PRICE RATIO TO ANALYZE OF THE COST OF COMMON EQUITY CAPITAL.

A. The MEPR analysis I utilize is useful in a corroborative sense, and can be a reliable indicator of the proper range of equity costs. The earnings-price ratio, which is one portion of the MEPR analysis, is calculated simply as the expected earnings per share divided by the current average market price. Further, the earnings-price ratio, itself, is an accurate indicator of equity capital cost rates when the market price of a stock is near its book value.

When the market price of a utility stock is below its book value, the earnings-price ratio overstates the cost of equity capital. Schedule 9 contains mathematical support for this

concept. The obverse is also true, i.e., the earnings-price ratio understates the cost of equity capital when the market price of a stock is above book value.

As a result of accounting treatment of regulatory assets and retirement benefits, the telcos under study have very high market-to-book ratios which average 4.36 (excluding USW). The accounting changes that have occurred in the telecommunications industry cause the reported financial book values and equity returns to differ from the regulatory books of account on which the earnings capacity of those firms remains primarily based. That difference between financial equity ratios (S.E.C. or "FR" based on financial accounting) and regulatory equity ratios (F.C.C. or "MR" based on regulatory accounting) has the effect of exaggerating the sustainable growth of the telecommunications companies under study. This means that those companies are earning returns based on a regulatory rate base that exceeds the asset (and common equity) base which appears in their financial reports. The cash flows produced by the telecommunications companies' regulatory operations have not changed dramatically, while the book equity base against which those cash flows are measured for financial reporting purposes, has diminished considerably during the 1990s. This administrative split between the accounting value and the earnings base of the telecommunications firm reduces the reliability of a modified earnings-price ration analysis for those firms.

The insurance firms and the gas distribution utilities under study have average market-to-book ratios of 1.73 and 1.57, respectively. Therefore, the earnings-price ratio alone would understate the cost of equity for either sample group.

Q. WHAT MODIFICATIONS DO YOU MAKE TO THE EARNINGS-PRICE RATIO, AND WHY ARE THOSE MODIFICATIONS NECESSARY?

A. I do not use the earnings-price ratio alone, i.e., without modification, as an indicator of equity capital cost rates for the reasons cited above. The earnings-price ratio, alone, is an accurate indicator of the cost of equity capital when utility market prices approximate book value. However, that condition does not exist in today's market for the companies under study in this analysis. Due to the relationship among the earnings-price ratio, the market-to-

book ratio and the investor-expected return on equity, in the MEPR analysis, I modify the earnings-price ratio by averaging that parameter with an investor-expected return on equity. This equity cost estimation technique is also termed the "mid-point approach" because the equity cost estimate is the mid-point (or average) between the earnings-price ratio and the expected return on equity.

Q. PLEASE EXPLAIN THE RELATIONSHIP AMONG THE EARNINGS-PRICE RATIO, THE EXPECTED RETURN ON EQUITY AND THE MARKET-TO-BOOK RATIO.

A. When the investor-expected return on equity for a utility company exceeds the investor-required return (the cost of equity capital), the market price of the utility will exceed its book value. As explained above, when the market price exceeds book value, the earnings-price ratio understates the cost of equity capital. Therefore, when the investor-expected equity return exceeds the cost of equity capital, the earnings-price ratio will understate that cost rate.

In situations where the expected utility equity return is below what investors require for that type of investment, market prices fall below book value. Further, when market-to-book ratios are below 1.0, the earnings-price ratio overstates the cost of equity capital. Thus, the expected rate of return on equity and the earnings-price ratio tend to move in a countervailing fashion around the cost of equity capital. When market-to-book ratios are above one, the expected equity return exceeds and the earnings-price ratio understates the cost of equity capital. When market-to-book ratios are below one, the expected equity return understates and the earnings-price ratio exceeds the cost of equity capital.

These relationships represent general rather than precisely quantifiable tendencies but are very useful in corroborating other cost of capital methodologies. The Federal Energy Regulatory Commission, in its generic rate of return hearings found this technique useful and indicated that under the circumstances of market-to-book ratios exceeding unity, the cost of equity is bounded above by the expected equity return and below by the earnings-price ratio (e.g., 50 Fed Reg, 1985, p. 21822; 51 Fed Reg, 1986, pp. 361-363; 37 FERC ¶ 61,287, pp. 58-61). The mid-point of these two parameters, therefore,

produces an estimate of the cost of equity capital which, when utility market-to-book ratios are different from unity, is far more accurate than the earnings-price ratio alone.

Q. IS THE RESULT OF THE MODIFIED EARNINGS-PRICE RATIO ANALYSIS FOR THE TELCOS AFFECTED BY THE ACCOUNTING CHANGES THOSE FIRMS HAVE UNDERTAKEN OVER THE LAST FEW YEARS?

A. Yes, as I noted above, the telco accounting changes do impact the result of my MEPR analysis. One of the tenets of the modified earnings price ratio analysis is that the earnings base of the firm (i.e., the base on which the allowed returns are applied and on which the earned returns are calculated) is consistent. However, the telcos' election to discontinue regulatory accounting for their utility assets violates that tenet. Returns for the telco's regulated operations continue to be allowed on an earnings base that is a function of regulatory accounting book value. However, financial earned returns (ROEs) are calculated on an equity base that has been diminished by the write-off of utility assets[9]. Therefore, when earned returns are calculated subsequent to the change in accounting methods, those returns are measured against a much smaller equity base and, while the actual dollar return has not increased, the ROE is dramatically over prior levels.

Therefore, while I believe the modified earnings price ratio analysis remains a viable corroborative methodology that continues to be reliable for utility operations that earn and report equity returns on the same basis (e.g., gas distributors), the current dichotomy between telephone regulatory and financial reporting renders the results of a MEPR analysis less informative with regard to the cost of equity capital for those firms.

Q. WHAT ARE THE RESULTS OF YOUR MODIFIED EARNINGS-PRICE RATIO ANALYSIS OF THE COST OF EQUITY FOR THE SAMPLE GROUPS UNDER STUDY?

[9] Telecom equity has been reduced in recent years for write-offs occasioned by the discontinuance of regulatory accounting (FASB 71), the accounting treatment of employee pension benefits and, in US WEST's case, the re-acquisition of its yellow pages operation, Dex.

A. Page 1 of Schedule 10 in Exhibit_(SGH-1) shows the institutional analyst's projected 2000 per share earnings for each of the firms in the telco sample group. Recent average market prices from Schedule 6 and Value Line's projected 2000 and 2003-2005 book equity returns for each company are also shown. The average earnings-price ratio for the RHCs is 5.36% and their 2000 projected equity returns average 27.75%. For the RHC sample group, the mid-point of the earnings price ratio and the current equity return is 16.55%[10]. For these companies, Value Line projects stable ROEs for the 2003-2005 period (including USW's projected 41% ROE), and the mid-point of the projected equity return and the current price-earnings ratio is 16.48%. The MEPR results for the telecommunications holding companies are well above the DCF results previously derived.

Page 2 of Schedule 10, in an situation which is effective opposite of that faced by the telcos, indicates very low equity capital costs for the insurance companies. Just as the telco's expected accounting equity returns are exaggerated due to a very low level of equity capital on their books of account, the insurance companies currently exhibit unusually high levels of equity capital (termed "surplus" in insurance accounting), causing the earned returns of those firms to be diminished. The result of that situation is a modified earnings-price ratio result that is well below the DCF result for those companies, and probably understates the cost of equity.

Page 3 of Schedule 10 shows that the current price-earnings ratio for the gas distributor sample group is 7.31%. The distribution companies' 2000 equity return is expected by Value Line to average 11.29%. For the gas distribution sample group, then, the mid-point of the earnings-price ratio and the current expected equity return is 9.30%.

According to Value Line, the distribution companies' 2003-2005 equity return is expected to average 13.14%. For the gas distribution sample group, then, the mid-point of the current earnings-price ratio (7.31%) and that 2003-05 projected equity return is

[10] The very high ROEs for the telcos are, again, due to the discontinuance of regulatory accounting and the write-down of assets for financial reporting. If the RHCs book value had grown at a conservative 5% rate since 1990, their 1999 book value (i.e., with no write offs, and no mergers) would have approximated $14.3 or 1.57 times the $9.1/share average projected for 1999 by Value Line (absent USW's "NMF). Measuring ROE for the telcos with a book value 1.45 times higher would produce expected ROEs in 1999 of approximately 14.5% rather than 28% and a MEPR result of about 10%.

10.23%. The near-term MEPR results are below the DCF equity cost estimates for the gas distributors previously derived, but the long-term projected MEPR results tend to support the DCF cost of equity estimate for those firms.

MARKET-TO-BOOK RATIO ANALYSIS

Q. PLEASE DESCRIBE YOUR MARKET-TO-BOOK (MTB) ANALYSIS OF THE COST OF COMMON EQUITY CAPITAL FOR THE SAMPLE GROUPS.

A. This technique of analysis is a derivative of the DCF model that attempts to compensate the capital cost derived for inequalities which might exist between a firm's market price and its book value per share. Although this method of analysis is derived from the DCF model and, therefore, cannot be considered a strictly independent check of that method, the MTB analysis is useful in a corroborative sense in that it seeks to determine the cost of equity using market-determined parameters in a different format than that employed in the DCF analysis. In the DCF analysis, the available data is "smoothed" to an extent to identify investors' long-term sustainable expectations. The MTB analysis that I employ, while based on the DCF theory, relies, instead, on point-in-time data projected one year and five years into the future and, thus, offers a practical corroborative check of the traditional DCF. The MTB formula is derived as follows:

Solving for "P" from Equation (1), the standard DCF model, we have

$$P = D/(k-g). \qquad (6)$$

But the dividend (D) is equal to the earnings (E) times the earnings payout ratio, or one minus the retention ratio (b), or

$$D = E(1-b). \qquad (7)$$

Substituting Equation (7) into Equation (6), we have

$$P = \frac{E(1-b)}{k-g} \quad . \qquad (8)$$

The earnings (E) are equal to the return on equity (r) times the book value of that equity (B). Making that substitution into Equation (8), we have:

$$P = \frac{rB(1-b)}{k-g} \quad . \qquad (9)$$

Dividing both sides of Equation (9) by the book value (B) and noting from Equation (ii) in Appendix B that g = br+sv,

$$\frac{P}{B} = \frac{r(1-b)}{k-br-sv} \quad . \qquad (10)$$

Finally, solving Equation (10) for the cost of equity capital (k) yields the MTB formula:

$$k = \frac{r(1-b)}{P/B} + br + sv. \qquad (11)$$

Equation (11) indicates that the cost of equity capital equals the expected return on equity multiplied by the payout ratio, divided by the market-to-book ratio plus growth. Schedule 11 shows the results of applying Equation (11) to the defined parameters for the telcos, insurance companies and the gas distribution utilities in the comparable samples. Pages 1 and 2 of Schedule 11 apply to the telcos while pages 3 and 4 contain data related to the insurance companies and pages 5 and 6 present the analysis for the distribution companies. Pages 1, 3 and 5 of Schedule 10 utilize current (2000) parameters for the MTB analysis while pages 2, 4 and 6 of that Schedule utilize Value Line's 2003-2005 projections.

The MTB cost of equity capital for the telcos is 13.41% using data from 2000 and 11.77% using data from the 2003-2005 period. The MTB cost of equity for the sample of insurance companies is 12.59% using the current year data and 12.51% using projected

data. For the gas distributors, the MTB cost of equity estimates are 10.86% (near term projections) and 10.21% (long-term projections).

SUMMARY

Q. PLEASE SUMMARIZE THE RESULTS OF YOUR EQUITY CAPITAL COST ANALYSES FOR THE SAMPLE GROUP TELECOMMUNICATIONS HOLDING COMPANIES AND THE GAS DISTRIBUTION COMPANIES.

A. My analysis of the cost of common equity capital for the telcos, insurance and the gas utility sample group is summarized in the table below.

METHOD	TELCOS	INSURANCE	GAS DISTRIB.
DCF	12.71%	12.48%	10.86%
CAPM	12.85%	13.61%	10.85%
MEPR	16.55% / 16.48%	6.78% / 8.04%	9.30% / 10.23%
MTB	13.41% / 11.77%	12.59% / 12.51%	10.86% / 10.21%

Weighing all the evidence presented herein, my best estimate of an appropriate range of cost of equity capital for a gas distribution operation similar in risk to the companies analyzed is 10.50% to 11.00%. In the case of the gas distributors, the corroborative equity cost estimation analyses produce results that are, for the most part, similar to or lower than the DCF estimate. In such a situation, a range of 10.50% to 11.00% gives primary weight to the DCF estimate for the gas distributors and recognizes that the corroborating methodologies produce results both below and above the DCF.

As can be seen from the table above, the corroborative methodologies currently produce estimates for the telcos that are also both above and below that sample group's

DCF equity cost estimate. For reasons of consistency, the Modified Earnings Price Ratio (MEPR) results for the telcos are reported in the table above, but should be afforded little weight due to the systematic aberrations in reported book returns for those firms. The average of the remaining corroborative methodologies (MTB and CAPM) for the telcos is 12.72%, approximating the DCF result of 12.71% [average MTB result (12.59%) + average CAPM result (12.85%) ÷ 2 = 12.72%]. Therefore, a range of equity capital cost estimates around the DCF result for the telcos in indicated. Rounding the DCF result to the nearest 1/4 percentage point, 12.75%, and establishing a 50 basis point range around that equity cost estimate produces a range of equity cost estimates for the telecommunications holding companies of 12.50% to 13.00%.

For the insurance companies reviewed, the DCF result is 12.48%, below the lower end of the range of equity cost estimates for the telcos. However, the CAPM and MTB corroborative methodologies for those firms produce an equity cost indication of 13.08% [average CAPM (13.61%) + average MTB (12.55%) ÷ 2 = 13.08%]. Although the MEPR analysis for the insurance companies produces much lower equity cost estimates, I do not find those results reliable due to the overcapitalization existing in the insurance industry at the current time. Also, the other corroborative methods indicate that my DCF result for the insurance companies may be understated. Therefore, a reasonable estimate of the cost of equity for those firms would coincide with that estimated for the telecommunications holding companies—12.50% to 13.00%.

As previously noted, diversified telecommunications holding companies and the insurance companies are riskier than local exchange telephone operations. Also, gas distributors have similar but less risk than a local exchange telephone operation. Therefore, an appropriate equity return for USWC's local exchange operation in Arizona is below that derived for the telco and insurance companies but above that appropriate for a gas distribution operation. An equity cost range of 11% to 12.50% (midpoint = 11.75%) encompasses the equity capital cost estimates of both the gas distribution sample and the telcos in that it includes the top of the range of the gas distributors (11%) and the bottom of the range of equity costs for the telcos and property/casualty insurance firms (12.50%).

Q. WHAT IS YOUR RECOMMENDATION WITH REGARD TO AN APPROPRIATE OVERALL RETURN ON RATE BASE FOR US WEST COMMUNICATIONS IN THIS PROCEEDING?

A. Exhibit_(SGH-1), Schedule 12, shows that with an allowed return on equity capital of 11.75%, using the Company's requested allocated capital structure, USWC-Arizona's overall cost of capital would be 9.68%. That overall cost of capital should be considered as the primary guide to setting fair and reasonable rate of return on USWC-Az's original cost rate base. Schedule 12 also indicates that, assuming a prospective Federal and State tax rate of 40%, that overall return would afford the Company an opportunity to achieve a pre-tax interest coverage level of 3.92 times.

Q. IN YOUR OPINION, MR. HILL, WOULD IT BE APPROPRIATE TO APPLY YOUR RECOMMENDED OVERALL RETURN TO A RATE BASE DIFFERENT FROM THE COMPANY'S ORIGINAL COST RATE BASE?

A. No. The profitability of the vast majority of utilities in the U.S. are determined on the basis of applying the firm's cost of capital to its original cost rate base. Moreover, that paradigm has led to a utility industry that has provided investors appropriate returns, allowing the utilities to attract sufficient capital in order to provide for the public's utility requirements. The adequacy of returns allowed under that paradigm is evidenced by market prices which are well above book value for most utility operations, including USWC.

To the extent that the cost of capital would be applied to a rate base which exceeds (understates) the regulated firm's original cost rate base, the resulting dollar return would exceed (understate) a fair return. In order to prevent the allowance of a return that is something other than a fair return, if the rate base is greater (smaller) than the regulated firm's original cost rate base; the return applied to that rate base should be adjusted downward (upward).

For example, it is my understanding that the "fair value" rate base in Arizona has been determined to be a 50/50 weighting of original cost rate base and what is termed a

"Reconstruction Cost New less Depreciation" (RCND) rate base. The primary difference between the original cost rate base and the RCND rate base is that, in the latter, the original cost of the plant equipment (by vintage) is increased to current levels through a price inflation adjustment which is modified by a measure of the useful life of each plant item (similar to depreciation). Therefore, the RCND rate base includes an inflation adjustment that the original cost rate base does not; and, for that reason, the former will be a higher dollar value than the latter. As I noted above, in order to provide a fair return in a situation when the utility rate base is to be greater than the original cost, the allowed return must be reduced below the cost of capital (which provides a fair return based on original cost rate base).

It is my understanding that Utilitech (Staff revenue requirements witnesses) has provided a calculation of the fair return on fair value rate base which incorporates my cost of capital findings.

FLOTATION COSTS

Q. HAVE YOU INCLUDED AN INCREMENT TO YOUR EQUITY CAPITAL COST ESTIMATE TO ACCOUNT FOR ISSUANCE EXPENSES AND MARKET PRESSURE?

A. No, an explicit adjustment to "account for" flotation costs is unnecessary for several reasons. First, such adjustments are usually predicated on the prevention of the dilution of stockholder investment. However, the reduction of the book value of stockholder investment due to issuance expenses can occur only when the utility's stock is selling at a market price equivalent to or below its book value. In the current market environment, with telecommunications common stock selling at more than a 400% premium to its book value, every time a new share of stock is sold, all shareholders realize an increase in the per share book value of their investment. In other words, the stockholders' investment value is increased when new stock is issued, not decreased, and there is no need to "compensate" stockholders for a hypothetical dilution of book value that does not exist.

Second, assuming *arguendo* the need for an issuance expense adjustment to the cost of equity, the majority of the issuance expenses incurred in any public offering are "underwriter's fees" or "discounts". Underwriter's discounts are not out-of-pocket expenses for the issuing company. On a per share basis, they represent only the difference between the price the underwriter receives from the public and the price the utility receives from the underwriter for its stock. As a result, underwriter's fees are not an expense incurred by the issuing utility and recovery of such "costs" should not be included in rates.

Third, my DCF growth rate analysis includes an upward adjustment to equity capital costs which accounts for investor expectations regarding stock sales at market prices in excess of book value, and any further explicit adjustment for issuance expenses is unnecessary.

Fourth, research[11] has shown that a specific adjustment for issuance expenses is unnecessary. There are other transaction costs which, when properly considered, eliminate the need for an explicit issuance expense adjustment to equity capital costs. The transaction cost that is improperly ignored by the advocates of issuance expense adjustments is brokerage fees. Issuance expenses occur with an initial issue of stock. Brokerage fees occur in the much larger secondary market where pre-existing shares are traded daily. Brokerage fees tend to increase the price of the stock to the investor to levels above that reported in the Wall Street Journal, for example. Therefore if those kinds of transaction costs were included in a DCF cost of capital estimate they would raise the effective market price, lower the dividend yield and lower the investors' required return. If one considers transaction costs which, supposedly, raise the required return (issuance expenses), then costs which lower the required return (brokerage fees) should also be considered. As shown by the research noted above, those transaction costs essentially offset each other and no specific equity capital cost adjustment is warranted.

[11] "A Note on Transaction Costs and the Cost of Common Equity for a Public Utility," Habr, D., National Regulatory Research Institute Quarterly Bulletin, January 1988, pp. 95-103.

IV. COMMENTS ON COMPANY TESTIMONY

Q. HOW HAS COMPANY WITNESS CUMMINGS ESTIMATED THE EQUITY CAPITAL COST OF US WEST COMMUNICATIONS?

A. Company witness Cummings has relied on an equal weighting of the results of a DCF analysis and a CAPM analysis to estimate the Company's equity capital cost rate. I believe the Company's DCF methodology is unsound and will address my concerns regarding that DCF analysis, initially. I will then address certain portions of his CAPM analysis. Because I have discussed the shortcomings of the CAPM when used in cost of capital analysis at length in Appendix D attached to this testimony, my comments on Mr. Cummings' CAPM will be relatively brief. Finally, I will also address Mr. Cummings' corroborative analyses.

Q. ON WHAT DCF MODEL HAS THE COMPANY RELIED TO PROVIDE AN ESTIMATE OF ITS EQUITY CAPITAL COST RATE?

A. Witness Cummings uses the following DCF formulation to estimate equity capital costs:

$$k = \frac{D_1(1+k)^{.75} + D_2(1+k)^{.50} + D_3(1+k)^{.25} + + D_4(1+k)^0}{P_0} + g \qquad (14)$$

The Company terms its version of the DCF the "quarterly DCF" model. This particular version of the DCF model produces cost of equity results that are higher than the standard DCF model. Witness Cummings' DCF, because it contains the same variable "k" on either side of the equation requires an iterative (i.e., trial and error) solution. In other words, given estimates of "g" and the next four quarterly dividends, a value for "k" is assumed and inserted into the equation. If the two sides of the equation are not equal, another "k" value, either higher or lower, must be tried and the process continued until the equation is correct.

Aside from the obvious mathematical complexity of this model, which makes it doubtful that the average investor actually uses it, this version of the DCF model effectively increases dividends increase every quarter. Not one of the companies analyzed by the Company witness has raised its dividend every quarter. USWC-Arizona's assumption of a

dividend increase every quarter, therefore, overstates investor expectations. Also, as noted previously in my testimony, since the DCF is derived as a quarterly model, it requires no additional "adjustments" and the proper dividend to use in the model is the expected next quarter dividend, annualized. If the dividend has regularly been increased in the quarter following analysis, then the current quarterly dividend should be increased by one plus the annual growth rate and then annualized to calculate the DCF dividend yield. However, the dividend does not increase every quarter nor do investors expect it to do so.

Witness Cummings' rationale supporting a constantly increasing dividend is grounded on the ability of investors to reinvest those dividends every quarter in equivalent risk/return investments to earn the incremental "time value of money". That may or may not represent the action of investors. Regardless, it is not the ratepayers' responsibility to provide the investor any additional return he or she might receive by reinvesting the quarterly dividend.

Finally, the Federal Energy Regulatory Commission, in its Generic Rate of Return rulemaking proceedings held during the 1980s and early 1990s, has considered and rejected the use of a DCF model which compounds the quarterly dividend. The FERC held in Order 461 (37 FERC ¶61,287) that if the allowed return were determined using a DCF model which included the dividend compounding recommended by Company witness Cummings, the investors would be compensated twice, "--once by the utility [through the allowed rate of return] and once through the investors' reinvestment of the dividends in some other alliterative investment."

Q. WHAT DCF GROWTH RATE METHODOLOGY DOES WITNESS CUMMINGS USE?

A. Witness Cummings relies exclusively on 5-year earnings growth rate forecasts.

Q. WHAT ARE YOUR COMMENTS ON THE EXCLUSIVE USE OF PROJECTED EARNINGS GROWTH RATES IN A DCF ESTIMATE OF THE COST OF EQUITY CAPITAL?

A. In my view, earnings growth rate projections are widely available, are used by investors and, therefore, deserve consideration in an informed, accurate assessment of the investor expected growth rate to be included in a DCF model. I do not believe, however, that projected earnings growth rates should be used as the *only* source of a DCF growth estimate as witness Cummings has done in this case. In other words, projected earnings growth rates are influential in, not determinative of, investor expectations.

Q. PLEASE EXPLAIN WHY EXCLUSIVE RELIANCE ON ANALYSTS' PROJECTED EARNINGS GROWTH RATES IN A DCF EQUITY COST ESTIMATE CAN PRODUCE UNRELIABLE RESULTS.

A. First, it is important to realize that, as I have previously noted in my testimony, projected growth rates may over- or understate dividend growth that can be sustained over the long term by the companies under review. This is important because sustainable growth is required in an accurate DCF assessment of the cost of equity capital. The efficacy of projected earnings growth rates in any specific DCF analysis can only be determined through a study of the underlying fundamentals of growth—something which Company witness Cummings fails to do with his exclusive reliance in analysts' earnings growth rate projections.

Second, there is often associated with the exclusive use of analysts' projected earnings growth rates an erroneous notion of "consensus", i.e., that projected earnings growth rates are what investors are using to estimate return requirements and that those estimates closely agree. As shown in the table below, which shows detailed statistics form analysts' growth rates estimates for Mr. Cummings sample group of telecommunications companies, what is often called a "consensus" earnings growth expectation are, in reality quite divergent.

TABLE I.

Company	Zacks 5-Year Earnings Proj.	Number of Estimates	Range of Estimates	
Bell Atlantic	11.39%	14	5.8%	15.0%
Bell South	11.38%	11	8.0%	16.6%
GTE Corp.	11.90%	13	7.0%	15.0%
SBC Comm.	12.99%	15	9.6%	15.4%
US WEST	7.12%	12	2.4%	10.0%
Averages	10.96%		6.6%	14.4%

Data from Market guide, Multex.com via Yahoo!

From Table I, we see that the analysts' "consensus" growth rate estimates for Mr. Cummings' telecommunications firms are based on projected earnings growth rates that, overall, show a divergence rather than a consensus of investor opinion. For example the analysts surveyed by the analysts that follow US WEST project earnings growth rates for the Company that range from 2.4% to 10%. It is important to remember that the average earnings projection, even though it is called a "consensus" earnings growth estimate, is based on what may be a very wide range of growth rate expectations among the professional analysts. Therefore, caution should be afforded the use of those earnings growth estimates in any DCF analysis and they should not be utilized exclusively as Mr. Cummings has elected to do.

Q. DON'T COST OF CAPITAL EXPERTS WHO RELY EXCLUSIVELY ON EARNINGS GROWTH PROJECTIONS REFER TO ACADEMIC STUDIES WHICH SHOW ANALYSTS' EARNINGS GROWTH ESTIMATES TO BE "SUPERIOR" TO OTHER GROWTH RATE ESTIMATION METHODS?

A. Yes, however, while such studies do show that projected growth rates are superior to simple, mechanical averages of historical growth rates, they do not suggest that projected earnings growth rates are determinative of investor expectations. What those studies actually do is make a good case for the consideration of analysts' growth rate forecasts in a reasoned examination of investor growth rate expectations. With that premise, I quite

agree, and that is how I have elected to use analysts' forecasts in my DCF analysis, i.e., as part of an analysis of growth rate expectations. Those studies do not provide a rationale for and *exclusive* reliance in earnings growth rate projections. Certainly analysts' growth rate projections can influence investor expectations, but it is unreasonable to conclude that they determine those expectations exclusively.

Q. WHAT ARE YOUR COMMENTS REGARDING MR. CUMMINGS' "COMPARABLE RISK COMPANY" DCF ANALYSIS?

A. Mr. Cummings' "comparable company" DCF cost of capital study examines the market data of a group of firms selected by a risk parameter screening process. Although Mr. Cummings selects those companies on the basis of bond rating and cash flow volatility, a key element omitted from his selection process is the level of competition to which the firms are exposed.

Interestingly, Mr. Cummings' selection process includes companies in the "similar risk"-company sample that are essentially utility operations and have, comparatively, low competitive risk. Therefore, only a few of the firms in Mr. Cummings "comparable risk" group enjoy a market position similar to a local exchange telephone operation. Mr. Cummings' DCF result for those utility companies averages is considerably lower than the overall average for the "similar risk"-company sample.

The average DCF result for the utility companies shown in Mr. Cummings' Exhibit PCC-06 (his DCF analysis of the "similar-risk" firms) is approximately 11%[12]. The average DCF result for the other firms is 14.5% (standard deviation = 2.02%). The DCF result for Mr. Cummings' "similar risk" firms with substantial market share positions (the utilities) is more than two full standard deviation units below the average of the unregulated companies included in that sample. Those data indicate that the DCF cost of equity for the competitive firms included in Mr. Cummings sample group is significantly different from the similar companies that enjoyed large market shares. Therefore, included in Mr.

[12] DPL, Inc. (10.7%), IPALCO Enterprises (10.4%), OGE Energy (12.0), Otter Tail Power (10.6%), WPS Resources (11.5%); Duke Energy omitted due to change in business, Northern States Power omitted due to merger and related stock price depression.

Cummings' "comparable risk" sample group selected on the basis of bond rating and cash flow volatility are two subgroups. Those two subgroups have markedly different equity capital costs, according to witness Cummings' own calculations, even though the companies were selected to be of similar risk.

Three conclusions must be drawn from this result: 1) the two groups cannot be of similar investment risk and Mr. Cummings' selection parameters (bond rating and cash flow variability) are insufficient to select similar-risk companies; 2) the risk factor which witness Cummings has failed to consider—the market share position of the firms—has a substantial impact on the market-required cost of equity; and 3) the cost of equity of utility operations which have bond rating and cash flow similarities to USWC is well below the equity cost of unregulated firms with similar bond ratings and cash flow variability. Finally, because Mr. Cummings' average DCF cost of equity for the utility firms with similar bond ratings and cash flow variability—11%—is below my recommended return on equity in this proceeding (11.75%), the latter can be considered to be conservative, according to the data contained in the Company's own analysis.

Q. DOES THIS CONCLUDE YOUR COMMENTS ON WITNESS CUMMINGS' DCF EQUITY COST ESTIMATION ANALYSIS?

A. Yes, it does.

Q. WHAT ARE YOUR COMMENTS ON COMPANY WITNESS CUMMINGS' CAPM ANALYSIS?

A. Witness Cummings uses the CAPM as a co-equal analytical method to the DCF. I have previously discussed the shortcomings of the CAPM when used to estimate the cost of capital in Section III and Appendix D of this testimony. For those reasons I rely on the CAPM as a check of the DCF, but do not believe it deserves co-equal status in estimating the cost of equity. Because I have previously discussed the issues relevant to the CAPM, I will not repeat the entirety of that logic here. However, there are aspects of Mr. Cummings'

application of the CAPM which causes the result to be overstated and of which the Commission should be aware.

Previously in this testimony, I have pointed out that the use of a long-term Treasury security as the risk-free rate in the CAPM includes a level of inflation-related systematic risk that is not called for in the theory on which the CAPM is based. Brealey and Meyers, an authority which Mr. Cummings cites in his Direct Testimony in this proceeding, in The Principles of Corporate Finance, 4th Ed. (McGraw-Hill, New York, p. 194), indicate that the difference between the historical average annual return of T-Bonds and T-Bills should be subtracted from the current T-Bond rate to produce what amounts to a forward-looking T-Bill rate—the proper risk-free rate to be included in the CAPM. However, Mr. Cummings fails to make such an adjustment.

While I have discussed many of the shortcomings of the beta coefficients, which are the key measure of risk in the CAPM model, two aspects are underscored in the workpapers provided by Mr. Cummings in response to Staff Data Request SGH-01-23. In his testimony, Mr. Cummings explains that he calculated his own beta coefficient for US WEST. Staff Data Request SGH-01-23 asked Mr. Cummings to provide those calculations, which he did.

First, the result of Mr. Cummings' regression analysis is a beta coefficient for US WEST of 0.64, not the 0.76 he ultimately uses to estimate the CAPM cost of equity. The 0.64 actual measured beta is often termed a "raw" beta and the 0.76 figure used by Mr. Cummings is termed an "adjusted" beta. Beta coefficients are sometimes adjusted for the supposed tendency for beta coefficients to migrate toward the market beta (1.0) over time. That is a theory in financial economics with which there is disagreement. As a result, both "raw" betas and "adjusted" betas are published in the financial media. Standard & Poor's, for example, publishes "raw" betas and Value Line publishes "adjusted" betas. The point is that it is not clear which actually represents the investment risk of the firm, and the equity cost impact of using one or the other is not trivial. For example, the 0.12 difference between Mr. Cummings' "adjusted" (0.76) and "raw" (0.64) beta for US WEST,

multiplied by a market risk premium of 8.4%[13], indicates an equity cost impact of 101 basis points [0.12 x 8.4% = 1.008%]. Mr. Cummings' CAPM result for US WEST was 12.0% (Cummings Direct, PCC-7), based on his "adjusted" beta. If he had used his "raw" beta calculation, his CAPM result would have been 101 basis points less, or 10.99%—well below my own equity cost estimate.

Second, Mr. Cummings' response to Staff Data Request SGH-01-23 also reveals the tenuous nature of beta as the sole measure of investment risk (which, in the CAPM context, it is). The statistical data accompanying Mr. Cummings calculation of beta indicate that the coefficient of determination or "r-squared" coefficient for that regression is 0.17. That statistic means that only 17% of the risk associated with an investment in US WEST, compared to an investment in the market as a whole, is captured by beta. That result is not an indictment of the manner in which Mr. Cummings calculated his beta coefficient; that he has done without flaw. Rather, that low r-squared statistic is typical for beta coefficients and underscores the fact that 1) beta, alone, is not a reliable indicator of investment risk, and 2) the CAPM should not be utilized as a primary indicator of the cost of equity capital in regulatory rate proceedings.

Q. DOES THIS CONCLUDE YOUR COMMENTS REGARDING MR. CUMMINGS' CAPM ANALYSIS?

A. Yes, it does.

Q. WITNESS CUMMINGS UTILIZES TWO CORROBORATIVE ANALYSES, WHICH HE TERMS "REASONABLENESS TESTS." WHAT ARE YOUR COMMENTS REGARDING HIS FIRST ANALYSIS?

A. Witness Cummings performs a DCF analysis on a sub-set of the S&P 500 Index and determines that the cost of capital of the "average" stock is higher than his recommendation for USWC-Arizona and that, therefore, his recommendation is reasonable. The witness is able to verify his result that the Company has "slightly" less risk than average by relying on

[13] Ibbotson's historical market risk premium range is 7.4% to 9.4%; 8.4% is a mid-point.

telecommunications firms' beta coefficients, which are below the definitional beta for the market—1.0. As I have noted previously in my testimony above, and as confirmed in recently published research in the field of theoretical finance, beta has been shown to be an unreliable indicator of relative risk. Therefore, this corroborative analysis suffers from the same shortcomings as the CAPM, i.e., a heavy reliance on the accuracy of beta.

In fact, witness Cummings' first corroborative analysis could be used to support my equity return recommendation in this proceeding. In my view, local exchange telephone company operations have substantially less risk than the average unregulated, competitive industrial firm. Therefore, my estimate of the cost of equity capital for telecommunications firms, 11.75%, which is below that of unregulated industrial firms but above that of similar-risk utility operations, is reasonable according to witness Cummings' DCF results for the average company.

Q. WHAT ARE YOUR COMMENTS ON WITNESS CUMMINGS' SECOND CORROBORATIVE METHODOLOGY?

A. Witness Cummings' second "reasonableness test" is another version of is first, and suffers from the same shortcomings. The witness subtracts bond yields from his estimate of the market return (discussed above), multiplies that risk premium by a telecommunications-type beta to arrive at a range of results which coincide with the upper end of his recommended return. As with the previous analysis, however, this risk premium/CAPM analysis does not constitute a check of the reasonableness of the witness' equity cost estimation techniques, it merely indicates that the equity cost he estimates for the market is higher than the cost rate he recommends in this proceeding. In my view, both of his equity cost estimates are overstated.

Q. DOES THIS CONCLUDE YOUR COMMENTS ON THE EQUITY COST ESTIMATES PROVIDED BY COMPANY WITNESS CUMMINGS?

A. Yes, it does.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY IN THIS PROCEEDING?

A. Yes, it does.

APPENDIX A

EDUCATION AND EMPLOYMENT HISTORY
OF
STEPHEN G. HILL

EDUCATION

Auburn University - Auburn, Alabama - Bachelor of Science in Chemical Engineering (1971); Honors - member Tau Beta Pi national engineering honorary society, Dean's list, candidate for outstanding engineering graduate; Organizations - Engineering Council, American Institute of Chemical Engineers

Tulane University - New Orleans, Louisiana - Masters in Business Administration (1973); concentration: Finance; awarded full two-year scholarship; Organizations - member MBA curriculum committee, Vice-President of student body, academic affairs

Continuing Education - NARUC Regulatory Studies Program at Michigan State University

EMPLOYMENT

West Virginia Air Pollution Control Commission

Position: Engineer ; Responsibility: Overseeing the compliance of all chemical companies in the State with the pollution guidelines set forth in the Clean Air Act. Analyzing proposed control facility costs with regard to their financial impact on the company under review and testifying before the Commission on those issues.

West Virginia Public Service Commission-Consumer Advocate

Position: Rate of Return Analyst ; Responsibility: All rate of return research and testimony promulgated by the Consumer Advocate; also testimony on engineering issues, when necessary.

PUBLICATIONS

"The Market Risk Premium and the Proper Interpretation of Historical Data," Proceedings of the Fourth NARUC Biennial Regulatory Information Conference, Volume I, pp. 245-255.

"Use of the Discounted Cash Flow Has Not Been Invalidated," Public Utilities Fortnightly, March 31, 1988, pp. 35-38.

MEMBERSHIPS

American Institute of Chemical Engineers; Society of Utility and Regulatory Financial Analysts (Certified Rate of Return Analyst)

APPENDIX B

Q. PLEASE PROVIDE AN EXAMPLE WHICH DESCRIBES THE DETERMINANTS OF LONG-TERM SUSTAINABLE GROWTH.

A. Assume that a hypothetical regulated firm had a first period common equity or book value per share of $10, the investor-expected return on that equity was 10% and the stated company policy was to pay out 60% of earnings in dividends. The first period earnings per share are expected to be $1.00 ($10/share book equity x 10% equity return) and the expected dividend is $0.60. The amount of earnings not paid out to shareholders ($0.40), the retained earnings, raises the book value of the equity to $10.40 in the second period. The table below continues the hypothetical for a five year period and illustrates the underlying determinants of growth.

TABLE A.

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	GROWTH
BOOK VALUE	$10.00	$10.40	$10.82	$11.25	$11.70	4.00%
EQUITY RETURN	10%	10%	10%	10%	10%	-
EARNINGS/SH.	$1.00	$1.040	$1.082	$1.125	$1.170	4.00%
PAYOUT RATIO	0.60	0.60	0.60	0.60	0.60	-
DIVIDENDS/SH.	$0.60	$0.624	$0.649	$0.675	$0.702	4.00%

We see that under steady-state conditions, the earnings, dividends and book value all grow at the same rate. Moreover, the key to this growth is the amount of earnings retained or reinvested in the firm and the return on that new portion of equity. If we let "b" equal the retention ratio of the firm (1 – the payout ratio) and let "r" equal the firm's expected return on equity, the DCF growth rate "g" (also referred to as the internal or sustainable growth rate) is equal to their product, or

$$g = br. \qquad \text{(i)}$$

Professor Myron Gordon, who developed the Discounted Cash Flow technique and first

introduced it into the regulatory arena, has determined that Equation (i) embodies the underlying fundamentals of growth and, therefore, is a primary measure of growth to be used in the DCF model. Professor Gordon's research also indicates that analysts' growth rate projections are useful in estimating investors' expected sustainable growth.

I should note here that the above hypothetical does not allow for the existence of external sources of equity financing, i.e., sales of common stock. Stock financing will cause investors to expect additional growth if the company is expected to issue new shares at a market price that exceeds book value. The excess of market over book would inure to current shareholders, increasing their per share equity value. Therefore, if the company is expected to continue to issue stock at a price that exceeds book value, the shareholders would continue to expect their book value to increase and would add that growth expectation to that stemming from earnings retention or internal growth. Conversely, if a company were expected to issue new equity at a price below book value, that would have a negative effect on shareholder's current growth rate expectations. In such a situation, shareholders would perceive an overall growth rate less than that produced by internal sources (retained earnings). Finally, with little or no expected equity financing or a market-to-book ratio near unity, investors would expect the sustainable growth rate for the company to equal that derived from Equation (i), "g = br." Dr. Gordon[1] identifies the growth rate which includes both expected internal and external financing as:

$$g = br + vs, \qquad \text{(ii)}$$

where,

g = DCF expected growth rate,
r = return on equity,
b = retention ratio,
v = fraction of new common stock sold that accrues to the current shareholder,
s = funds raised from the sale of stock

[1]Gordon, M.J., The Cost of Capital to a Public Utility, MSU Public Utilities Studies, East Lansing, Michigan, 1974, pp., 30–33.

as a fraction of existing equity.

Additionally,

$$v = 1 - BV/MP, \qquad \text{(iii)}$$

where,

MP = market price,
BV = book value.

I have used Equation (iii) as the basis for my examination of the investor expected long-term growth rate (g) in this proceeding.

Q. IN YOUR PREVIOUS EXAMPLE, EARNINGS AND DIVIDENDS GREW AT THE SAME RATE (br) AS DID BOOK VALUE. WOULD THE GROWTH RATE IN EARNINGS OR DIVIDENDS, THEREFORE, BE SUITABLE FOR DETERMINING THE DCF GROWTH RATE ?

A. No, not necessarily. Rates of growth derived from earnings or dividends alone can be unreliable due to extraneous influences on those parameters such as changes in the expected rate of return on common equity or changes in the payout ratio. That is why it is necessary to examine the underlying determinants of growth through the use of a sustainable growth rate analysis.

If we take the hypothetical example previously stated and assume that, in year three, the expected return on equity rises to 15%, the resultant growth rate for earnings and dividends far exceeds that which the company could sustain indefinitely. The potential error in using those growth rates to estimate "g" is illustrated in the following table.

TABLE B.

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	GROWTH
BOOK VALUE	$10.00	$10.40	$10.82	$11.47	$12.157	5.00%
EQUITY RETURN	10%	10%	15%	15%	15%	10.67%
EARNINGS/SH.	$1.00	$1.040	$1.623	$1.720	$1.824	16.20%
PAYOUT RATIO	0.60	0.60	0.60	0.60	0.60	-
DIVIDENDS/SH.	$0.60	$0.624	$0.974	$1.032	$1.094	16.20%

What has happened is a shift in steady-state growth paths. For years one and two, the sustainable rate of growth (g=br) is 4.00%, just as in the previous hypothetical. Then, in the last three years, the sustainable growth rate increases to 6.00% (g=br = 0.4x15%). If the regulated firm were expected to continue to earn a 15% return on equity and retain 40% of its earnings, then a growth rate of 6.0% would be a reasonable estimate of the long-term sustainable growth rate. However, the compound annual growth rate for dividends and earnings exceeds 16% which is the result only of an increased equity return rather than the intrinsic ability of the firm to grow continuously at a 16% annual rate. Clearly, this type of estimate of future growth cannot be used with any reliability at all. In the case of the hypothetical, to utilize a 16% growth rate in a DCF model would be to expect the company's return on common equity to increase by 50% every five years into the indefinite future. This would be a ridiculous forecast for any regulated firm and underscores the importance of utilizing the underlying fundamentals of growth in the DCF model.

It can also be demonstrated that a change in our hypothetical regulated firm's payout ratio makes the past rate of growth in dividends an unreliable basis for predicting "g". If we assume our regulated firm consistently earns its expected equity return (10%) but in the third year, changes its payout ratio from 60% to 80% of earnings, the results are shown in the table below.

TABLE C.

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	GROWTH
BOOK VALUE	$10.00	$10.40	$10.82	$11.036	$11.26	3.01%
EQUITY RETURN	10%	10%	10%	10%	10%	-
EARNINGS/SH.	$1.00	$1.040	$1.082	$1.104	$1.126	3.01%
PAYOUT RATIO	0.60	0.60	0.80	0.80	0.80	7.46%
DIVIDENDS/SH.	$0.60	$0.624	$0.866	$0.833	$0.900	10.67%

What we see here is that, although the company has registered a high dividend growth rate (10.67%), it is, again, not at all representative of the growth that could be sustained indefinitely, as called for in the DCF model. In actuality, the sustainable growth rate has declined from 4.0% the first two years to only 2.0% (g=br = 0.2x10%) during the last three years due to the increased payout ratio. To utilize a 10% growth rate in a DCF analysis of this hypothetical regulated firm would 1) assume the payout ratio of the firm would continue to increase 33% every five years into the indefinite future, 2) lead to the highly implausible result that the firm intends to consistently pay out more in dividends than it earns and 3) grossly overstate the cost of equity capital.

APPENDIX C
SAMPLE COMPANY GROWTH RATE ANALYSES

TELECOMMUNICATIONS COMPANIES

BEL - BELL ATLANTIC - BEL's sustainable growth rate began the five-year historical period at a 7% rate, but through higher earned returns due to accounting changes (book equity write-downs), the "b times r" growth rate rose to 15% by 1999. The sustainable growth rate averaged 10.83% over the most recent five-year period. Value Line projects "b times r" growth in the future in the 15% to 16% range, again, a product primarily of an equity base reduced through accounting treatment. Further, because of write-offs, BEL's book value declined at a 2.5% rate over the most recent five years and, due to Bell Atlantic's merger with NYNEX the projected growth in book value is also expected to jump to the 14% level over the next five years. BEL's earnings per share are expected to grow at an 11% (VL) to 11.39% (Analysts') rate, which is higher than the 7.5% rate of growth in earnings experienced by that company over the most recent five years, but does not aproach the level indicated by the sustainable growth data. Historically, BEL's dividends increased at a 2.5% annual rate, but are projected by Value Line to increase at only a slightly higher rate, 3%, over the next five years. The average earnings, dividend and book value growth rates projected by Value Line for this company is 9%. Investors can reasonably expect a sustainable internal growth for this company of 10.5%.

With regard to expected growth from external sources (sales of stock at prices above book value), BEL's shares outstanding grew at a 15.4% rate over the past five years due to the merger with NYNEX. Since the merger the company's shares outstanding have decreased. Using 1999 as a base, Value Line's projection of total shares outstanding for BEL during the 2003-2005 period indicates a –0.75% growth rate in the number of shares. A growth rate in the number of shares outstanding of –0.25% for this company is reasonable.

BLS - Bell South - Bell South's sustainable growth rate began the five-year historical period at 6.8%, but rapidly grew to 16% by 1999 as equity returns and retention ratios increased. Value Line projects that earned returns will stabilize for BLS over the next five years but retention ratios will continue to increase, giving rise to an internal growth rate estimate of nearly 20% by the 2003-2005 period. BLS' book value, which increased at a 2% rate over the past five years, according to Value Line, is projected to increase at a 9.5% rate in the future. VL and Analysts' project earnings growth rates for BLS of 13% and 11.38%, respectively. However, BLS' dividend growth projections indicate only a 2.5% rate of growth in the future. Historically, BLS' earnings grew at a 11.5% rate while dividends increased at only a 1.5% rate. These data show that investors can reasonably expect that long-term sustainable growth for this company will be higher in the future than it has been in the past, though not as high as that indicated by the projected sustainable growth rate data. The average earnings, dividend and book value growth rates projected by Value Line for this company is 9%. A 10.5% internal growth rate is reasonable in this instance.

BLS' sares grew at only a –1.35% rate over the past five years, and Value Line projects that the number of shares outstanding will not decrease through the 2003-2005 period. A growth rate in the number of shares outstanding of -.25% provides reasonable long-term estimate for this company.

GTE – GTE Corp. - GTE's sustainable growth rate began the historical period at 10.3%, and averaged 12.45% for the five-year period, with a moderation in growth in 1998. However, VL projects the sustainable will rise by the 2003-05 period to a level near 16%, through an increasing retention ratio. GTE's book value growth during the most recent five years (-5%), again affected by reductions in book equity, is expected to rebound to a 17% rate in the future. GTE's earnings per share are projected to increase at a 11.5% (VL) to 11.9% (Analysts') rate, but its dividends are expected to grow at only a 0.5% rate, moderating long-term growth expectations. Historically GTE's earnings have shown 6.5% growth, while its dividends increased at a 1% rate. The average projected earnings, dividend and book value growth for GTE published by Value Line is 9.67%, well below historical sustainable growth rate averages. Therefore, investors can reasonably expect a sustainable growth rate somewhat lower than that recently established; 11.25% is reasonable for this company.

Regarding share growth, GTE's shares outstanding grew at a –0.03% rate over the past five years. The number of shares is expected to grow at approximately a 0.02% rate through 2003-05, but beyond 1999, the number of shares are not expected to increase. An expectation of share growth of 0% for this company is reasonable.

SBC - SBC Communications - SBC's sustainable growth rate began the five-year historical period at about a 14% rate, and averaged almost 16% for the entire 5-year period. Value Line projects that SBC's high equity returns will moderate somewhat and a 14% rate of internal growth will be maintained through the 2003-2005 period. As with the other RHCs, the per share data series projections indicate slower long-term growth for this company. For example, Value Line and institutional Analysts project 11.5% and 12.9% growth rates in earnings per share. However, over the past five years, when earnings growth for SBC was 10.5%, that company's dividends grew at only a 4% rate. Value Line projects that dividends will increase at a 5.5% rate in the future, higher than past growth but well below other growth rate measures, moderating long-term growth rate expectations. The average earnings, dividends and book value projected by Value Line for SBC is 11.5%, the highest projected growth rate for the telecommunications companies studied here. In this instance, a long-term sustainable internal growth rate of 11.0% is reasonable for this company.

Value Line's projections for shares outstanding for SBC take into account that company recent acquisition of Ameritech and include the issuance of over 1 billion shares of stock. Those data are not useful in estimating a long-term growth rate in shares outstanding. However, Value Line also reports that SBC's shares outstanding showed only a 0.01% rate of growth prior to that company's acquisition of Pacific Telesis. Also, following the Ameritech merger, Value Line projects no increase in shares outstanding for SBC. Therefore, investors relying on these data would anticipate no additional growth over the long-term due to sales of stock at prices above book value.

USW - US WEST Communications - Over the most recent five years USW's internal sustainable growth has averaged only 3.56%, even with earned returns (on a diminished book value) of approximately 30%. Due to USW's additional write-down of book value in 1998 to only $1.50 per share, Value Line reports the company's return on equity as "NMF"—no meaningful figure. In the future, Value Line projects that USW will earn equity returns in excess of 40%, and will retain more earnings, creating a sustainable growth projection by the 2003-2005 period of 25%. In my view, that figure does not represent a reasonable expectation for long-term sustainable growth. That very low 1998 book value also gives rise to a very

high book value growth projection of USW (23%). However, measured from the prior year (1997) USW's projected book value growth is 9.3%. Again, for this firm, the per share data series show considerably lower growth rates for USW. For example, Value Line also projects USW's earnings and dividends will increase at 13% and 0% rates, respectively. Institutional Analysts' five-year earnings growth projection for USW is lower than Value Line's: 7.12% (12 analysts polled). Again, the low rate of dividend growth projected over the next five years would cause investors to moderate any long-term growth expectations indicated by the sustainable growth rate data. However, it is reasonable to believe that USW's long-term future growth will exceed historical growth rate levels. An internal growth rate of 8.25% is reasonable for USW.

With regard to share growth the historical data published by Value Line for USW indicate a growth in shares outstanding of about 1.7%. However, over the next five years, Value Line projects very little growth from shares through the 2003-2005 period. A growth rate in the number of shares outstanding for USW of 0% is reasonable on a forward-looking basis.

PROPERTY/CASUALTY INSURANCE COMPANIES

BKLY - W. R. Berkley Corp. - BKLY's sustainable growth rate averaged 7.04% over the five-year historical period. After continuing to pay dividends with negative earnings level in 1999, VL projects that sustainable growth by the 2003-05 period at about 6.6%, roughly equal to historical averages. BKLY's book value, however, which increased at a 9% rate during the most recent five years is expected to decline to a 2% rate in the future. In addition, BKLY's dividends are expected to grow at a 5.5% rate, which is below the projected sustainable growth and well below the historical dividend growth of 11.5%. Those data indicate that growth expectations for this company will be lower in the future. Earnings growth projections show a steady to moderating trend. Historically BKLY's earnings grew at a 5.5% rate, according to Value Line but are expected to decline to a 2% to over the next five years. Analysts, however, project 14% earnings growth for this company, a very wide disparity. The sustainable growth rate data indicate that investors can expect sustainable growth from BKLY in the future to approximate that which has existed in the past, but dividend, book value and (some) earnings growth projections indicate steady or downward growth trends. Investors can reasonably expect a sustainable growth rate of 7.0% for this company.

Regarding share growth, BKLY's shares outstanding fell at approximately a 4% rate over the past five years following a large equity issuance in 1995. The growth rate in shares outstanding was negative prior to and following that equity issuance. The growth rate in the number of shares outstanding is expected to decline at a 1.25% rate between 1999 and the 2003-05 period. An expectation share growth of –1.5% for this company is reasonable.

CB - The Chubb Corporation - CB's sustainable internal growth rate averaged 8.08% over the five-year historical period, winding up in 1999 just below the average 5-year level. VL projects CB's growth will moderate in the future, reaching 6.82% by 2003-05. CB's book value growth rate is expected to remain relatively stable, increasing slightly to 9% from 8.5%. Also, CB's earnings per share are projected to increase at 6.5% (VL) and 11.8% (Analysts), but its dividends are expected to grow at 7%, similar to levels indicated by the projected sustainable growth rate. Historically, CB's earnings and dividends grew at 6% and 8% rates, respectively, according to VL. Given both higher and lower projections for the

future, investors can expect a sustainable growth rate near past averages, and 8% is a reasonable expectation for CB.

Regarding share growth, CB's shares outstanding grew at a 0.26% rate over the past five years. The level of share growth is expected by VL to decline at a 1.9% rate through 2003-05. An expectation share growth of –0.25% for this company is reasonable.

CINF - Cincinnati Financial Corp. - CINF's sustainable growth rate averaged 3.93% over the five-year historical period, but fell below that level during the most recent two years, indicating a downward trend. VL expects internal growth to continue at the level which existed during the historical study period, indicating sustainable growth by the 2003-05 period of about 4%. CINF's book value grew at a 21.5% rate during the most recent five years (that rate fell to 8.7% over the psat three years), but is expected by Value Line to increase at a 15% rate in the future. Also, CINF's earnings per share are projected to increase at a 11.5% to 10% rate (VL & Analysts, respectively). Historically, CINF's earnings growth was 7.5%. Those per share data indicate an increasing growth expectation for CINF, relative to historical growth. However, CINF's dividends, which grew at a 12.5% rate over the most recent five years are expected to fall to a 10.5% rate in the future. The projected earnings, dividend and book value growth rates are considerably higher than indicated by the sustainable growth rate. Investors can reasonably expect a sustainable growth rate of 10.75% for this company.

Regarding share growth, CINF's shares outstanding fell at approximately a 0.7% rate over the past five years. That level of shares outstanding is expected by VL to fall at nearly a 1.5% rate through 2003-05. An expectation share growth of -1% for this company is reasonable.

OCAS - Ohio Casualty Corp. - OCAS's sustainable internal growth rate averaged 3.92% over the five-year historical period. VL projects OCAS's growth to fall below historical average levels in 2000, with negative growth predicted and then increase to roughly 6.7% by 2003-05. OCAS's book value growth rate is expected to fall from 11% to only 1.5%, indicating an expectation for lower growth in the future. Also, OCAS's earnings per share are projected to increase at 7% (VL) and 10% (Analysts), but its dividends are expected to grow at 3%, moderating growth expectations. Historically, OCAS's earnings and dividends grew at 3% and 4.5% rates, respectively, according to VL. Investors can reasonably expect a sustainable growth rate of 7.75%, from OCAS.

Regarding share growth, OCAS's shares outstanding grew at a negative 4% rate over the past five years. The level of share growth is expected by VL to be flat through 2003-2005, indicating –0.03% growth by that time. An expectation share growth of –0.25% for this company is reasonable.

SAFC - SAFECO Corporation - SAFC's sustainable growth rate averaged 4.59% for the five-year historical period. The sustainable growth in the most recent year, however, was approximately 1.3%, well below the five-year average. The sustainable growth in 2000 is projected to continue at levels below that five-year average, and to rise by the 2003-05 period to a level of approximately 4%. These data would indicate that investors can expect future growth to approximate past averages. However, SAFC's book value growth during the most recent five years (15.5%) is expected to decline in the future to a growth rate of 5.5%. SAFC's earnings per share are projected to increase at a 7% (VL) to 9.4% (Analysts) rate, and its dividends are expected to grow at a 12.5% rate, after increasing at a 9% rate over the past five years. Investors can reasonably expect a sustainable growth rate of 9.00% for this company.

Regarding share growth, SAFC's shares outstanding grew at a 0.57% rate over the past five years due to a large equity issuance in 1997. Since then, the number of shares outstanding has been reduced. The number of shares outstanding is expected to decline through the 2003-05 period, at approximately a 1.5% rate. An expectation share growth of -0.25% for this company is reasonable.

SPC - St. Paul Companies - SPC's sustainable growth rate averaged 8.88% over the five-year historical period. After falling well below that historical average sustainable growth rate level in 1998, VL projects a sustainable growth by the 2003-05 period to recover to a level somewhat below the historical average; approximately 7.3%. SPC's book value, which increased at a 12.5% rate during the most recent five years, is expected to fall to a 5% rate in the future. Also, SPC's dividends are expected to grow at a 4% rate, after increasing at a 7% rate over the most recent five years. Also, SPC's earnings grew at an 11.5% rate historically, but are expected to increase at a rate of from 4% (by VL) to 10.07% (by Analysts), i.e., below past averages and braketing sustainable growth rate levels. Investors can reasonably expect a sustainable growth rate of 8.25% for SPC.

Regarding share growth, SPC's shares outstanding grew at approximately an 7.5% rate over the past five years due to a large equity issuance in 1998. Prior to that time, shares outstanding were declining. The growth rate in the number of shares outstanding is expected to decline again through 2003-05 at a –1.8% rate. An expectation share growth of 0% for this company is reasonable.

SIGI - Selective Insurance Group - SIGI's sustainable growth rate averaged 7.64% over the five-year historical period, showing a declining trend. VL projects that the company will maintain sustainable growth levels through the 2003-05 period at approximately 7.3%--roughly equal to historical averages. SIGI's projected book value growth rate, however, shows growth declining from 11% over the past five years to 6.5% in the future. SIGI's earnings per share are projected to increase at a 5%-9% (VL & Analysts, respectively) rate, after growing at a 15% rate, historically. The company's dividends are expected to grow at a 3.5% rate, after increasing at only a 0.5% rate in the past. Investors can reasonably expect a sustainable growth rate of 8.25% for this company.

Regarding share growth, SIGI's shares outstanding fell at approximately a 2% rate over the past five years. That level of shares outstanding is expected by VL to continue to decline at approximately a 0.5% rate through 2003-05. An expectation share growth of –0.75% for this company is reasonable.

TRH - Transatlantic Holdings Inc. - TRH's sustainable growth rate averaged 12.55% over the five-year historical period with lower results in the most recent year. VL projects sustainable growth by the 2003-05 period will moderate to approximately 11%. TRH's book value, which increased at an 17.5% rate during the most recent five years, is expected to increase at a 14.0% rate in the future. Also, TRH's dividends are expected to grow at a 12% rate, which is higher than the indicated sustainable growth but below the historical dividend growth of 15.5%. Earnings show a substantial moderating trend. Historically TRH's earnings grew at a 20.5% rate, but are expected to continue in the future at a 9% rate (VL & Analysts). The dividend, earnings, and book value growth rate data for this company indicate that growth in those parameters is trending toward the projected sustainable growth rate. Investors can reasonably expect a sustainable growth rate of 10.75% for TRH.

Regarding share growth, TRH's shares outstanding rose at approximately a 0.3% rate over the past five years. The growth rate in the number of shares outstanding is expected to increase at a 0.1% rate through 2003-05. Those

projections indicate that future share growth will moderate. An expectation share growth of 0.15% for this company is reasonable.

AIG - American International Group - AIG's sustainable growth rate averaged 12.65% for the five-year historical period. The sustainable growth in 2000 is projected to rise slightly above levels that were recently achieved, and fall back, by the 2003-05 period to a level near 13.5%. AIG's book value growth during the most recent five years (13%) is expected to be decline to a 12% rate in the future. AIG's earnings per share are projected to increase at a 13% (VL) to 14.3% (Analysts) rate, and its dividends are expected to grow at a 13.5% rate, similar to long-term sustainable growth expectations. Investors can reasonably expect a sustainable growth rate of 13%.

Regarding share growth, AIG's shares outstanding increased at approximately a 3.8% rate over the past five years, due to an equity issuance in 1999. The number of shares outstanding declined prior to that equity issuance. Following two years of no growth, share growth is expected to continue at approximately 0.6% . An expectation share growth of 0.5% for this company is reasonable.

UNIT - Unitrin, Incorporated - UNIT's sustainable internal growth rate averaged 3.44% over the five-year historical period. VL projects UNIT's growth to fall below historical average levels in 2000 and then increase to approximately the 3.7% level by 2003-05. Indicating future growth at the same rate as historical growth. UNIT's book value growth is expected to decrease slightly from 3.5% to 3.0%. However, UNIT's earnings per share are projected to increase at a 10.5% (VL) rate [Analysts 5-year growth rates not available], and its dividends are expected to grow at 6.5%. Historically, UNIT's earnings and grew at 8.5% and the company's dividends (which were just initiated in 1990) showed 15% growth, according to Value Line. However, that historical growth in dividends would not be weighed heavily by investors in assessing long-term sustainable growth. Investors can reasonably expect a sustainable growth rate of 7.75%, from UNIT. That growth rate level is well above the sustainable growth indication, but gives recognition to the near-term growth potential contained in the Value Line's projected earnings and dividend growth for this company.

Regarding share growth, UNIT's shares outstanding grew at a negative 2% rate over the past five years. The level of reduction in shares outstanding is expected by VL to moderate to approximately a –1.5% rate through 2003-05. An expectation share growth of negative 1.5% for this company is reasonable.

GAS DISTRIBUTORS

ATG - AGL Resources - ATG's sustainable growth rate has averaged about 1.8% over the most recent five year period (1995-1999), including a set-back with substantially negative growth in 1999, due to restructuring. VL expects ATG's sustainable growth to approximate that historical growth rate level by 2001 and to reach 3.8% by the 2003-2005 period. ATG's book value growth rate is expected to be 3% over the next five years, an increase from the 2.5% rate of growth experienced over the past five years. Also, ATG's earnings per share are projected to increase at a 5.37% (IBES) to 5% (VL) rate, but its dividends are expected to grow at only 1%, moderating sustainable growth expectations. Over the past five years, ATG's earnings grew at a 2.0% rate while its dividends increased at a 1.0%

rate. Investors can reasonably expect a sustainable growth rate in the future of 3.75% for ATG.

Regarding share growth, ATG's shares outstanding grew at approximately a 1% rate over the past five years. Following negative growth in 2000 and 20001, the number of shares is projected by VL to increase very slightly through 2003-05. An expectation of share growth of 0.25% for this company is reasonable.

ATO – Atmos Energy Corp - ATO's sustainable growth rate averaged about 3% for the five-year historical period, with a substantial increase in 1998. However, sustainable growth in 1999 fell to –2.36%. Absent that negative result, ATO's historical sustainable growth averages 4.3%. Value Line projects a continuation of negative growth in 2000, and then rise by the 2003-05 period to a level near 7%, through an increasing ROE. ATO's book value growth during the most recent five years (4.5%) is expected to remain stable at a 4.5% rate in the future. ATO's earnings per share are projected to increase at a 10.5% (VL) to 7.3% (IBES) rate, but its dividends are expected to grow at only a 4% rate, moderating long-term growth expectations. Historically ATO's earnings have shown 5% growth, while its dividends increased at a 4.5% rate. Investors can reasonably expect a sustainable growth rate higher than that recently established; 5.5% is reasonable for this company.

Regarding share growth, ATO's shares outstanding grew at approximately a 19% rate over the past five years, due to a merger-related increase in the number of shares outstanding. Since the merger shares have increased at a 2.5% rate. After growing at a 2.25% to 2.4% rate through 2001, the number of shares is expected to grow at approximately a 3% rate through 2003-05. An expectation of share growth of 2.5% for this company is reasonable.

CGC - Cascade Natural Gas Company - CGC's sustainable growth rate averaged negative 0.67% over the five-year historical period with the company paying out more in dividends that it had in earnings in most of those years. IN 1999, however, the company's sustainable growth rose to 2.7%. VL projects that the retention ratio and ROE will rise through 2003-05, bringing sustainable growth near 5.35%. CGC's book value, which increased at a 1% rate during the most recent five years, is expected to increase at a 4% rate in the future, approximating the sustainable growth projection. CGC's earnings per share are projected to increase at a 9.5% (VL) to 4.7% (IBES) rate (a relatively wide disparity in earnings projections), but its dividends are expected to grow at only a 0.5% rate, moderating long-term growth expectations. Also, the difference in earnings growth rate projections for this company indicates that Value Line's earnings growth projections, which are grounded on a prediction of sharply higher ROE's may not be representative of long-term sustainable growth. Historically CGC's earnings grew at a 5.5% rate and its dividends showed 0.5% growth, according to Value Line. The projected sustainable growth, earnings and book value growth rate data indicate that investors can expect the growth from CGC to be higher in the future than has existed in the past. Investors can reasonably expect a sustainable growth rate of 4.0% for CGC.

Regarding share growth, CGC's shares outstanding grew at approximately a 5% rate over the past five years due to an equity issuance in 1996. Since that time shares outstanding have grown at less than 0.5% per year. Further, after showing no growth in 2000 and 20001, CGC's growth rate in shares outstanding is expected to rise at about a 1.6% rate of increase through 2003-05. Those projections indicate that future share growth will be well below past averages. An expectation of share growth of 1.75% for this company is reasonable.

NJR - New Jersey Resources - NJR's sustainable growth rate averaged 3.84% over the five-year period. NJR's average historical sustainable growth has shown steady improvement since 1992, reaching 4.81% in 1999. VL projects, by the 2003-05 period, sustainable growth will rise to levels approximating 7.8%. NJR's book value shows a somewhat less dramatic improvement -- book value grew at a 2.5% rate during the most recent five years but is expected to rise to a 6% rate in the future, according to Value Line. Value Line projects a rate of earnings increase for NJR of 8%, while IBES projects 6.6%. Dividends are expected to grow at a 2.5% rate, moderating long-term growth expectations somewhat. Historically NJR's earnings grew at a 6% rate while its dividends increased at only a 1.5% rate. Therefore, like many other gas distributors, NJR's earnings can be expected to recover rapidly from lower levels experienced in the early 1990s, but will not support dividend increases at the same rate. Investors can reasonably expect a long-term sustainable growth rate of 6.5%.

Regarding share growth, NJR's shares outstanding grew at a –0.07% rate over the past five years. The five-year average level of share growth is expected to decrease to approximately 0.5% annually through 2003-05. An expectation of share growth of –0.25% for this company is reasonable.

NWNG - Northwest Natural Gas - NWNG's sustainable growth rate averaged 2.58% for the five-year period. Absent the negative results experienced in 1998, the average growth would be approximately 3.5%. VL expects sustainable growth to rise to about a 4.5% level through the 2003-05 period. NWNG's book value growth is expected to continue to increase at a 4.5%, slightly below the historical level of 5%. NWNG's earnings per share growth is projected to increase at a 5.5% (VL) to 4.02% (IBES) rate, but its dividends are expected to grow at only a 1% rate, moderating long-term growth expectations. Historically NWNG's earnings and dividends increased at 8.5% and 1% rates, respectively, according to Value Line. Investors can reasonably expect sustainable growth from NWNG to exceed past averages, a sustainable internal growth rate of 4.5% is reasonable for this company.

Regarding share growth, NWNG's shares outstanding grew at approximately a 3% rate over the past five years. That growth in the number of shares is expected by VL to drop to approximately 1.6% through 2003-05. An expectation of share growth of 2.5% for this company is reasonable.

PNY - Piedmont Natural Gas - PNY's sustainable internal growth rate averaged 3.81% over the five-year historical period, but declined below that level in the most recent year. VL projects PNY's sustainable growth to rise to a level of approximately 5.25% through 2003-05. However, PNY's book value growth rate is expected to continue in the future at the historical level of 6.5%, pointing to relative growth rate stability for this company. PNY's earnings per share are projected to increase at 7% to 5.6% (VL & IBES), while its dividends are expected to grow at a 4.5% rate, down from a 6% rate, historically. Sustainable growth has been relatively consistent for this company and is expected to trend upward somewhat in the future close to the 5% level. Dividend growth has been above 5% but is expected to fall below the 5% level in the future, therefore, investors can reasonably expect a sustainable growth rate of 5.25%, from PNY.

Regarding share growth, PNY's shares outstanding grew at a 2% rate over the past five years. The level of share growth is expected by VL to drop to approximately 1% through 2003-05. An expectation of share growth of 1.5% for this company is reasonable.

SJI – South Jersey Industries - SJI's sustainable growth rate has averaged only about 1.4% over the most recent five year period (1995-1999), with results in 1999 dramatically above the historical growth rate level. That higher level of growth is expected to be sustained in 2000 and 20001 and to rise to approximately 4.4% by the 2003-2005 period. SJI's book value growth rate is expected to be 4% over the next five years—an increase from the 3% rate of growth experienced over the past five years. Also, SJI's earnings per share are projected to increase at a 5.25% (IBES) to 7.5% (VL) rate (due to the increasing size of some profitable unregulated operations), but its dividends are expected to grow at only 1.5%, moderating sustainable growth expectations. Over the past five years, SJI's earnings grew at a 1.0% rate while its dividends increased at a 0.5% rate. Investors can reasonably expect a sustainable growth rate in the future to be considerably higher than past averages, 4.5% is reasonable for for SJI.

Regarding share growth, SJI's shares outstanding grew at a 1.1% rate over the past five years. The number of shares outstanding is projected by VL to rise at approximately a 3% rate through 2003-05. An expectation of share growth of 2% for this company is reasonable.

APPENDIX D

CAPITAL ASSET PRICING MODEL

There are many reasons why the Capital Asset Pricing Model (CAPM) should be used with caution in estimating the cost of equity capital. The CAPM was originally designed as a point-in-time tool for selecting stock portfolios that matched a particular investor's risk/return preference. Its use in rate of return analysis to estimate multi-period return expectations for one stock or one type of stock, rather than a diversified portfolio of stocks, takes the model out of the context for which it was intended. Also, questions regarding the fundamental applicability of the CAPM theory and the veracity of beta have arisen recently in the financial literature.

Over the past few years there has been much comment in the financial literature over the strength of the assumptions that underlie the CAPM and the inability to substantiate those assumptions through empirical analysis. Also, there are three fundamental problems with the key CAPM risk measure (beta) that indicate that the CAPM analysis is not a reliable primary indicator of equity capital costs. The first two have been widely known for some time, but the third, and perhaps most damaging criticism, has emerged only in the past few years.

First, cost of capital analysis is a decidedly forward-looking, or *ex-ante*, concept. Beta is not. The measurement of beta is derived completely with historical, or *ex-post*, information. Therefore, the beta of a particular company, because it is usually derived with five years of historical data, is slow to change to current (i.e., forward-looking) conditions, and some price abnormality that may have happened four years ago could substantially affect beta while, currently, being of little actual concern to investors. Moreover, this same shortcoming which assumes that past results mirror investor expectations for the future plagues the market risk premium in an ex-post, or historically-oriented CAPM.

Second, the beta coefficients for any individual stock have very low "r^2" values and, statistically, must be considered relatively poor indicators of company-specific risk. The statistical reliability of beta is thought to increase when it is used to identify the

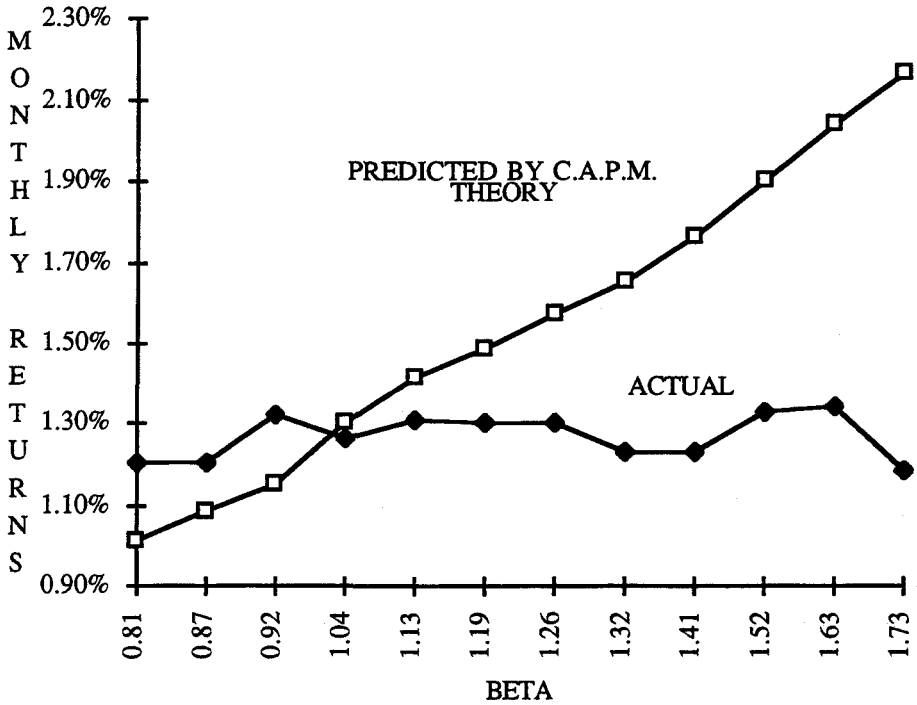
risk/return profile of a diversified group of stocks. However, that is not the manner in which beta is used in regulation, and the low statistical reliability of beta is problematic in cost of capital analysis. As a result of the low statistical reliability of beta, different investor services offer different -- and sometimes widely divergent -- estimates of beta.

Third, a recent study performed for the Center for Research in Security Prices at the University of Chicago Graduate School of Business shows that the assumed relationship between beta, risk and return (i.e., beta varies directly with risk and return) simply does not exist in the marketplace. As Value Line reported in its Industry Review published in March of 1992:

> "Two of the most prestigious researchers in the financial community, Professors Eugene F. Fama and Kenneth R. French from the University of Chicago have challenged the traditional relationship between Beta and return in a recent paper published by the Center for Research in Security Prices. In this study, the duo traced the performance of thousands of stocks over 50 years, but found no statistical support for the hypothesis that the relationship between volatility and return is significantly different from random. Indeed, professor Fama concluded, 'The fact is that Beta, as the sole variable explaining returns on stocks, is dead.' These findings support previous studies that have called into question the real-world applicability of the CAPM Beta, including papers by Keim (Financial Analysts Journal, 1986), and Roll (Journal of Financial Economics, 1977). Never before, however, has the lack of a statistically significant relationship between beta and return been so rigorously and dramatically established." (Value Line Industry Review, March 13, 1992, p. 1-8)

A graphical summary of the findings published in the Fama and French article ("The Cross-Section of Expected Stock Returns," The Journal of Finance, Vol. XLVII, No. 2, June 1992, pp. 427-465) is shown below in Chart I:

CHART I.
MONTHLY STOCK RETURNS v. BETA
1963-1990



Graphing monthly returns against the average beta for the different stock groupings presented by Fama and French shows that the actual risk/return relationship that has existed over the 1963-1990 period (labeled "actual" in Chart I) is vastly different from that predicted by the CAPM theory. For example, Fama and French found that there was little difference in the average monthly returns of stocks with high betas (beta = 1.73, monthly return = 1.18%) and stocks with low betas (beta = 0.81, monthly return = 1.20%), while the assumption embodied in the CAPM is that the returns for those types of stocks should be substantially different. These findings led the researchers to conclude:

> "In short, our tests do not support the most basic prediction of the SLB [Sharpe-Litner-Black, CAPM] model, that average returns are positively related to market ßs." (Id., p. 428)

Fama and French have continued their investigation of the CAPM since their

1992 article and have postulated that a more accurate CAPM would use two additional risk measures in addition to beta. Their three-factor CAPM uses relative size as measured by market value of the firm's stock compared to that of the market index and relative book value-to-market value ratio compared to that of the market index as additional measures of risk[1]. The continuing research of Fama and French indicate that their three-factor CAPM is theoretically superior to the "standard" CAPM which relies on betas as the sole indicator of relative risk, producing results which more closely mimic historical experience.

However, it is important to note that while those authors tout the superiority of their three-factor CAPM to the single-beta CAPM on theoretical grounds, they recognize that there are significant problems with any type of asset pricing model when it comes to using the model to estimate the cost of equity capital. In "Industry Costs of Equity" a working paper published by the Center for Research in Security Prices (Revised October 1996), Fama and French point out quite clearly that the volatility inherent in the historical data is such that a cost of equity estimate produced by <u>any</u> asset pricing model -- whether the traditional CAPM or their three-factor CAPM -- is subject to wide error:

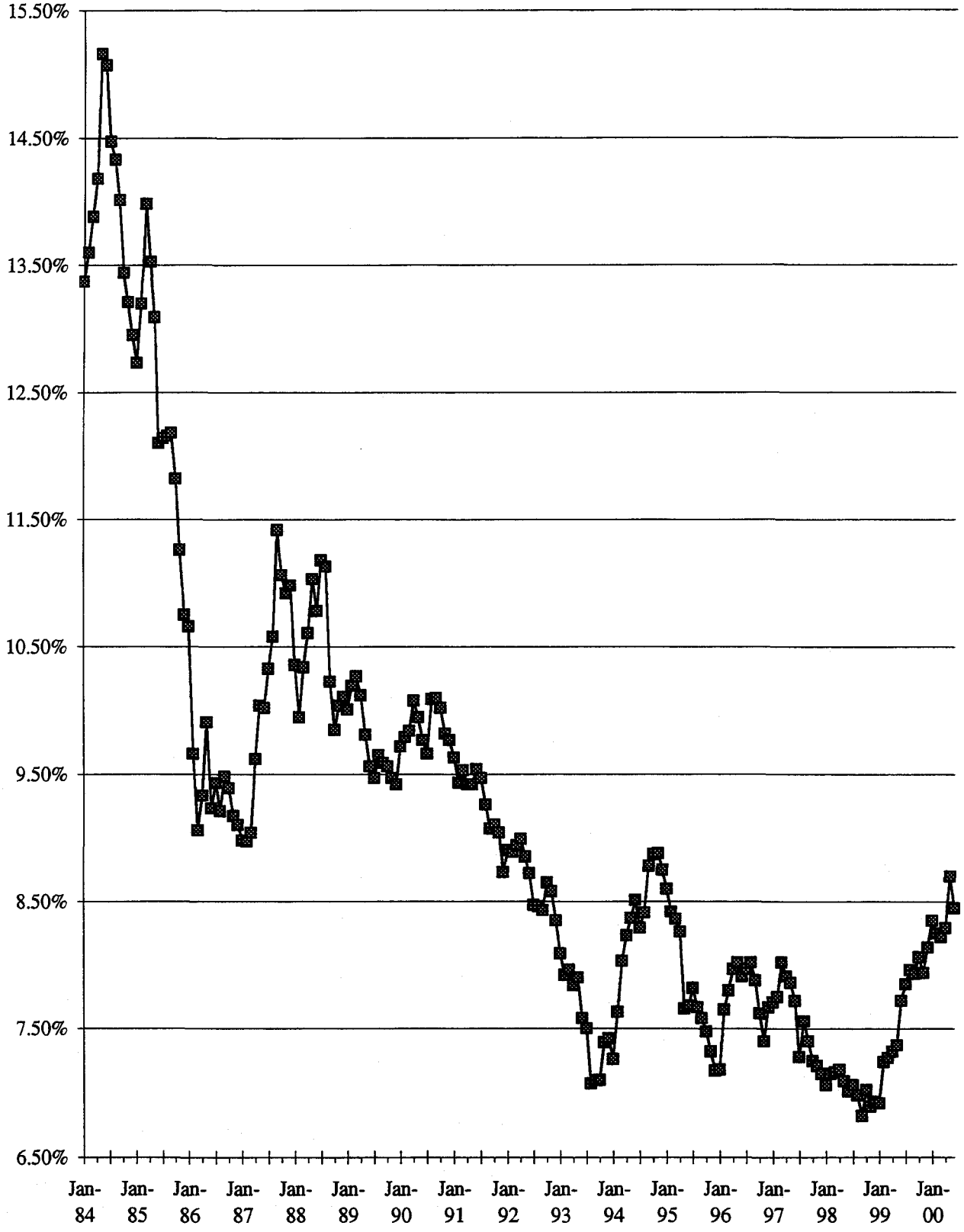
> "We do not take a stance on which is the right asset pricing model. Instead we use both the CAPM and our three-factor model to estimate industry costs of equity (CE's). Our goal is to illustrate in detail two problems that plague CE estimates from any asset pricing model.
>
> The first problem is imprecise estimates of risk loadings [betas or beta-equivalents for other risk measures]. Estimates of CAPM and three-factor risk loadings for industries would be precise if the loadings were constant. We find however, that there is strong variation through time in the CAPM and three-factor risk loadings of industries. As a result, if we are trying to measure an industry's current risk loadings and cost of equity, estimates from full sample (1963-1994) regressions are not more accurate than the imprecise estimates from regressions that use only the latest three years of data. And industries give an understated picture of the problems that

[1] Fama and French postulate that firm size and book-to-market ratio effectively proxy the risk-return characteristics of earnings-price ratios and sales growth, the latter having been determined to have more explanatory power with regard to relative risk and return than beta alone.

> will arise in estimating risk loadings for individual firms and investment projects.
>
> The second problem is imprecise estimates of factor risk premiums. For example, the price of risk in the CAPM is the expected return on the market portfolio minus the risk-free interest rate, $E(R_M)-R_f$. The annualized average excess return on the Center for Research in Security Prices (CSRP) value-weighted market portfolio of NYSE, AMEX and NASDAQ stocks for our 1963-1994 sample period is 5.16%; its standard error is 2.71%. Thus, if we use the historical market premium to estimate the expected premium, the traditional plus-and-minus-two-standard-error interval ranges from less than zero to more than 10.0%.
>
> Our message is that uncertainty of this magnitude about risk premiums, coupled with the uncertainty about risk loadings, implies woefully imprecise estimates of the cost of equity." (Fama, French, "Industry Costs of Equity," Center for Research in Security Prices at the University of Chicago Graduate School of Business (First Draft March 1994, Revised October 1996), pp. 1-2)

While this recently published conclusion as to the imprecision of equity cost estimates produced by CAPM-type models does not negate the risk/return basis of asset pricing, it does definitely call for a more accurate measure other than beta (or other risk indicators) with which asset returns can be more reliably indexed. However, unless and until such an index is published and widely accepted in the marketplace, CAPM cost of equity capital estimates should be relegated to a supporting role or informational status. Therefore, for the reasons set out above, I use the CAPM for informational purposes and do not rely on that methodology as a primary equity capital cost estimation technique, and I recommend that the Commission adopt a similar view toward the CAPM cost of equity capital estimates presented in this proceeding.

US WEST COMMUNICATIONS
Moody's A-Rated Utility Bond Yields

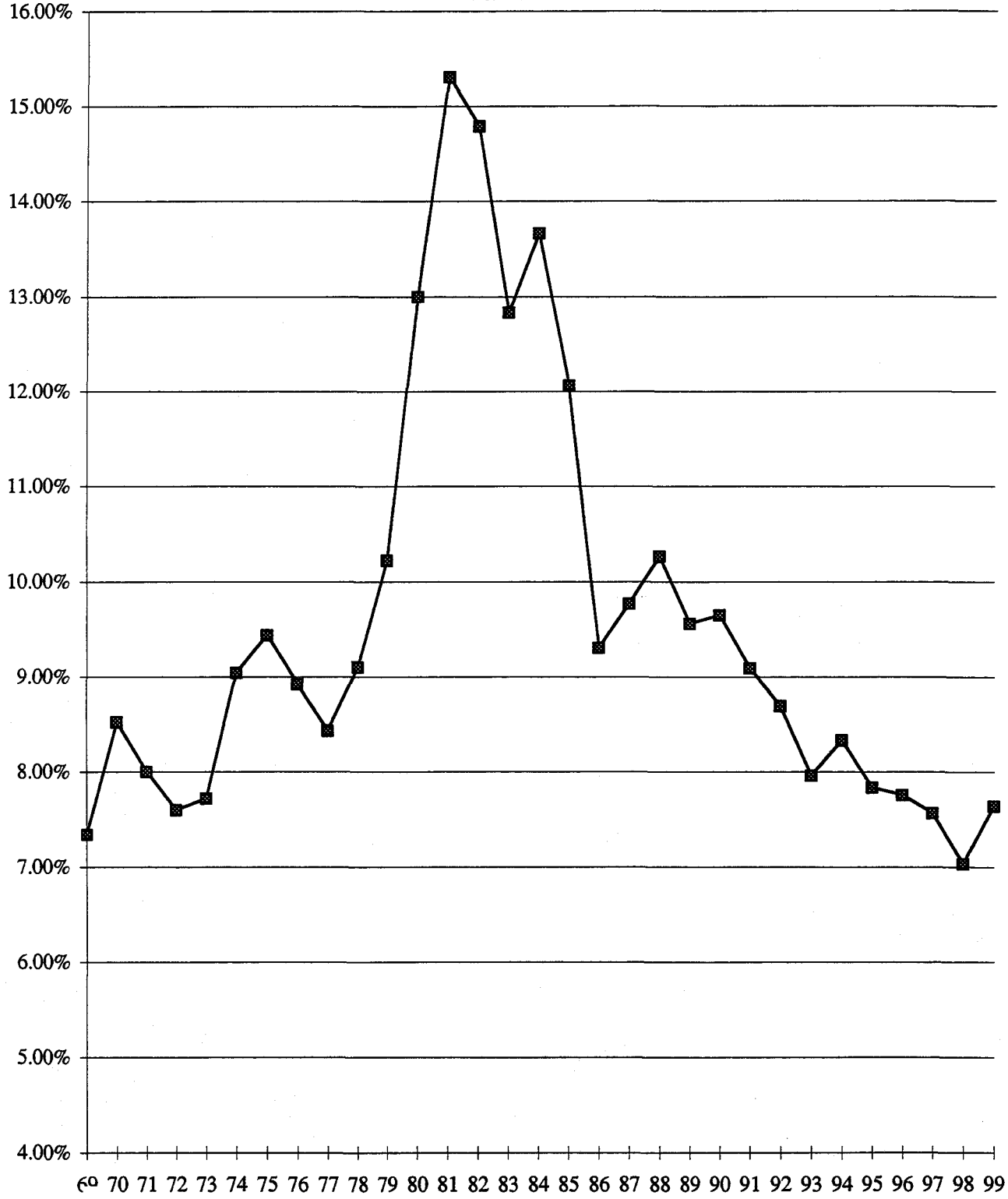


All data from CompuServe and Moody's Investor Service Website, Economic Commentary.

US WEST COMMUNICATIONS

Moody's A-rated Utility Bond Yields

1969-1999



All data from CompuServe and Moody's Public Utility Reports.

US WEST COMMUNICATIONS
CAPITAL STRUCTURE

CONSOLIDATED OPERATIONS

AMOUNT (000,000)

Type of Capital	1995	1996	1997	1998	1999	5-YEAR AVERAGE
Common Equity	$3,675	$4,085	$4,367	$755	$1,255	$2,827
Long-term Debt	$5,691	$5,665	$5,020	$8,642	$10,189	$7,041
TOTALS	$9,366	$9,750	$9,387	$9,397	$11,444	$9,869

PERCENTAGE

Type of Capital	1995	1996	1997	1998	1999	5-YEAR AVERAGE
Common Equity	39.24%	41.90%	46.52%	8.03%	10.97%	29.33%
Long-term Debt	60.76%	58.10%	53.48%	91.97%	89.03%	70.67%
TOTALS	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%

TELEPHONE OPERATIONS

AMOUNT (000,000)

Type of Capital	1995	1996	1997	1998	1999	5-YEAR AVERAGE
Common Equity	$3,746	$4,060	$4,400	$4,463	$4,720	$4,278
Long-term Debt	$5,411	$5,375	$5,019	$5,154	$5,408	$5,273
Short-term Debt	$995	$834	$497	$789	$1,684	$960
TOTALS	$10,152	$10,269	$9,916	$10,406	$11,812	$10,511

PERCENTAGE

Type of Capital	1995	1996	1997	1998	1999	5-YEAR AVERAGE
Common Equity	36.90%	39.54%	44.37%	42.89%	39.96%	40.73%
Long-term Debt	53.30%	52.34%	50.62%	49.53%	45.78%	50.31%
Short-term Debt	9.80%	8.12%	5.01%	7.58%	14.26%	8.95%
TOTALS	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%

Data from US WEST 1998 Investor Handbook and 1/26/00 S.E.C. Form 8-K.

US WEST COMMUNICATIONS

CAPITAL STRUCTURE OF TELECOMMUNICATIONS HOLDING COMPANIES

COMPANY	COMMON EQUITY	PREFERRED STOCK	LONG-TERM DEBT	SHORT-TERM DEBT
1 Bell Atlantic	43.23%	0.00%	47.78%	8.99%
2 Bell South	46.90%	0.00%	27.78%	25.32%
3 GTE Corp.	31.53%	0.00%	40.62%	27.85%
4 SBC Corp.	54.99%	2.06%	36.01%	6.94%
5 US WEST	8.79%	0.00%	71.10%	20.11%
AVERAGE	**37.09%**	**0.41%**	**44.66%**	**17.84%**
AVERAGE W/O USW	**44.16%**	**0.52%**	**38.05%**	**17.28%**

Data from Value Line Ratings & Reports, April 7, 2000.

US WEST COMMUNICATIONS

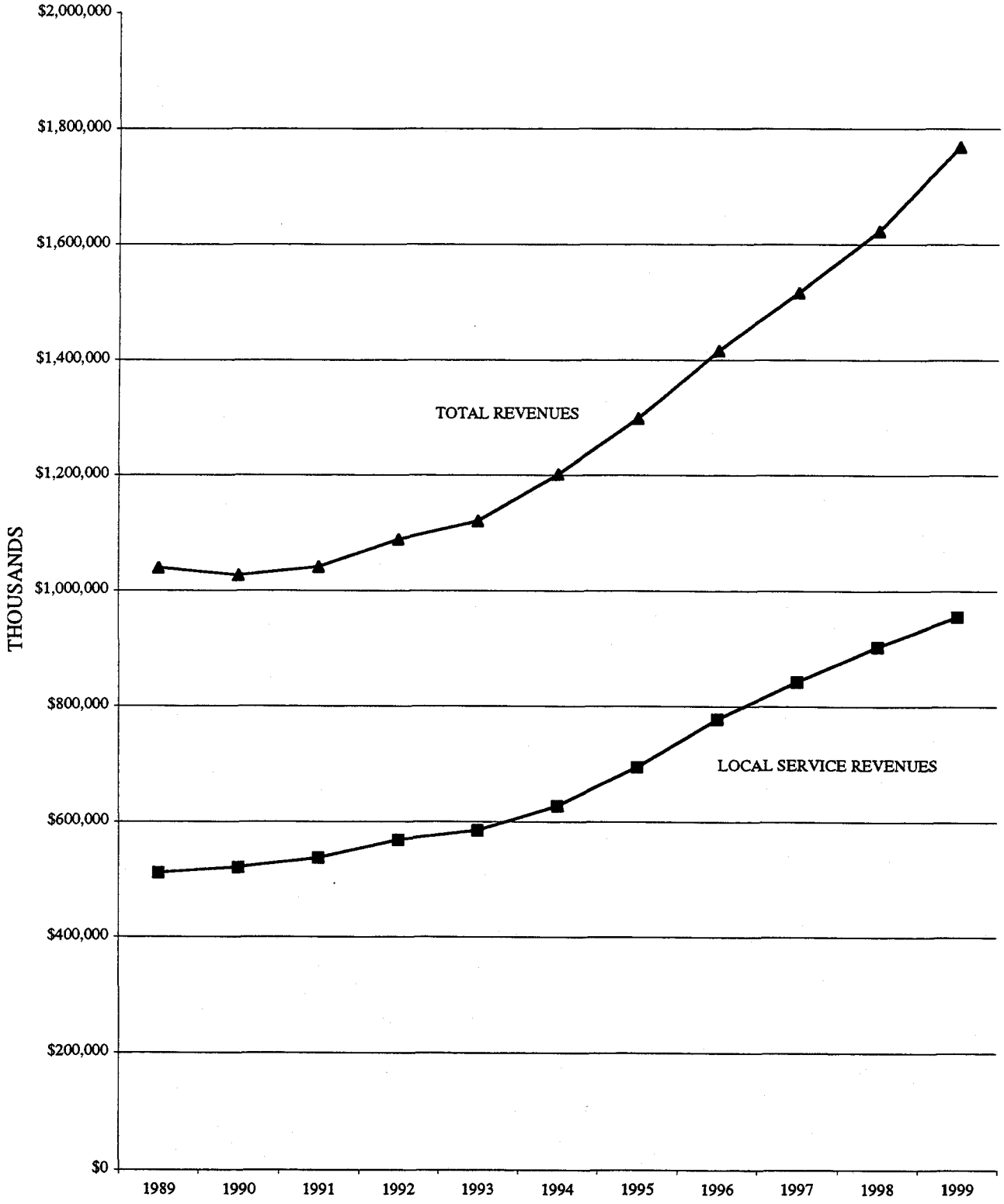
RATEMAKING CAPITAL STRUCTURE

TYPE OF CAPITAL	AMOUNT	PERCENT OF TOTAL	COST RATE†	WT. AVG. COST RATE
Common Equity	$1,015,260	52.43%	-	-
Total Debt	$920,981	47.57%	7.39%	3.52%
TOTALS	$1,936,241	100.00%		

† Cost rates from USW Exhibit PCC-02 (May 3, 2000).

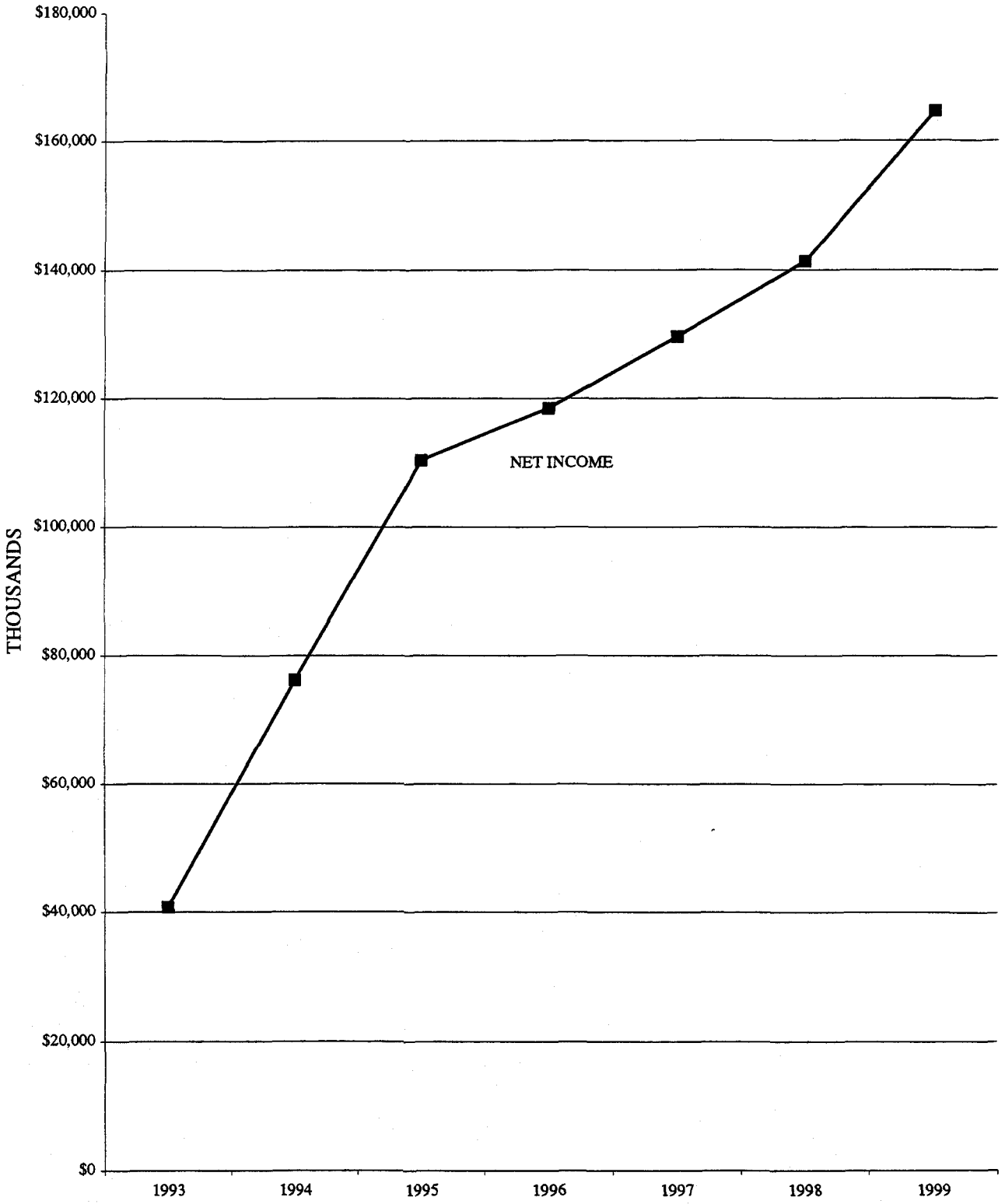
US WEST COMMUNICATIONS

ARIZONA JURISDICTIONAL REVENUES



Data from Company response to SGH01-11.

US WEST COMMUNICATIONS
ARIZONA JURISDICTIONAL NET INCOME



Data from Company response to SGH01-11.

US WEST COMMUNICATIONS
DCF GROWTH RATE PARAMETERS
TELECOMMUNICATIONS COMPANIES

COMPANY	INTERNAL GROWTH				EXTERNAL GROWTH	
BEL	RETENTION RATIO	EQUITY RETURN	"g"	BOOK VALUE ($/SHARE)	SHARES OUTST (MILLIONS)	SHARE GROWTH
1995	0.2784	25.4%	7.07%	7.63	875.53	
1996	0.2778	23.4%	6.50%	8.48	875.63	
1997	0.3992	29.0%	11.58%	8.24	1553.00	
1998	0.4338	32.5%	14.10%	8.39	1553.30	
1999	0.4884	30.5%	14.90%	9.80	1553.00	
AVERAGE GROWTH			10.83%	-2.50%		15.41%
2000	0.5224	29.0%	15.15%		1540.00	-0.84%
2001	0.5452	29.0%	15.81%		1525.00	-0.91%
2003-2005	0.6206	26.0%	16.14%	13.00%	1495.00	-0.76%

COMPANY	INTERNAL GROWTH				EXTERNAL GROWTH	
BLS	RETENTION RATIO	EQUITY RETURN	"g"	BOOK VALUE ($/SHARE)	SHARES OUTST (MILLIONS)	SHARE GROWTH
1995	0.3661	18.8%	6.88%	5.95	1988.00	
1996	0.4331	19.0%	8.23%	6.68	1982.00	
1997	0.4894	18.4%	9.00%	7.64	1984.00	
1998	0.5576	20.2%	11.26%	8.26	1950.00	
1999	0.6200	25.8%	16.00%	7.86	1883.00	
AVERAGE GROWTH			10.27%	2.00%		-1.35%
2000	0.6545	26.0%	17.02%		1883.00	0.00%
2001	0.6800	26.0%	17.68%		1883.00	0.00%
2003-2005	0.7634	26.0%	19.85%	9.50%	1883.00	0.00%

COMPANY	INTERNAL GROWTH				EXTERNAL GROWTH	
GTE	RETENTION RATIO	EQUITY RETURN	"g"	BOOK VALUE ($/SHARE)	SHARES OUTST (MILLIONS)	SHARE GROWTH
1995	0.2797	36.8%	10.29%	7.05	975.06	
1996	0.3472	38.0%	13.19%	7.62	963.10	
1997	0.3793	34.8%	13.20%	8.39	958.00	
1998	0.3876	28.4%	11.01%	9.06	968.00	
1999	0.4613	31.5%	14.53%	11.10	974.00	
AVERAGE GROWTH			12.45%	-5.00%		-0.03%
2000	0.5117	30.5%	15.61%		975.00	0.10%
2001	0.5586	28.5%	15.92%		975.00	0.05%
2003-2005	0.6746	23.5%	15.85%	17.00%	975.00	0.02%

US WEST COMMUNICATIONS
DCF GROWTH RATE PARAMETERS
TELECOMMUNICATIONS COMPANIES

COMPANY	INTERNAL GROWTH				EXTERNAL GROWTH	
SBC	RETENTION RATIO	EQUITY RETURN	"g"	BOOK VALUE ($/SHARE)	SHARES OUTST (MILLIONS)	SHARE GROWTH
1995	0.4645	30.2%	14.03%	5.13	1218.70	
1996	0.5029	30.7%	15.44%	5.70	1199.70	
1997	0.5109	34.0%	17.37%	5.38	1837.30	
1998	0.5481	32.2%	17.65%	6.52	1959.30	
1999	0.5488	27.8%	15.26%	7.87	3395.40	
AVERAGE GROWTH			15.95%	-1.00%		29.20%
2000	0.5739	25.5%	14.63%		3400.00	0.14%
2001	0.6077	24.5%	14.89%		3400.00	0.07%
2003-2005	0.6595	21.5%	14.18%	17.50%	3400.00	0.03%

COMPANY	INTERNAL GROWTH				EXTERNAL GROWTH	
USW	RETENTION RATIO	EQUITY RETURN	"g"	BOOK VALUE ($/SHARE)	SHARES OUTST (MILLIONS)	SHARE GROWTH
1995	0.0894	31.8%	2.84%	7.34	473.64	
1996	0.1230	29.7%	3.65%	8.15	480.46	
1997	0.1673	25.0%	4.18%	8.66	485.06	
1998	0.2914	NMF	NMF	1.50	502.90	
1999	0.3456	NMF	NMF	2.48	505.70	
AVERAGE GROWTH			3.56%	-		1.65%
2000	0.3706	NMF	NMF		506.00	0.06%
2001	0.4137	NMF	NMF		507.00	0.13%
2003-2005	0.6492	41.0%	26.62%	23.50%	510.00	0.17%

Data from Value Line, Ratings & Reports, April 7, 2000.

US WEST COMMUNICATIONS
DCF GROWTH RATE PARAMETERS
INSURANCE COMPANIES

COMPANY	INTERNAL GROWTH				EXTERNAL GROWTH	
BKLY	RETENTION RATIO	EQUITY RETURN	"g"	BOOK VALUE ($/SHARE)	SHARES OUTST (MILLIONS)	SHARE GROWTH
1995	0.8325	06.5%	5.41%	23.50	30.25	
1996	0.8633	10.3%	8.89%	25.13	29.45	
1997	0.8467	10.5%	8.89%	28.72	29.57	
1998	0.7330	06.8%	4.98%	28.79	26.50	
1999	1.5714	NMF	NMF	23.10	25.60	
AVERAGE GROWTH			7.04%	9.00%		-4.09%
2000	0.5840	04.5%	2.63%		24.75	-3.32%
2001	0.6267	05.5%	3.45%		24.00	-0.50%
2003-2005	0.7778	08.5%	6.61%	2.00%	24.00	-1.28%

COMPANY	INTERNAL GROWTH				EXTERNAL GROWTH	
CB	RETENTION RATIO	EQUITY RETURN	"g"	BOOK VALUE ($/SHARE)	SHARES OUTST (MILLIONS)	SHARE GROWTH
1995	0.7506	13.2%	9.91%	30.17	174.42	
1996	0.6087	08.9%	5.42%	31.24	174.86	
1997	0.7358	13.6%	10.01%	33.64	168.72	
1998	0.7041	12.5%	8.80%	34.78	162.27	
1999	0.6339	09.9%	6.28%	35.74	176.21	
AVERAGE GROWTH			8.08%	8.50%		0.26%
2000	0.6267	10.0%	6.27%		170.00	-3.52%
2001	0.5944	09.0%	5.35%		170.00	-1.78%
2003-2005	0.6818	10.0%	6.82%	9.00%	160.00	-1.91%

COMPANY	INTERNAL GROWTH				EXTERNAL GROWTH	
CINF	RETENTION RATIO	EQUITY RETURN	"g"	BOOK VALUE ($/SHARE)	SHARES OUTST (MILLIONS)	SHARE GROWTH
1995	0.6767	08.5%	5.75%	15.91	167.13	
1996	0.6260	07.0%	4.38%	19.02	166.91	
1997	0.6893	06.3%	4.34%	28.30	166.69	
1998	0.5960	04.3%	2.56%	33.72	168.68	
1999	0.5526	04.7%	2.60%	33.46	162.02	
AVERAGE GROWTH			3.93%	21.50%		-0.77%
2000	0.5778	04.5%	2.60%		158.50	-2.17%
2001	0.5579	05.0%	2.79%		155.00	-2.19%
2003-2005	0.5789	07.0%	4.05%	15.00%	150.00	-1.53%

US WEST COMMUNICATIONS
DCF GROWTH RATE PARAMETERS
INSURANCE COMPANIES

COMPANY	INTERNAL GROWTH				EXTERNAL GROWTH	
OCAS	RETENTION RATIO	EQUITY RETURN	"g"	BOOK VALUE ($/SHARE)	SHARES OUTST (MILLIONS)	SHARE GROWTH
1995	0.4328	08.6%	3.72%	15.69	70.79	
1996	0.4203	08.3%	3.49%	16.72	70.28	
1997	0.5602	09.9%	5.55%	19.55	67.24	
1998	0.3623	07.0%	2.54%	21.12	62.54	
1999	0.4682	09.2%	4.31%	19.16	60.08	
AVERAGE GROWTH			3.92%	11.00%		-4.02%
2000	-0.3143	04.0%	-1.26%		60.00	-0.13%
2001	0.0800	05.5%	0.44%		60.00	-0.07%
2003-2005	0.5840	11.5%	6.72%	1.50%	60.00	-0.03%

COMPANY	INTERNAL GROWTH				EXTERNAL GROWTH	
SAFC	RETENTION RATIO	EQUITY RETURN	"g"	BOOK VALUE ($/SHARE)	SHARES OUTST (MILLIONS)	SHARE GROWTH
1995	0.6782	10.0%	6.78%	31.61	125.98	
1996	0.6810	10.7%	7.29%	32.58	126.31	
1997	0.6639	07.6%	5.05%	44.63	141.20	
1998	0.4683	05.5%	2.58%	40.9	136.30	
1999	0.2356	05.4%	1.27%	33.5	128.90	
AVERAGE GROWTH			4.59%	15.00%		0.57%
2000	0.0000	05.0%	0.00%		127.00	-1.47%
2001	0.2300	05.0%	1.15%		125.00	-1.52%
2003-2005	0.4776	08.5%	4.06%	4.50%	120.00	-1.42%

COMPANY	INTERNAL GROWTH				EXTERNAL GROWTH	
SPC	RETENTION RATIO	EQUITY RETURN	"g"	BOOK VALUE ($/SHARE)	SHARES OUTST (MILLIONS)	SHARE GROWTH
1995	0.7218	14.0%	10.11%	22.11	168.18	
1996	0.7115	13.9%	9.89%	23.97	166.40	
1997	0.7572	16.7%	12.64%	27.53	167.46	
1998	0.5619	06.8%	3.82%	30.48	233.75	
1999	0.6916	11.5%	7.95%	28.68	224.80	
AVERAGE GROWTH			8.88%	12.50%		7.52%
2000	0.6109	09.0%	5.50%		220.00	-2.14%
2001	0.6300	09.0%	5.67%		215.00	-2.20%
2003-2005	0.6925	10.5%	7.27%	5.00%	205.00	-1.83%

US WEST COMMUNICATIONS
DCF GROWTH RATE PARAMETERS
INSURANCE COMPANIES

COMPANY	INTERNAL GROWTH				EXTERNAL GROWTH	
SIGI	RETENTION RATIO	EQUITY RETURN	"g"	BOOK VALUE ($/SHARE)	SHARES OUTST (MILLIONS)	SHARE GROWTH
1995	0.6906	12.1%	8.36%	15.15	28.83	
1996	0.6989	11.7%	8.18%	16.31	29.09	
1997	0.7533	12.3%	9.27%	19.16	29.51	
1998	0.6782	08.8%	5.97%	21.30	28.52	
1999	0.6828	09.4%	6.42%	21.46	26.56	
AVERAGE GROWTH			7.64%	11.00%		-2.03%
2000	0.6250	07.5%	4.69%		26.00	-2.11%
2001	0.6343	08.0%	5.07%		26.00	-1.06%
2003-2005	0.7382	10.0%	7.38%	6.50%	26.00	-0.43%

COMPANY	INTERNAL GROWTH				EXTERNAL GROWTH	
TRH	RETENTION RATIO	EQUITY RETURN	"g"	BOOK VALUE ($/SHARE)	SHARES OUTST (MILLIONS)	SHARE GROWTH
1995	0.9269	13.3%	12.33%	28.72	34.42	
1996	0.9287	13.6%	12.63%	32.95	34.52	
1997	0.9274	13.7%	12.71%	38.36	35.36	
1998	0.9399	15.4%	14.47%	46.45	34.67	
1999	0.9148	11.6%	10.61%	47.3	34.80	
AVERAGE GROWTH			12.55%	17.50%		0.27%
2000	0.9113	11.0%	10.02%		34.80	0.00%
2001	0.9083	11.0%	9.99%		34.80	0.00%
2003-2005	0.9211	12.0%	11.05%	14.00%	35.00	0.11%

COMPANY	INTERNAL GROWTH				EXTERNAL GROWTH	
AIG	RETENTION RATIO	EQUITY RETURN	"g"	BOOK VALUE ($/SHARE)	SHARES OUTST (MILLIONS)	SHARE GROWTH
1995	0.9365	12.4%	11.61%	9.91	2000.50	
1996	0.9384	12.9%	12.10%	11.13	1980.50	
1997	0.9408	13.7%	12.89%	12.2	1967.40	
1998	0.9372	13.7%	12.84%	13.78	1968.20	
1999	0.9404	14.7%	13.82%	14.42	2323.70	
AVERAGE GROWTH			12.65%	13.00%		3.82%
2000	0.9388	15.3%	14.36%		2325.00	0.06%
2001	0.9404	15.5%	14.58%		2325.00	0.03%
2003-2005	0.9375	14.5%	13.59%	12.00%	2400.00	0.65%

US WEST COMMUNICATIONS
DCF GROWTH RATE PARAMETERS
INSURANCE COMPANIES

COMPANY	INTERNAL GROWTH				EXTERNAL GROWTH	
UNIT	RETENTION RATIO	EQUITY RETURN	"g"	BOOK VALUE ($/SHARE)	SHARES OUTST (MILLIONS)	SHARE GROWTH
1995	0.4652	09.9%	4.61%	19.80	76.98	
1996	0.3750	09.0%	3.38%	19.82	74.68	
1997	0.4059	09.9%	4.02%	20.39	75.17	
1998	0.3367	08.4%	2.83%	23.99	75.98	
1999	0.2784	08.5%	2.37%	24.19	70.99	
AVERAGE GROWTH			3.44%	3.50%		-2.00%
2000	0.1176	07.5%	0.88%		69.00	-2.80%
2001	0.2889	09.5%	2.74%		68.00	-2.13%
2003-2005	0.3333	11.0%	3.67%	3.00%	66.00	-1.45%

Data from Value Line Ratings & Reports, March 31 and June 2, 2000.

US WEST COMMUNICATIONS
DCF GROWTH RATE PARAMETERS
GAS DISTRIBUTION COMPANIES

COMPANY	INTERNAL GROWTH				EXTERNAL GROWTH	
ATG	RETENTION RATIO	EQUITY RETURN	"g"	BOOK VALUE ($/SHARE)	SHARES OUTST (MILLIONS)	SHARE GROWTH
1994	0.2180	12.5%	2.73%	10.12	55.02	
1995	0.2263	12.1%	2.74%	10.56	55.70	
1996	0.2117	11.3%	2.39%	10.99	56.60	
1997	0.2340	11.3%	2.64%	11.42	57.30	
1998	-0.1868	07.9%	-1.48%	11.59	57.10	
AVERAGE GROWTH			1.80%	2.50%		0.93%
1999	0.0609	10.0%	0.61%		56.70	-0.70%
2000	0.1360	10.5%	1.43%		56.70	-0.50%
2002-2004	0.3030	12.5%	3.79%	3.00%	57.00	-0.04%

COMPANY	INTERNAL GROWTH				EXTERNAL GROWTH	
ATO	RETENTION RATIO	EQUITY RETURN	"g"	BOOK VALUE ($/SHARE)	SHARES OUTST (MILLIONS)	SHARE GROWTH
1994	0.2459	11.9%	2.93%	10.2	15.52	
1995	0.3642	13.9%	5.06%	10.75	16.02	
1996	0.2463	12.0%	2.96%	11.04	29.64	
1997	0.4239	14.9%	6.32%	12.21	30.40	
1998	-0.3580	06.6%	-2.36%	12.09	31.25	
AVERAGE GROWTH			2.98%	4.50%		19.12%
1999	-0.2667	07.5%	-2.00%		32.00	2.40%
2000	0.3444	14.5%	4.99%		32.70	2.29%
2002-2004	0.4375	15.5%	6.78%	4.50%	36.50	3.15%

COMPANY	INTERNAL GROWTH				EXTERNAL GROWTH	
CGC	RETENTION RATIO	EQUITY RETURN	"g"	BOOK VALUE ($/SHARE)	SHARES OUTST (MILLIONS)	SHARE GROWTH
1994	-0.2000	08.1%	-1.62%	9.76	9.14	
1995	-0.8462	03.5%	-2.96%	10.09	10.79	
1996	-0.0323	09.1%	-0.29%	10.16	10.97	
1997	-0.1429	08.3%	-1.19%	10.07	11.05	
1998	0.2258	12.0%	2.71%	10.36	11.05	
AVERAGE GROWTH			-0.67%	1.00%		4.86%
1999	0.2615	12.5%	3.27%		11.05	0.00%
2000	0.3071	13.0%	3.99%		11.05	0.00%
2002-2004	0.4118	13.0%	5.35%	4.00%	12.00	1.66%

US WEST COMMUNICATIONS
DCF GROWTH RATE PARAMETERS
GAS DISTRIBUTION COMPANIES

COMPANY	INTERNAL GROWTH				EXTERNAL GROWTH	
NJR	RETENTION RATIO	EQUITY RETURN	"g"	BOOK VALUE ($/SHARE)	SHARES OUTST (MILLIONS)	SHARE GROWTH
1994	0.2124	13.1%	2.78%	14.55	17.79	
1995	0.2476	13.5%	3.34%	15.15	18.08	
1996	0.2793	14.3%	3.99%	15.57	17.88	
1997	0.2961	14.4%	4.26%	16.33	17.81	
1998	0.3253	14.8%	4.81%	17.03	17.74	
AVERAGE GROWTH			3.84%	2.50%		-0.07%
1999	0.3509	15.0%	5.26%		17.50	-1.35%
2000	0.3825	15.5%	5.93%		17.25	-1.39%
2002-2004	0.4865	16.0%	7.78%	6.00%	17.25	-0.56%

COMPANY	INTERNAL GROWTH				EXTERNAL GROWTH	
NWNG	RETENTION RATIO	EQUITY RETURN	"g"	BOOK VALUE ($/SHARE)	SHARES OUTST (MILLIONS)	SHARE GROWTH
1994	0.2671	10.9%	2.91%	14.55	22.24	
1995	0.3909	12.7%	4.96%	15.37	22.56	
1996	0.3125	11.0%	3.44%	16.02	22.86	
1997	-0.1961	06.0%	-1.18%	16.59	24.85	
1998	0.2765	10.0%	2.76%	17.35	24.95	
AVERAGE GROWTH			2.58%	5.00%		2.92%
1999	0.3111	10.0%	3.11%		25.25	1.20%
2000	0.3421	10.0%	3.42%		25.60	1.29%
2002-2004	0.4348	10.5%	4.57%	4.50%	27.00	1.59%

COMPANY	INTERNAL GROWTH				EXTERNAL GROWTH	
PNY	RETENTION RATIO	EQUITY RETURN	"g"	BOOK VALUE ($/SHARE)	SHARES OUTST (MILLIONS)	SHARE GROWTH
1994	0.2483	11.4%	2.83%	12.31	28.84	
1995	0.3114	12.6%	3.92%	13.07	29.55	
1996	0.3459	13.1%	4.53%	13.9	30.19	
1997	0.3469	13.2%	4.58%	14.91	30.74	
1998	0.2688	11.8%	3.17%	15.71	31.30	
AVERAGE GROWTH			3.81%	6.50%		2.07%
1999	0.3048	12.5%	3.81%		31.50	0.64%
2000	0.3333	12.5%	4.17%		31.75	0.72%
2002-2004	0.4036	13.0%	5.25%	6.50%	33.00	1.06%

US WEST COMMUNICATIONS
DCF GROWTH RATE PARAMETERS
GAS DISTRIBUTION COMPANIES

COMPANY	INTERNAL GROWTH				EXTERNAL GROWTH	
SJI	RETENTION RATIO	EQUITY RETURN	"g"	BOOK VALUE ($/SHARE)	SHARES OUTST (MILLIONS)	SHARE GROWTH
1994	0.1273	11.2%	1.43%	14.67	10.72	
1995	0.1529	10.6%	1.62%	16.06	10.76	
1996	0.1579	10.6%	1.67%	16.11	10.77	
1997	-0.1250	08.2%	-1.03%	15.7	10.78	
1998	0.2836	11.5%	3.26%	17	11.20	
AVERAGE GROWTH			1.39%	3.00%		1.10%
1999	0.3209	11.5%	3.69%		11.55	3.13%
2000	0.3422	11.5%	3.94%		12.00	3.51%
2002-2004	0.3846	11.5%	4.42%	4.00%	13.00	3.03%

Data from Value Line Ratings & Reports, March 24, 2000.

US WEST COMMUNICATIONS

DCF GROWTH RATES
TELECOMMUNICATIONS COMPANIES

COMPANY	br	+	sv=g*(M/B-1)			=	g
BEL	10.50%	+	-0.25%	(4.31	- 1)	=	10.09%
BLS	10.50%	+	-0.25%	(4.89	- 1)	=	10.01%
GTE	11.25%	+	0.00%	(4.19	- 1)	=	11.25%
SBC	11.00%	+	0.00%	(4.05	- 1)	=	11.00%
USW	8.25%	+	0.00%	(13.56	- 1)	=	8.25%

Average Market-to-Book Ratio† = 4.36

BEL	=	Bell Atlantic
BLS	=	Bell South
GTE	=	GTE Corp.
SBC	=	SBC Communications Inc.
USW	=	US WEST, Inc

† excludes consideration of USW's market-to-book ratio
g*= expected growth in number of shares outstanding

US WEST COMMUNICATIONS

GROWTH RATE COMPARISON
TELECOMMUNICATIONS COMPANIES

		Value Line Projected			Analysts'	Value Line Historic			Analysts' & VL	5-yr Compound Hist.		
COMPANY	br + sv	EPS	DPS	BVPS	EPS	EPS	DPS	BVPS	AVGS.	EPS	DPS	BVPS
BEL	10.09%	11.00%	3.00%	13.00%	11.39%	7.50%	2.50%	-2.50%	6.56%	11.54%	2.71%	7.59%
BLS	10.01%	13.00%	2.50%	9.50%	11.38%	11.50%	1.00%	2.00%	7.27%	14.46%	1.37%	7.39%
GTE	11.25%	11.50%	0.50%	17.00%	11.90%	6.50%	1.00%	-5.00%	6.20%	8.08%	0.00%	12.76%
SBC	11.00%	11.50%	5.50%	17.50%	12.99%	10.50%	4.00%	-1.00%	8.71%	8.21%	3.38%	12.51%
USW	8.25%	13.00%	0.00%	23.50%	7.12%	-	-	-	10.91%	7.67%	0.00%	-12.57%
		12.00%	2.30%	16.10%		9.00%	2.13%	-1.63%		9.99%	1.49%	5.54%
AVERAGES	10.12%		10.13%		10.96%		3.17%		7.93%		5.67%	

US WEST COMMUNICATIONS

DCF GROWTH RATES
INSURANCE COMPANIES

COMPANY	br	+	sv=g*(M/B-1)			=	g
BKLY	7.00%	+	-1.50%	(0.88	- 1)	=	7.18%
CB	8.00%	+	-0.25%	(1.73	- 1)	=	7.82%
CINF	10.75%	+	-1.00%	(1.12	- 1)	=	10.63%
OCAS	7.75%	+	-0.25%	(0.71	- 1)	=	7.82%
SAFC	9.00%	+	-0.25%	(0.68	- 1)	=	9.08%
SPC	8.25%	+	0.00%	(1.21	- 1)	=	8.25%
SIGI	8.25%	+	-0.75%	(0.86	- 1)	=	8.35%
TRH	10.75%	+	0.15%	(1.60	- 1)	=	10.84%
AIG	13.00%	+	0.50%	(7.22	- 1)	=	16.11%
UNIT	7.75%	+	-1.50%	(1.35	- 1)	=	7.23%

Average Market-to-Book Ratio = 1.73

BKLY	=	W. R. Berkley Corp.
CB	=	Chubb Corporation
CINF	=	Cincinnati Financial Corp.
OCAS	=	Ohio Casualty Corp.
SAFC	=	SAFECO Corporation
SPC	=	St. Paul Companies, Inc.
SIGI	=	Selective Insurance Group, Inc.
TRH	=	Transatlantic Holdings Inc.
AIG	=	Amer International Group, Inc.
UNIT	=	Unitrin

g*= expected growth in number of shares outstanding

US WEST COMMUNICATIONS

GROWTH RATE COMPARISON
INSURANCE COMPANIES

COMPANY	br + sv	Value Line Projected EPS	Value Line Projected DPS	Value Line Projected BVPS	Analyst's EPS	Value Line Historic EPS	Value Line Historic DPS	Value Line Historic BVPS	Analyst's & VL AVGS.	5-yr Compound Hist. EPS	5-yr Compound Hist. DPS	5-yr Compound Hist. BVPS
BKLY	7.18%	2.00%	5.50%	2.00%	14.00%	5.50%	11.50%	9.00%	7.07%	-8.13%	10.20%	0.96%
CB	7.82%	6.50%	7.00%	9.00%	11.78%	6.00%	8.00%	8.50%	8.11%	-0.93%	7.39%	4.78%
CINF	10.63%	11.50%	10.50%	15.00%	10.00%	7.50%	12.50%	21.50%	12.64%	6.24%	12.06%	17.51%
OCAS	7.82%	7.00%	3.00%	1.50%	10.00%	3.00%	4.50%	11.00%	5.71%	-12.18%	3.90%	3.68%
SAFC	9.08%	7.00%	12.50%	4.50%	9.38%	4.00%	9.00%	15.00%	8.77%	-13.90%	8.02%	1.20%
SPC	8.25%	4.00%	4.00%	5.00%	10.07%	11.50%	7.00%	12.50%	7.72%	-0.64%	6.26%	6.51%
SIGI	8.35%	5.00%	3.50%	6.50%	9.00%	15.00%	0.50%	11.00%	7.21%	-2.44%	1.39%	7.75%
TRH	10.84%	9.00%	12.00%	14.00%	9.00%	20.50%	15.50%	17.50%	13.93%	8.47%	12.74%	13.42%
AIG	16.11%	13.00%	13.50%	12.00%	14.30%	15.00%	13.50%	13.00%	13.47%	14.22%	13.40%	10.05%
UNIT	7.23%	10.50%	6.50%	3.00%	n/a	8.50%	15.00%	3.50%	7.83%	-1.89%	8.45%	4.01%
		7.55%	7.80%	7.25%		9.65%	9.70%	12.25%		-1.12%	8.38%	6.99%
AVERAGES	9.33%		7.53%		10.84%		10.53%		9.25%		4.75%	

US WEST COMMUNICATIONS

DCF GROWTH RATES
GAS DISTRIBUTION COMPANIES

COMPANY	br	+	sv=g*((M/B+1)/2-1)			=	g
ATG	3.75%	+	0.25%	((1.39	+ 1)/2-1)	=	3.80%
ATO	5.50%	+	2.50%	((1.39	+ 1)/2-1)	=	5.99%
CGC	4.00%	+	1.75%	((1.64	+ 1)/2-1)	=	4.56%
NJR	6.50%	+	-0.25%	((2.25	+ 1)/2-1)	=	6.34%
NWNG	4.50%	+	2.50%	((1.19	+ 1)/2-1)	=	4.74%
PNY	5.25%	+	1.50%	((1.72	+ 1)/2-1)	=	5.79%
SJI	4.50%	+	2.00%	((1.44	+ 1)/2-1)	=	4.94%

Average Market-to-Book Ratio = 1.57

ATG	=	AGL Resources
ATO	=	Atmos Energy Corporation
CGC	=	Cascade Natural Gas Corporation
NJR	=	NUI Corp.
NWNG	=	New Jersey Resources Corp.
PNY	=	Northwest Natural Gas Co.
SJI	=	Piedmont Natual Gas Company
0.00%	=	South Jersey Industries, Inc.

g*= expected growth in number of shares outstanding

US WEST COMMUNICATIONS

GROWTH RATE COMPARISON
GAS DISTRIBUTION COMPANIES

COMPANY	br + sv	Value Line Projected EPS	Value Line Projected DPS	Value Line Projected BVPS	Analyst's EPS	Value Line Historic EPS	Value Line Historic DPS	Value Line Historic BVPS	Analyst's & VL AVGS.	5-yr Compound Hist. EPS	5-yr Compound Hist. DPS	5-yr Compound Hist. BVPS
ATG	3.80%	5.00%	1.00%	3.00%	5.37%	2.00%	1.00%	2.50%	2.84%	-2.87%	0.76%	3.47%
ATO	5.99%	10.50%	4.00%	4.50%	7.33%	5.00%	4.50%	4.50%	5.76%	-5.90%	4.38%	3.13%
CGC	4.56%	9.50%	0.50%	4.00%	4.67%	5.50%	0.50%	1.00%	3.67%	10.20%	0.00%	1.18%
NJR	6.34%	8.00%	2.50%	6.00%	6.63%	6.00%	1.50%	2.50%	4.73%	6.55%	2.50%	3.94%
NWNG	4.74%	5.50%	1.00%	4.50%	4.02%	8.50%	1.00%	5.00%	4.22%	2.26%	1.00%	4.35%
PNY	5.79%	7.00%	4.50%	6.50%	5.57%	6.00%	6.00%	6.50%	6.01%	7.69%	6.02%	6.35%
SJI	4.94%	7.50%	1.50%	4.00%	5.25%	1.00%	0.50%	3.00%	3.25%	5.44%	0.28%	4.29%
		7.57%	2.14%	4.64%		4.86%	2.14%	3.57%		3.34%	2.13%	3.82%
AVERAGES	5.17%		4.79%		5.55%		3.52%		4.35%		3.10%	

US WEST COMMUNICATIONS

STOCK PRICE, DIVIDENDS, YIELDS
TELECOMMUNICATIONS COMPANIES

COMPANY	AVG. STOCK PRICE 5/1/00-6/8/00 (PER SHARE)		ANNUALIZED DIVIDEND (PER SHARE)	DIVIDEND YIELD
BEL	$53.66	*	$1.70	3.16%
BLS	$46.73		$0.76	1.63%
GTE	$63.69		$1.88	2.95%
SBC	$43.92		$1.02	2.31%
USW	$73.23		$2.14	2.92%
			AVERAGE	**2.59%**

*Dividend increase expected in next quarter. Current dividend multiplied by (1+g), derived in Schedule 4.

US WEST COMMUNICATIONS

STOCK PRICE, DIVIDENDS, YIELDS
INSURANCE COMPANIES

COMPANY	AVG. STOCK PRICE 5/1/00-6/8/00 (PER SHARE)		ANNUALIZED DIVIDEND (PER SHARE)	DIVIDEND YIELD
BKLY	$21.63		$0.52	2.40%
CB	$65.90		$1.32	2.00%
CINF	$39.75		$0.76	1.91%
OCAS	$13.32		$0.92	6.91%
SAFC	$22.73	*	$1.55	6.81%
SPC	$36.63		$1.08	2.95%
SIGI	$18.99		$0.60	3.16%
TRH	$86.04		$0.50	0.58%
AIG	$115.45		$0.14	0.12%
UNIT	$32.47		$1.50	4.62%
			AVERAGE	**3.15%**

*Dividend increased by (1+g).

US WEST COMMUNICATIONS

STOCK PRICE, DIVIDENDS, YIELDS
GAS DISTRIBUTION COMPANIES

COMPANY	AVG. STOCK PRICE 5/1/00-6/8/00 (PER SHARE)	ANNUALIZED DIVIDEND (PER SHARE)	DIVIDEND YIELD
ATG	$16.64	$1.08	6.49%
ATO	$16.53	$1.14	6.90%
CGC	$16.95	$0.96	5.66%
NJR	$39.70	$1.72	4.33%
NWNG	$21.44	$1.24	5.78%
PNY	$28.89	$1.46	5.05%
SJI	$26.00	$1.46	5.61%
		AVERAGE	**5.69%**

US WEST COMMUNICATIONS

DCF COST OF EQUITY CAPITAL
TELECOMMUNICATIONS COMPANIES

COMPANY	DIVIDEND YIELD Schedule 6	GROWTH RATE Schedule 5	DCF COST OF EQUITY CAPITAL
BEL	3.16%	10.09%	13.25%
BLS	1.63%	10.01%	11.64%
GTE	2.95%	11.25%	14.20%
SBC	2.31%	11.00%	13.31%
USW	2.92%	8.25%	11.17%
		AVERAGE	**12.71%**
		STANDARD DEVIATION	**1.26%**

US WEST COMMUNICATIONS

DCF COST OF EQUITY CAPITAL
INSURANCE COMPANIES

COMPANY	DIVIDEND YIELD Schedule 6	GROWTH RATE Schedule 5	DCF COST OF EQUITY CAPITAL
BKLY	2.40%	7.18%	9.59%
CB	2.00%	7.82%	9.82%
CINF	1.91%	10.63%	12.55%
OCAS	6.91%	7.82%	14.73%
SAFC	6.81%	9.08%	15.89%
SPC	2.95%	8.25%	11.20%
SIGI	3.16%	8.35%	11.51%
TRH	0.58%	10.84%	11.42%
AIG	0.12%	16.11%	16.23%
UNIT	4.62%	7.23%	11.85%
		AVERAGE	**12.48%**
		STANDARD DEVIATION	**2.36%**

US WEST COMMUNICATIONS

DCF COST OF EQUITY CAPITAL
GAS DISTRIBUTION COMPANIES

COMPANY	DIVIDEND YIELD Schedule 6	GROWTH RATE Schedule 5	DCF COST OF EQUITY CAPITAL
ATG	6.49%	3.80%	10.29%
ATO	6.90%	5.99%	12.88%
CGC	5.66%	4.56%	10.22%
NJR	4.33%	6.34%	10.68%
NWNG	5.78%	4.74%	10.52%
PNY	5.05%	5.79%	10.85%
SJI	5.61%	4.94%	10.55%
		AVERAGE	**10.86%**
		STANDARD DEVIATION	**0.92%**

US WEST COMMUNICATIONS

CAPM COST OF EQUITY CAPITAL
TELECOMMUNICATIONS COMPANIES

k = rf + B (rm - rf)

[rf]* = 6.05%
[rm - rf]† = 7.40% (geometric mean)
[rm - rf]† = 9.40% (arithmetic mean)
average beta = 0.81

k = 6.05% + 0.81 (7.40%/9.40%)
k = 6.05% + 5.99%/7.61%
k = 12.04% / 13.66%

Midpoint = 12.85%

*Risk-free rate average of current T-Bill (5.92%) and T-Bill futures (6.17%) rates [5.92%+6.17%/2=6.05%].
T-Bill futures rate at December 2000, from Wall Street Journal, June 8, 2000, p. C18.
Current T-Bill yield, six-week average yield from Value Line Selection & Opinion (4/28/00-6/2/00)
†Geometric and arithmetic market risk premiums from Ibbotson Associates 1999 SBBI Yearbook, p. 33.

US WEST COMMUNICATIONS

CAPM COST OF EQUITY CAPITAL
INSURANCE COMPANIES

k = rf + B (rm - rf)

[rf]* = 6.05%
[rm - rf]† = 7.40% (geometric mean)
[rm - rf]† = 9.40% (arithmetic mean)
average beta = 0.90

k = 6.05% + 0.90 (7.40%/9.40%)
k = 6.05% + 6.66%/8.46%
k = 12.71% / 14.51%

Midpoint = 13.61%

*Risk-free rate average of current T-Bill (5.92%) and T-Bill futures (6.17%) rates [5.92%+6.17%/2=6.05%].
T-Bill futures rate at December 2000, from Wall Street Journal, June 8, 2000, p. C18.
Current T-Bill yield, six-week average yield from Value Line Selection & Opinion (4/28/00-6/2/00)
†Geometric and arithmetic market risk premiums from Ibbotson Associates 1999 SBBI Yearbook, p. 33.

US WEST COMMUNICATIONS

CAPM COST OF EQUITY CAPITAL
GAS DISTRIBUTION COMPANIES

k = rf + B (rm - rf)

[rf]* = 6.05%
[rm - rf]† = 7.40% (geometric mean)
[rm - rf]† = 9.40% (arithmetic mean)
average beta = 0.57

k = 6.05% + 0.57 (7.40%/9.40%)
k = 6.05% + 4.23%/5.37%
k = 10.28% / 11.42%

Midpoint = 10.85%

*Risk-free rate average of current T-Bill (5.92%) and T-Bill futures (6.17%) rates [5.92%+6.17%/2=6.05%].
T-Bill futures rate at December 2000, from Wall Street Journal, June 8, 2000, p. C18.
Current T-Bill yield, six-week average yield from Value Line Selection & Opinion (4/28/00-6/2/00)
†Geometric and arithmetic market risk premiums from Ibbotson Associates 1999 SBBI Yearbook, p. 33.

US WEST COMMUNICATIONS

PROOF

If book value exceeds market price,
the market-to-book ratio is less than 1.0,
and the earnings-price ratio exceeds the cost of capital.

MP = market price
BV = book value
i = cost of equity capital
r = earned return
E = earnings

1. At $MP = BV$, $i = r = \frac{E}{MP}$.

2. $E = rBV$.

3. Then, $\frac{E}{MP} = \frac{rBV}{MP}$.

4. When $BV > MP$, i.e., $\frac{BV}{MP} > 1$, then,

   a. $\frac{E}{MP} > r$, since $\frac{E}{MP} = \frac{rBV}{MP} > r$, because $\frac{BV}{MP} > 1$;

   b. $i > r$, since at $\frac{BV}{MP} = 1$, $i = \frac{E}{MP} = \frac{rBV}{MP}$, but if $\frac{BV}{MP} > 1$, then $i > r$; and

   c. $\frac{E}{MP} > i$, since at $\frac{BV}{MP} = 1$, $i = \frac{E}{MP} = \frac{rBV}{MP}$, but if $\frac{BV}{MP} > 1$, then $\frac{E}{MP} > i$, because,

      1) $\frac{BV}{MP} > 1$, through MP decreasing, and, if so, $\frac{E}{MP}$ increases, therefore, $\frac{E}{MP} > i$, or

      2) $\frac{BV}{MP} > 1$, through BV increasing, and, if so, given $E = rBV$, $\frac{E}{MP}$ increases, therefore, $\frac{E}{MP} > i$.

5. Ergo, $\frac{E}{MP} > i > r$, the cost of capital exceeds the earned return.

US WEST COMMUNICATIONS

MODIFIED EARNINGS-PRICE RATIO ANALYSIS
TELECOMMUNICATIONS COMPANIES

COMPANY	Analyst's PROJ. 2000 EARNINGS (Per Share)	MARKET PRICE (Per share)	EARNINGS-PRICE RATIO		CURRENT R.O.E. 2000	PROJECTED R.O.E. 2003-2005
BEL	$3.30	$53.66	6.15%		29.00%	26.00%
BLS	$2.22	$46.73	4.75%		26.00%	26.00%
GTE	$3.83	$63.69	6.01%		30.50%	23.50%
SBC	$2.29	$43.92	5.21%		25.50%	21.50%
USW	$3.42	$73.23	4.67%		NMF	41.00%
		AVERAGE	5.36%		27.75%	
		CURRENT M.E.P.R.		**16.55%**		
		AVERAGE	5.36%			27.60%
		PROJECTED M.E.P.R.			**16.48%**	

US WEST COMMUNICATIONS

MODIFIED EARNINGS-PRICE RATIO ANALYSIS
INSURANCE COMPANIES

COMPANY	Analyst's PROJ. 2000 EARNINGS (Per Share)	MARKET PRICE (Per share)	EARNINGS-PRICE RATIO		CURRENT R.O.E. 2000	PROJECTED R.O.E. 2003-2005
BKLY	$1.21	$21.63	5.59%		4.50%	8.50%
CB	$4.02	$65.90	6.10%		10.00%	10.00%
CINF	$1.65	$39.75	4.15%		4.50%	7.00%
OCAS	($0.33)	$13.32	NMF		4.00%	11.50%
SAFC	$0.96	$22.73	4.22%		5.00%	8.50%
SPC	$2.77	$36.63	7.56%		9.00%	10.50%
SIGI	$1.57	$18.99	8.27%		7.50%	10.00%
TRH	$5.56	$86.04	6.46%		11.00%	12.00%
AIG	$3.67	$115.45	3.18%		15.30%	14.50%
UNIT	$1.94	$32.47	5.97%		7.50%	11.00%
		AVERAGE	5.72%		7.83%	
		CURRENT M.E.P.R.		**6.78%**		
		AVERAGE	5.72%			10.35%
		PROJECTED M.E.P.R.			**8.04%**	

US WEST COMMUNICATIONS

MODIFIED EARNINGS-PRICE RATIO ANALYSIS
GAS DISTRIBUTION COMPANIES

COMPANY	Analyst's PROJ. 2000 EARNINGS (Per Share)	MARKET PRICE (Per share)	EARNINGS-PRICE RATIO	CURRENT R.O.E. 2000	PROJECTED R.O.E. 2003-2005
ATG	$1.14	$16.64	6.85%	10.00%	12.50%
ATO	$1.00	$16.53	6.05%	7.50%	15.50%
CGC	$1.34	$16.95	7.91%	12.50%	13.00%
NJR	$2.68	$39.70	6.75%	15.00%	16.00%
NWNG	$1.78	$21.44	8.30%	10.00%	10.50%
PNY	$2.11	$28.89	7.30%	12.50%	13.00%
SJI	$2.08	$26.00	8.00%	11.50%	11.50%
		AVERAGE	7.31%	11.29%	
		CURRENT M.E.P.R.		**9.30%**	
		AVERAGE	7.31%		13.14%
		PROJECTED M.E.P.R.		**10.23%**	

US WEST COMMUNICATIONS

MARKET-TO-BOOK RATIO ANALYSIS
TELECOMMUNICATIONS COMPANIES

k = R.O.E.(1-b)/(M/B) + g
[2000]

COMPANY									MARKET-TO-BOOK COST OF EQUITY
BEL	k= 29.0%	(1-	0.5224)/	4.31	+	10.09%	=		13.30%
BLS	k= 26.0%	(1-	0.6545)/	4.89	+	10.01%	=		11.85%
GTE	k= 30.5%	(1-	0.5117)/	4.19	+	11.25%	=		14.80%
SBC	k= 25.5%	(1-	0.5739)/	4.05	+	11.00%	=		13.68%
USW	k= NMF	(1-	0.3706)/	13.56	+	8.25%	=		NMF
								AVERAGE	**13.41%**
								STANDARD DEVIATION	**1.22%**

Note: Equity returns and retention ratios based on Value Line current year projections.

US WEST COMMUNICATIONS

MARKET-TO-BOOK RATIO ANALYSIS
TELECOMMUNICATIONS COMPANIES

k = R.O.E.(1-b)/(M/B) + g
[2003-2005]

COMPANY								MARKET-TO-BOOK COST OF EQUITY
BEL	k= 26.0%	(1-	0.6206)/	4.31	+	10.09%	=	12.38%
BLS	k= 26.0%	(1-	0.7634)/	4.89	+	10.01%	=	11.27%
GTE	k= 23.5%	(1-	0.6746)/	4.19	+	11.25%	=	13.08%
SBC	k= 21.5%	(1-	0.6595)/	4.05	+	11.00%	=	12.81%
USW	k= 41.0%	(1-	0.6492)/	13.56	+	8.25%	=	9.31%
							AVERAGE	**11.77%**
							STANDARD DEVIATION	**0.80%**

Note: Equity returns and retention ratios based on Value Line three- to five-year projections.

US WEST COMMUNICATIONS

MARKET-TO-BOOK RATIO ANALYSIS
INSURANCE COMPANIES

k = R.O.E.(1-b)/(M/B) + g
[2000]

COMPANY									MARKET-TO-BOOK COST OF EQUITY
BKLY	k= 04.5%	(1-	0.5840)/	0.88	+	7.18%	=		9.32%
CB	k= 10.0%	(1-	0.6267)/	1.73	+	7.82%	=		9.98%
CINF	k= 04.5%	(1-	0.5778)/	1.12	+	10.63%	=		12.34%
OCAS	k= 04.0%	(1-	-0.3143)/	0.71	+	7.82%	=		15.24%
SAFC	k= 05.0%	(1-	0.0000)/	0.68	+	9.08%	=		16.46%
SPC	k= 09.0%	(1-	0.6109)/	1.21	+	8.25%	=		11.15%
SIGI	k= 07.5%	(1-	0.6250)/	0.86	+	8.35%	=		11.61%
TRH	k= 11.0%	(1-	0.9113)/	1.60	+	10.84%	=		11.45%
AIG	k= 15.3%	(1-	0.9388)/	7.22	+	16.11%	=		16.24%
UNIT	k= 07.5%	(1-	0.1176)/	1.35	+	7.23%	=		12.14%
								AVERAGE	**12.59%**
								STANDARD DEVIATION	**2.53%**

Note: Equity returns and retention ratios based on Value Line current year projections.

US WEST COMMUNICATIONS

MARKET-TO-BOOK RATIO ANALYSIS
INSURANCE COMPANIES

k = R.O.E.(1-b)/(M/B) + g
[2003-2005]

COMPANY									MARKET-TO-BOOK COST OF EQUITY
BKLY	k= 08.5%	(1-	0.7778)/	0.88	+	7.18%	=		9.34%
CB	k= 10.0%	(1-	0.6818)/	1.73	+	7.82%	=		9.66%
CINF	k= 07.0%	(1-	0.5789)/	1.12	+	10.63%	=		13.28%
OCAS	k= 11.5%	(1-	0.5840)/	0.71	+	7.82%	=		14.57%
SAFC	k= 08.5%	(1-	0.4776)/	0.68	+	9.08%	=		15.63%
SPC	k= 10.5%	(1-	0.6925)/	1.21	+	8.25%	=		10.92%
SIGI	k= 10.0%	(1-	0.7382)/	0.86	+	8.35%	=		11.39%
TRH	k= 12.0%	(1-	0.9211)/	1.60	+	10.84%	=		11.43%
AIG	k= 14.5%	(1-	0.9375)/	7.22	+	16.11%	=		16.23%
UNIT	k= 11.0%	(1-	0.3333)/	1.35	+	7.23%	=		12.67%
								AVERAGE	**12.51%**
								STANDARD DEVIATION	**2.40%**

Note: Equity returns and retention ratios based on Value Line three- to five-year projections.

US WEST COMMUNICATIONS

MARKET-TO-BOOK RATIO ANALYSIS
GAS DISTRIBUTION COMPANIES

k = R.O.E.(1-b)/(M/B) + g
[2000]

COMPANY									MARKET-TO-BOOK COST OF EQUITY
ATG	k= 10.0%	(1-	0.0609)/	1.39	+	3.80%	=		10.57%
ATO	k= 07.5%	(1-	-0.2667)/	1.39	+	5.99%	=		12.83%
CGC	k= 12.5%	(1-	0.2615)/	1.64	+	4.56%	=		10.19%
NJR	k= 15.0%	(1-	0.3509)/	2.25	+	6.34%	=		10.67%
NWNG	k= 10.0%	(1-	0.3111)/	1.19	+	4.74%	=		10.52%
PNY	k= 12.5%	(1-	0.3048)/	1.72	+	5.79%	=		10.83%
SJI	k= 11.5%	(1-	0.3209)/	1.44	+	4.94%	=		10.37%
								AVERAGE	**10.86%**
								STANDARD DEVIATION	**0.89%**

Note: Equity returns and retention ratios based on Value Line current year projections.

US WEST COMMUNICATIONS

MARKET-TO-BOOK RATIO ANALYSIS
GAS DISTRIBUTION COMPANIES

k = R.O.E.(1-b)/(M/B) + g
[2003-2005]

COMPANY									MARKET-TO-BOOK COST OF EQUITY
ATG	k= 12.5%	(1-	0.3030)/	1.39	+	3.80%	=		10.08%
ATO	k= 15.5%	(1-	0.4375)/	1.39	+	5.99%	=		12.26%
CGC	k= 13.0%	(1-	0.4118)/	1.64	+	4.56%	=		9.23%
NJR	k= 16.0%	(1-	0.4865)/	2.25	+	6.34%	=		10.00%
NWNG	k= 10.5%	(1-	0.4348)/	1.19	+	4.74%	=		9.72%
PNY	k= 13.0%	(1-	0.4036)/	1.72	+	5.79%	=		10.29%
SJI	k= 11.5%	(1-	0.3846)/	1.44	+	4.94%	=		9.86%
								AVERAGE	**10.21%**
								STANDARD DEVIATION	**0.97%**

Note: Equity returns and retention ratios based on Value Line three- to five-year projections.

US WEST COMMUNICATIONS

OVERALL COST OF CAPITAL

TYPE OF CAPITAL	PERCENT OF TOTAL	COST RATE	WT. AVG. COST RATE
Common Equity	52.43%	11.75%	6.16%
Total Debt	47.57%	7.39%	3.52%
TOTALS	100.00%		9.68%

PRE-TAX INTEREST COVERAGE = 3.92x

*Assumming the Company experiences a 40% Federal and State income tax rate, prospectively, the pre-tax overall return would be 13.78% [9.68% - 3.52% = 6.16%/(1-40%) = 10.527%% + 3.52%]. That pre-tax overall return (13.78%), divided by the weighted cost of debt (3.52%), indicates a pre-tax interest coverage level of 3.92 times.

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BEFORE THE ARIZONA CORPORATION COMMISSION

U S WEST COMMUNICATIONS, INC.

DOCKET NO. E-1051B-99-105

PREPARED TESTIMONY OF

STEVEN C. CARVER

MICHAEL L. BROSCH

STAFF ACCOUNTING SCHEDULES

On Behalf of the
Arizona Corporation Commission Staff

August, 2000

PREPARED TESTIMONY OF
STEVEN C. CARVER
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US WEST COMMUNICATIONS, INC.
DOCKET NO. T-1051B-99-105

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BEFORE THE
ARIZONA CORPORATION COMMISSION
PREPARED TESTIMONY OF
STEVEN C. CARVER

US WEST COMMUNICATIONS, INC.
DOCKET NO. T-1051B-99-105

Q. Please state your name and business address.

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

Q. What is your present occupation?

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

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

A. Utilitech was retained by the Staff of the Arizona Corporation Commission (hereinafter "Staff" or "ACC Staff") to review the rate filing of US West Communications, Inc. ("USWC" or "Company") in Docket No. T-1051B-99-105 and to file testimony with this Commission respecting the results of our review. U S WEST and Qwest Communications ("Qwest") recently consummated a merger of the two companies. Although Qwest is the surviving corporation, the pending docket was filed and has, by and large, been processed prior to completion of the merger. For reference purposes, my testimony will continue to address the Company as USWC or U S WEST, rather than Qwest.

Q. Please summarize the purpose and content of your testimony in this Docket.

A. Generally, my responsibilities in this docket included the review and evaluation of various elements of operating income and rate base included within USWC's overall revenue

requirement recommendation. As a result, I sponsor and address in testimony various rate base and operating income adjustments proposed by the ACC Staff. The ratemaking adjustments which I do not sponsor are addressed by ACC Staff witness Michael L. Brosch. Other ACC Staff witnesses filing testimony in this proceeding include Mr. Stephen G. Hill, who provides recommendations concerning the appropriate capital structure and cost rates that should be employed for intrastate ratemaking purposes, and Mr. William Dunkel on the areas of rate design, capital recovery and fair value. The revenue requirement effect of the various Staff adjustments and recommendations are reflected in the ACC Staff Accounting Schedules, which I will introduce and jointly sponsor with Mr. Brosch.

Specifically, my testimony describes and sponsors, on behalf of the ACC Staff, various rate base and operating income adjustments. These adjustments include the elimination of certain test year incentive compensation costs, the annualization of depreciation expense, the elimination of image advertising and sponsorship costs, the imputation of additional revenues associated with FCC Deregulated products/ services, and the correction and/or reversal of certain adjustments recommended by the Company. Additional adjustments I sponsor include the elimination of the pension asset from rate base, the annualization of wage and salary expense, as well as the computation of the amount of interest expense deductible in quantifying income tax expense for ratemaking purposes using the interest synchronization methodology. The index at the beginning of my testimony and the first page of the ACC Staff Accounting Schedules identify each individual adjustment that I will discuss in testimony.

EDUCATION AND EXPERIENCE

Q. What is your educational background?

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

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

A. From 1977 to 1987, I was employed by the Missouri Public Service Commission in various professional auditing positions associated with the regulation of public utilities. In that capacity, I was responsible for the submission of expert testimony as a Staff witness. During the period 1977 through 1979, I participated in a Federal Energy Regulatory Commission compliance audit, reviewed utility certificate and financing applications, and participated in and supervised various accounting compliance and rate case audits (including earnings reviews) of electric, gas and telephone utility companies.

In October 1979, I was promoted to the position of Accounting Manager of the Kansas City Office of the Commission Staff and assumed supervisory responsibilities for a staff of ten regulatory auditors. I directed numerous rate case audits of large electric, gas and telephone utility companies operating in the State of Missouri and coordinated such activities with other Commission departments. My responsibilities also included the development and review of accounting issues, the preparation of Staff issues for hearings, and the provision of assistance to Staff counsel in drafting hearing memoranda, cross-examination questions and legal briefs.

In April 1983, I was promoted by the Commission to the position of Chief Accountant and assumed overall management and policy responsibilities for the Accounting Department. This department was comprised of approximately forty professional staff members specializing in

1 regulatory accounting and depreciation issues. I provided guidance and assistance in the
2 technical development of Staff issues in major rate cases and coordinated the general audit and
3 administrative activities of the Department. During 1986-1987, I was actively involved in a
4 docket established by the Missouri Public Service Commission to investigate the revenue
5 requirement impact of the Tax Reform Act of 1986 on Missouri utilities.

6 In 1986, I prepared the comments of the Missouri Public Service Commission respecting the
7 Proposed Amendment to FAS Statement No. 71 (relating to phase-in plans, plant
8 abandonments, plant cost disallowances, etc.) as well as the Proposed Statement of Financial
9 Accounting Standards for Accounting for Income Taxes. I actively participated in the
10 discussions of a subcommittee responsible for drafting the comments of the National
11 Association of Regulatory Utility Commissioners ("NARUC") on the Proposed Amendment
12 to FAS Statement No. 71 and subsequently appeared before the Financial Accounting
13 Standards Board with a Missouri Commissioner to present the positions of NARUC and the
14 Missouri Commission.

15 In July of 1983 and in addition to my duties as Chief Accountant, I was appointed Project
16 Manager of the Commission Staff's construction audits of two nuclear power plants owned by
17 electric utilities regulated by the Missouri Public Service Commission. As Project Manager,
18 I was involved in the staffing and coordination of the construction audits and in the
19 development and preparation of the Staff's audit findings for presentation to the Commission.
20 In this capacity, I coordinated and supervised a matrix organization of Staff accountants,
21 engineers, attorneys and consultants.

22 I commenced employment with the firm in June 1987. During my employment with Utilitech,
23 I have been associated with various regulatory projects on behalf of clients in the States of
24 Arizona, Florida, Hawaii, Illinois, Indiana, Mississippi, Missouri, New Mexico, Oklahoma,

Pennsylvania, Texas, Utah, Washington, West Virginia and Wyoming. I have conducted revenue requirement and special studies of various regulated utilities (i.e., electric, gas, telephone and water) and have filed testimony on behalf of: the Arizona Corporation Commission Staff; the Florida Public Counsel; the Hawaii Department of Commerce and Consumer Affairs Division of Consumer Advocacy; the Indiana Utility Consumer Counselor; the City of Jefferson of the State of Missouri; the Oklahoma Attorney General; the Oklahoma Corporation Commission Staff; the Pennsylvania Office of the Consumer Advocate; the Missouri Public Service Commission Staff; the New Mexico PRC Staff; the Office of Public Counsel of the State of Missouri; the Telecommunication Ratepayers Association for Cost-Based and Equitable Rates; the United States Executive Agencies; the Utah Committee of Consumer Services and the Public Counsel Section of the Washington Attorney General. Since joining the firm, I have continued to appear as an expert witness before the Missouri Public Service Commission on behalf of various clients, including the Commission Staff.

EXECUTIVE SUMMARY

Q. What overall revenue requirement has the ACC Staff proposed for USWC's intrastate regulated operations?

A. In its initial filing in this proceeding, USWC filed accounting and financial information supporting a revenue deficiency of about $225.9 million, using an original cost rate base and a June 30, 1998 historical test year. USWC's application only sought a rate increase of $70.9 million.

On May 3, 2000, the Company updated its revenue requirement filing to reflect a test year ended December 31, 1999. This test year "update" supported an overall revenue requirement of $201.2 million, as set forth on USWC Exhibit GAR-S1 (Redding Supplemental Exhibits), and a revised rate increase request of $88.6 million (Data Request No. 43-19S1). In comparison, the ACC Staff has assembled a revenue requirement recommendation supporting an overall rate increase of approximately $7.2 million. A series of accounting schedules supporting the Staff recommendations are located in the joint ACC Staff Accounting Schedules that have been separately bound.

Q. Please summarize the financial impact of the larger ratemaking adjustments proposed by the ACC Staff, contributing to this difference between the revenue requirement recommendations of USWC and the ACC Staff.

A. The more significant ratemaking adjustments comprising the difference between the Company and Staff recommendations are summarized in the following table. It should be noted that a detailed reconciliation of the various differences in revenue requirement is set forth on Schedule E of the ACC Staff Accounting Schedules.

Schedule Reference	Description	Estimated Revenue Requirement (Millions)
n/a	Return on Equity	($29.2)
B-3	Pension Asset	(5.9)
B-5	Proforma Depreciation – Reserve Reversal	9.0
C-1	Revenue Annualization – Local Service	(9.0)
C-5	Directory Imputation	(42.0)
C-8	Service Quality Program Elimination	(9.8)
C-10	EOP NonLabor Reversal	(9.8)
C-11	Year-End Wage & Salary Annualization	(13.9)
C-12	Incentive Compensation	(5.5)
C-13	SOP 98-1 (Internal-Use-Software)	(32.8)
C-14	USWC Payroll Adjustment Reversal	(13.3)
C-15	Proforma Depreciation Annualization	(3.0)
C-17	FCC Deregulated Service Imputation	(3.6)
C-18, B-7	FCC Dereg – Separations Adjustment	3.8
C-22	Depreciation on Unrecorded Retirements	(2.9)
C-27	Image Advertising / Olympic Sponsorship	(10.1)
C-29	Exchange Sale Allocation Adjustments	(11.4)
C-30	Reciprocal Compensation	11.6
	Total	($177.8)

Q. Could you please summarize how the ACC Staff Accounting Schedules are organized?

A. Yes. The components of the proposed revenue requirement appear on ACC Staff Schedule A. The Staff's proposed rate base is brought forward from ACC Staff Schedule B, Summary of

Jurisdictional Rate Base. Similarly, the Staff's adjusted net operating income recommendation is brought forward from ACC Staff Schedule C, Summary of Operating Income, while the cost of capital recommendation is obtained from ACC Staff Schedule D, Capital Structure Summary.

ACC Staff Schedule A-1 presents the calculation of the gross revenue conversion factor used to convert the net operating income deficiency (or excess) on ACC Staff Schedule A into the appropriate revenue requirement amount. The various adjustments to rate base and operating income are supported by individual supporting schedules and some supplemental workpapers. The witness sponsoring each schedule comprising the Staff's overall recommendation is identified in the upper left-hand corner thereof and is listed on the schedule index located at the front of the ACC Staff Accounting Schedules.

Q. How will you identify and refer to the individual Staff accounting adjustments?

A. Both rate base and operating income adjustments have been numbered sequentially, but separately, beginning with the number "one". In order to distinguish the first rate base adjustment from the first operating income adjustment, the adjustment number is preceded by a reference to the schedule on which the adjustment was posted. For example, the posting schedule for the rate base adjustments is ACC Staff Schedule B. So, the first rate base adjustment would then be referenced as ACC Staff Schedule (or Adjustment) B-1. Similarly, the first operating income adjustment would be identified as ACC Staff Schedule (or Adjustment) C-1, since ACC Staff Schedule C is the posting schedule for the income statement adjustments. For purposes of the Staff's testimony in this proceeding, Mr. Brosch and I will use the words "schedule" and "adjustment" interchangeably when referring to the individual adjustments proposed by the Staff.

Q. Please describe the Staff's approach to quantifying revenue requirement in this proceeding.

A. The Staff Accounting Schedules use the Company's "update" amounts (as filed in May 2000) for rate base, revenues and expenses as a starting point, which were then adjusted to reflect the impact of the various Staff proposed adjustments thereto. By starting with the Company's "update" filing, each test year ratemaking adjustment recommended by the Staff represents a reconciling difference, positive or negative, which can be used to quantify the value of the various issues between the Staff's recommendation and the Company's overall revenue requirement. In fact, ACC Staff Schedule E represents a reconciliation of the revenue requirement differences between the Company and the Staff by individual adjustment.

Q. Referring to ACC Staff Schedule A, could you please explain the format employed in quantifying the Staff's overall revenue requirement?

A. Yes. In developing its overall revenue requirement recommendation in this proceeding, the Staff has prepared a series of recommended adjustments to the Company's filed case which are designed to match the various components of the ratemaking equation and maintain the integrity of the December 31, 1999, end-of-period test year. In so doing, the Staff proposes that the effect of various changes (e.g., investment, prices and volumes) which typically occur subsequent to the selected test year should be excluded from the determination of overall revenue requirement, as presented on ACC Staff Schedule A.

Overall, the Staff disagrees with the Company's use of a global end-of-period annualization approach and the piecemeal recognition of changes occurring beyond December 31, 1999. Instead, the Staff recommends that the Commission normalize test year operating results, adopt annualization adjustments for specific identifiable components of revenues and expenses, and annualize book depreciation expense on year-end depreciable plant in order to appropriately recognize ongoing costs and revenues. The rationale underlying the Staff's proposed test year approach will be addressed in the Test Year section of my testimony.

Q. On behalf of the Staff, has Utilitech thoroughly reviewed the various revenue requirement adjustments proposed by USWC such that the inclusion of an adjustment without modification should signify Staff's agreement with, or acquiescence to, the appropriateness of any such items for ratemaking purposes?

A. No. As consultants to the ACC Staff, we did review and submit discovery, as necessary, on all of the Company's various adjustments (and workpapers) in varying degrees. Although we have proposed numerous adjustments to the Company's filing, we have not necessarily proposed an adjustment for each and every item identified due to materiality and/or work prioritizations. Consequently, the inclusion of a Company adjustment without modification should <u>not</u> be construed as agreement with or endorsement of that particular adjustment amount or adoption of the underlying methodology or theory.

TEST YEAR

Q. What test year was employed in this Docket?

A. When USWC originally submitted its rate filing in this proceeding, the Company's revenue requirement was based on a test year ending June 30, 1998. During the procedural conference on April 4, 2000, the Chief Hearing Officer ordered U S WEST to update its test year through calendar year 1999. [Prehearing Conference, tr.16.] As a result, USWC's revenue requirement "update" is based on a historical test year which starts with the Company's results of operations for the twelve month period ended December 31, 1999.

Q. Has the ACC Staff employed the same test year update as that filed by the Company?

A. Yes. The Staff's proposed revenue requirement employs the Company's proforma amounts for rate base, revenues and expenses from the 1999 test year update as a starting point. These components of the ratemaking formula were then adjusted to reflect the impact of the Staff's proposed adjustments thereto.

Q. Has USWC proposed a year-end or average approach to test year valuation?

A. In general terms, USWC has proposed use of end-of-period investment, volumes (access lines, employee headcounts, etc.) and prices (wage and salary rates, revenue prices, etc.) in quantifying overall revenue requirement. However, for certain elements of revenue requirement (wage/ salary rates, reciprocal compensation, exchange sale, broadband asset transfer and depreciation accrual rates), the Company has quantified ratemaking adjustments which have the effect of recognizing post-test year levels or events. More expansively, USWC has proposed to annualize virtually all revenue and expense accounts using a "December 1999 times 12" ("Dec*12") or a year-end trending methodology.

Although Company witness George Redding dedicated several pages of both his direct testimony and supplemental direct testimony to a discussion of the test year, USWC's filing is internally inconsistent and serves to misstate various elements of the ratemaking equation. At pages 12-13 of his direct testimony, Mr. Redding discusses the concept of using an end-of-period rate base in Arizona and the need to consistently adjust the income statement to test year-end. Beginning at line 1 of page 13, Mr. Redding states:

> Given the requirement for an end of period rate base, it is logical to also state the income statement at the same level. However, I do have a problem with picking and choosing. This can lead to a great deal of mischief and cause the test year to be misleading. For example, if revenue volumes and employee levels were both rising over the course of the year, an adjustment that took only the revenues to end of period levels would obviously mistate [sic] the test year and provide a poor proxy for the period when new rates will be in effect. [Redding Direct, p.13]

While I generally agree with Mr. Redding's concerns about consistency, the Company's EOP annualization does not necessarily achieve reasonable results.

The revenue and expense levels actually incurred by the Company represent the product of prices and quantities, or "P*Q". When employing an end-of-period (EOP) test year approach, I agree with Mr. Redding that the ratemaking process should recognize the effects of known changes in test year prices or quantities, or both, to the extent that such changes can be clearly identified, verified and quantified, all else remaining equal. However, I disagree that a blanket annualization methodology that relies on multiplying a single month of revenues/ expenses times twelve necessarily achieves the desired and intended matching. Moreover, USWC's EOP annualization approach has the effect of setting rates based on what effectively becomes a one-month test year.

Q. Why is that?

A. Let me explain by using a simplified example. Assume that the Company buys 12 "widgets" over the course of the calendar year for a price of $1 each. If the Company has consistently bought and expects to continue to buy 12 widgets and the price is not expected to vary from $1 per unit, then it would be reasonable for the test year to reflect $12 of widgets expense. The proposed "Dec*12" annualization methodology will only yield the $12 expected level of widgets expense if, and only if, the Company had either recorded widget expense of $1 in December or quantified a manual adjustment to December's recorded expenses in order to include the $1 therein.

For example, if the Company bought all twelve widgets in December, this methodology would result in annual widgets expense of $144 (i.e., 12 widgets times $1 times 12 months), absent normalizing adjustments to remove the cost of the excess widgets. At the opposite extreme, this methodology could result in "zero" widgets expense if the Company happened to purchase no widgets in December (i.e., 0 widgets times $1 times 12) and failed to identify the need to manually add $1 to December expense.

Although this example focuses on the quantity component of the "P*Q" equation, unit prices can and do change over time. Factors such as seasonality, heightened competition, oversupply, consolidation of purchasing power, changes in source of supply and inflation can all impact the price paid for each individual widget, which is magnified by the quantity purchased. These factors are likely to produce non-representative amounts in any single month, but tend to smooth out across a full twelve-month test year.

Q. Is "December 1999 times 12" the only component of the Company's annualization?

A. No. The Company did employ a trending technique in an attempt to evaluate the extent to which the amount recorded in December was representative. As I understand the Company's

methodology, if the revenue or expense recorded in December 1999 appeared to be "in-trend" with comparable per book data in the months of October-November 1999 and January-February 2000, the Company concluded that "December 1999 times 12" would yield reasonable results. However, if December was "out-of-trend", the Company would either attempt to identify specific normalization adjustments to increase or decrease the December recorded revenues/ expenses or adjust December to fit the trend, using a five-month averaging methodology. In any event, USWC attempted to use the trending approach to identify and eliminate out-of-trend conditions from influencing the annualization process.

Unfortunately, the focus of both the "December 1999 times 12" method and the trending approach divert attention away from the reasonableness of unit prices and related quantities. Instead, an implied assumption underlying the Company's approach is that some revenues/ expenses will be overstated, but offset by understatements in other areas. In my opinion, this does not represent a sound annualization approach for use in the ratemaking process.

Q. Could you identify the USWC adjustment that annualizes test year revenues and expenses in this manner?

A. Yes. USWC Adjustment P-01, End of Period Annualization, primarily uses this annualization approach. Referring to the Company's update filing, Supplemental Exhibit GAR-S7 increases operating revenues by $3.9 million and increases operating expenses by $28.3 million. While Mr. Brosch and I will individually discuss the various components of this Company adjustment, USWC has increased its overall revenue requirement by about $24.4 million using this approach.

Q. Has the Staff proposed adjustments to move prices and quantities to year-end levels, consistent with the use of an EOP rate base?

A. Yes. While the Staff has endeavored to apply a relatively stringent test year approach in order to consistently value the various components of the ratemaking equation, there are unique circumstances currently affecting the Company's operations which deserve and demand recognition in the quantification of overall revenue requirement. As the Commission is aware, the Company has negotiated, but not yet closed, an agreement to sell certain rural Arizona exchanges. Also, the pending rate proceeding is the result of a lengthy docket before this Commission concerning various revisions to USWC's Arizona depreciation rates, which was not concluded until after the 1999 test year. Further, the Company initiated a separate proceeding to transfer certain broadband assets to a non-regulated affiliate. Although the procedural schedule in the latter proceeding has been delayed, each of these matters uniquely affect the Company's operating results in the State of Arizona.

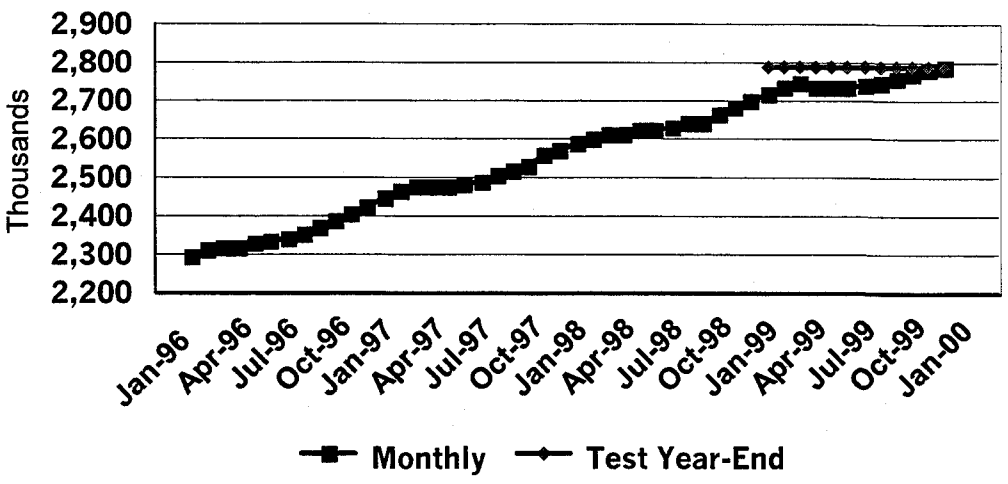
Beyond adjustments for the exchange sale, depreciation accrual rates and broadband transfer, the Staff has proposed specific adjustments to annualize discrete, identifiable components of revenues and expenses to test year-end. Although the Company may attempt to characterize this approach as "picking and choosing" or leading "to a great deal of mischief," it is important to recognize that some revenues and expenses are reasonably stated at actual recorded levels, in the absence of detailed information demonstrating otherwise. The presentation of global revenue or expense annualization adjustments, for the mere sake of being able to state that every dollar has been annualized, is not necessarily a good thing. Said differently, it is not reasonable to shift to USWC's single-month test period to reasonably quantify the Arizona revenue requirement.

Staff has endeavored to process this update filing on an expedited basis, focusing and prioritizing its efforts on elements of the ratemaking formula that merit attention. As a consequence, the Staff has presented what it believes is a reasonable quantification of USWC's

overall intrastate revenue requirement, using a reasonable year-end valuation approach for all elements where known and measurable changes require annualization.

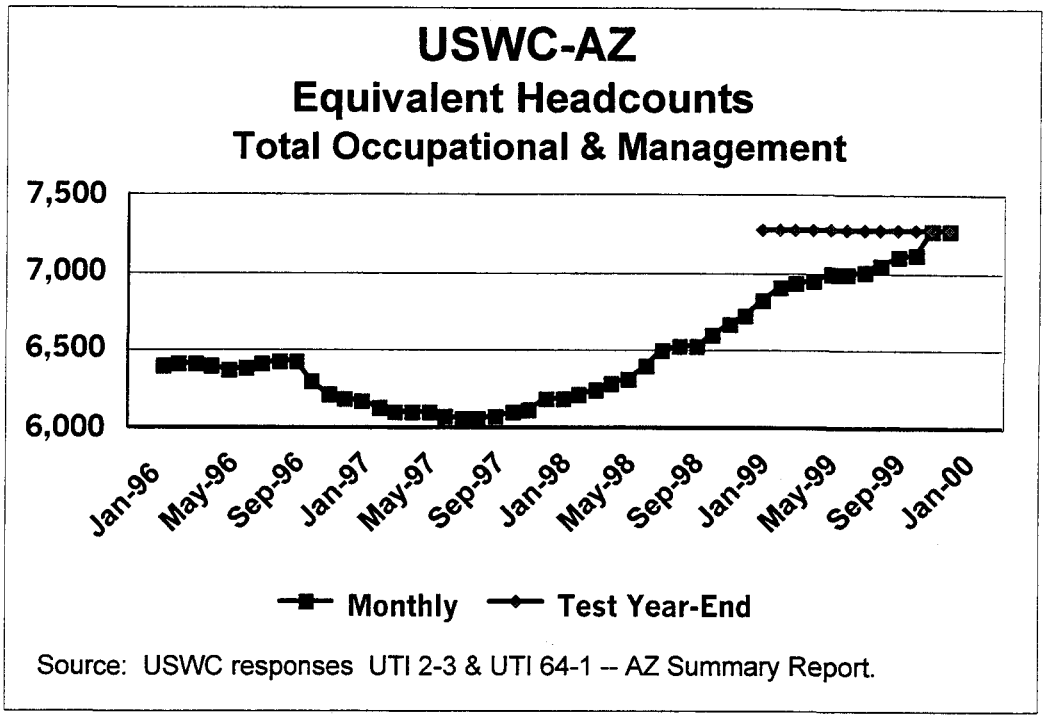
Q. Have you attempted to examine the historical trend in USWC's net rate base, expenses and volumetric statistics in Arizona?

A. Yes. I have reviewed overall data concerning USWC's Arizona trends in investment, operating expenses, access lines and changes in equivalent employee headcounts. As shown by the following graph, access lines, which serve as a general indicator of recurring revenue levels, have grown consistently since 1986 – a trend which continued throughout 1999 into 2000.



Source: USWC responses UTI 2-3 & UTI 64-1 -- AZ Summary Report.

Equivalent employee levels fluctuate from month to month, but have increased significantly since late 1997.



In order to minimize the volume of confidential data contained within my testimony, these graphs only present the non-confidential data supplied in response to the referenced discovery requests (i.e., data through December 1999). Subsequent to the test year, access lines and employee headcounts have continued to increase.

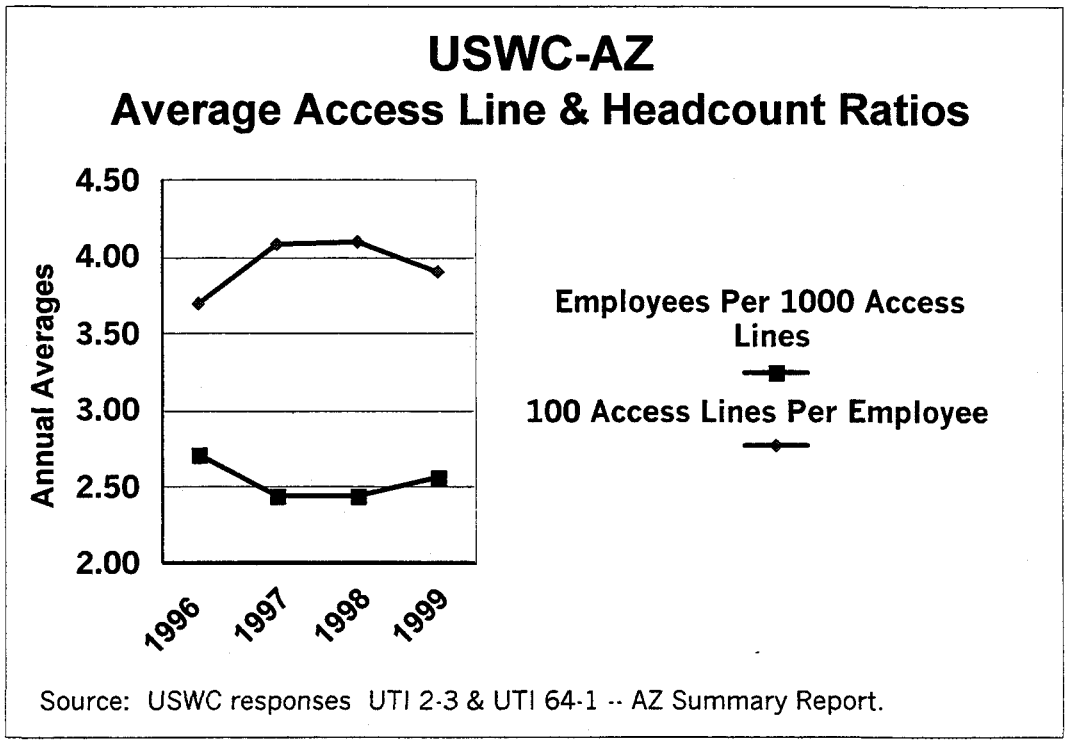
Staff has proposed annualization adjustments, as appropriate, to reflect revenue changes and the significant growth in access lines that occurred during the test year. The direct testimony of ACC Staff witness Brosch will address USWC's operating revenues and introduce certain ratemaking adjustments proposed by the Staff.

With regard to employee headcounts, I will sponsor an adjustment to annualized wage and salary expense at test year-end, in order to recognize the increased employee headcounts and wage/ salary rates experienced through the end of 1999. Although USWC has also proposed

an adjustment to annualize wage and salary increases that occur subsequent to the test year, I will recommend the exclusion of the post-test year increases.

Q. How does the growth in access lines compare to the growth in employee levels?

A. Although employee levels have increased since late 1997, the growth in access lines appears to have largely offset that increase during this time frame. The following graph presents two related statistics which indicate relative employee efficiency in relation to access lines.

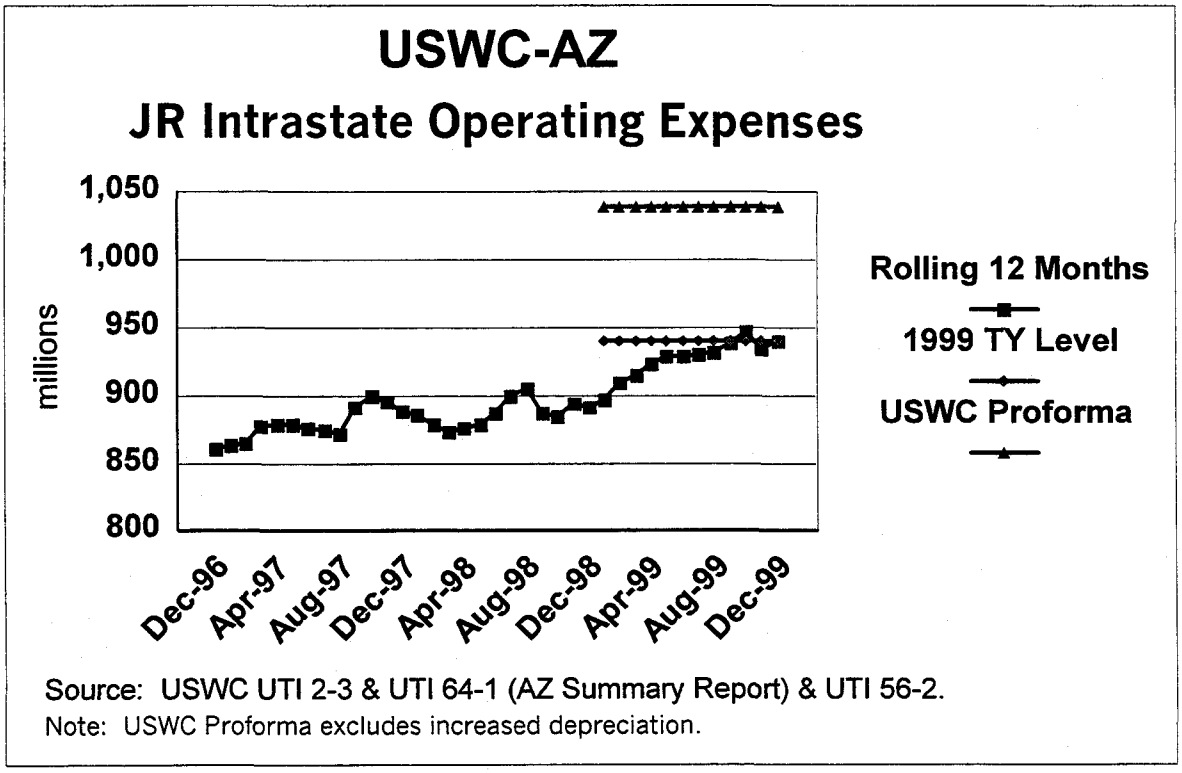


As shown by this graph of the non-confidential data supplied by the Company, the rate of growth in access lines since 1997 has largely offset the increase in employee levels, thereby resulting in the relatively constant ratios during the more recent periods. Based on the statistical information I have reviewed and test year matching concepts, I believe that the annualization approach proposed by Staff better synchronizes revenues and labor expense at year-end levels and avoids the need to engage in the detailed identification and analysis of the

post-test year known and measurable growth in revenues, access lines and other offsetting changes.

Q. Have you also compared the Company's overall Arizona intrastate expense levels?

A. Yes. I have reviewed the overall trend in USWC's intrastate operating expense levels (excluding FCC Deregulated Services) prior to and continuing beyond the test year. Absent further detailed discovery and evaluation of the Company's accounting records for the year 2000, the Staff is unable to assess or comment on the factors that may contribute to changes in post-test year expense levels. In any event, the following graph compares the level of intrastate operating expense "as recorded" during the test year (i.e., the twelve months ended December 1999) with rolling twelve months of actual intrastate expense starting with December 1996. For example, the data point labeled "Dec-99" reflects the actual intrastate operating expense for the twelve month period ending in December 1999.



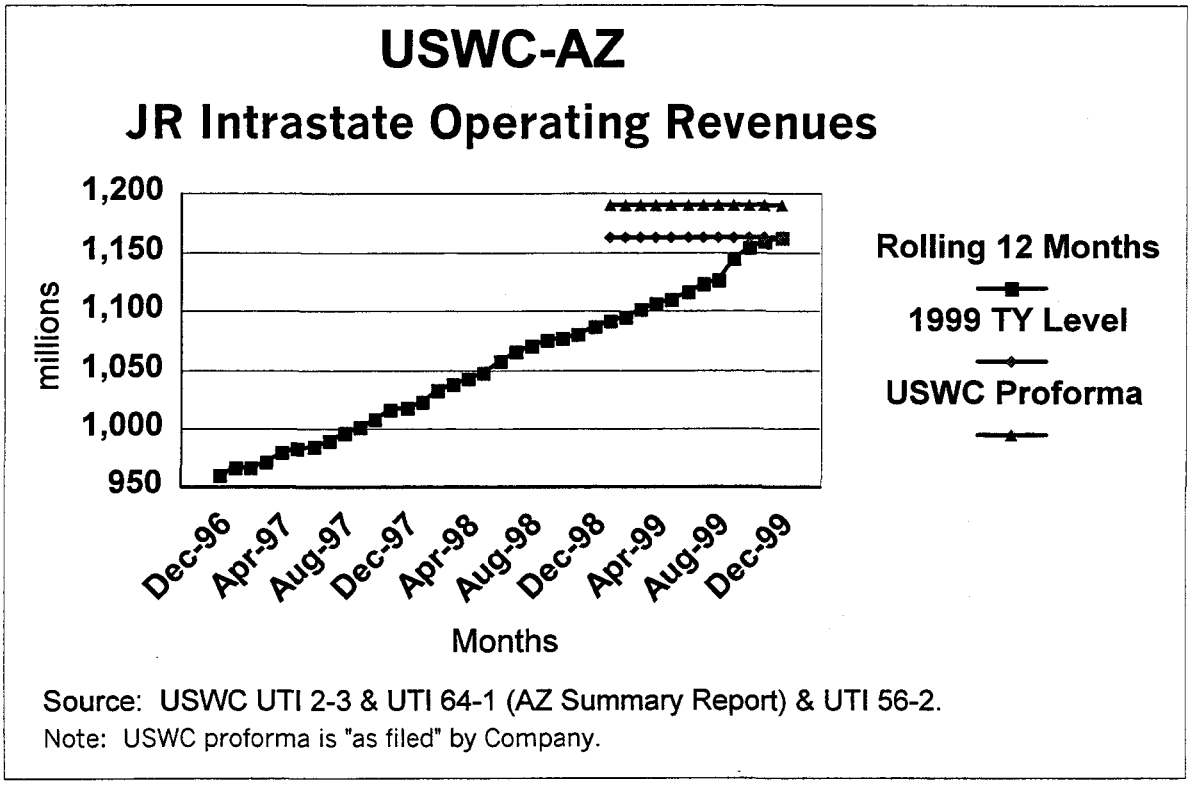
Source: USWC UTI 2-3 & UTI 64-1 (AZ Summary Report) & UTI 56-2.
Note: USWC Proforma excludes increased depreciation.

While recorded expense levels are influenced by changes in both prices and quantities as well as a variety of correcting and out-of-period journal entries, this graph does show an increasing historical trend in operating expense. For comparison purposes, the graph also reflects the test year unadjusted as well as the Company's proforma level of operating expense (excluding the effect of the change in depreciation accrual rates).

In order to minimize the presentation of confidential information, this graph does not reflect any data beyond 1999. While the Staff has not analyzed and audited the price and quantity drivers influencing the expenses recorded in the post-test year months of January-April 2000, it is notable that even dramatic post-test year increases in intrastate operating expenses, as presented in the underlying documentation, do not reach the extraordinarily high proforma level included in USWC's proposed revenue requirement.

Q. Have you prepared a similar graph of operating revenues?

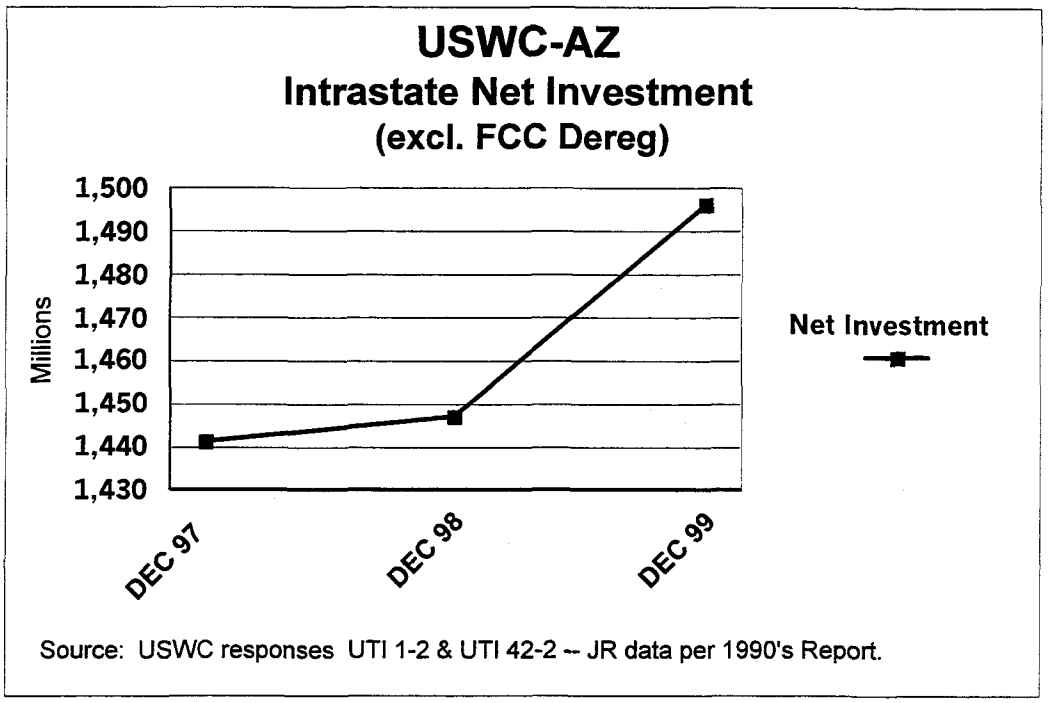
A. Yes. The following graph represents a similar comparison of intrastate operating revenues over the same time frame, excluding any confidential post-test year information.



Clearly, revenues are increasing at a steady rate and may be less susceptible to misstatement through the annualization process. However, as Mr. Brosch explains in his testimony, the revenue effects of the new broadband affiliate, reciprocal compensation, and the nature of each type of revenue must be analyzed and understood in developing appropriate ratemaking adjustments.

Q. Earlier, you also mentioned that you had also reviewed data concerning USWC's investment in Arizona. Is that correct?

A. Yes. Because three primary elements (plant in service, accumulated depreciation/ amortization reserves and deferred income tax reserves) drive the Company's rate base, the follow graph compares historical intrastate "net investment" balances (excluding FCC Deregulated Services) at December1997, December 1998, and December 1999.



USWC's net investment in these rate base components has increased over the past several years. Subsequent to the test year, the net intrastate investment has continued to increase, but has not been analyzed to determine whether the increase would be appropriate for regulatory recognition.

Q. With these graphs showing increased revenues, expenses and investment, is it reasonable to assume that these changes will automatically put upward pressure on the rates charged for telecommunications service?

A. No. It is generally anticipated that the passage of time will result in increasing costs and investments, during periods of even modest inflation. As a result, the use of an end of period rate base and year-end revenue/ expense annualization adjustments might be expected to yield higher revenue requirements. However, after considering recent trends in access lines, headcounts, revenues, expenses and net investment, the data indicates that <u>all</u> components of the ratemaking equation are changing over time. It is only by conducting a detailed analysis

and investigation into the underlying data that a determination can be made as to whether the overall revenue requirement has changed materially during the selected test year, thereby justifying an increase in the Company's tariff rates and charges. The key issue is whether revenues are growing faster or slower than overall costs, including investment return, necessary to support those revenues. As an indication of the existence of this offsetting phenomenon, it is observed that the Company's last rate case was processed about six years ago.

Q. Why is the proper selection and balanced adjustment of a test year important in the determination of just and reasonable public utility rates?

A. The ratemaking equation commonly employed by this Commission, and other regulatory agencies, compares a required return on rate base to the investment return generated by adjusted test year operating results. If the return generated by the adjusted operating results (i.e., adjusted operating income and rate base) is deficient, a rate increase is required to provide the utility an opportunity to earn a "reasonable" return on its investment. Conversely, an excessive return would support a reduction in utility rates.

For the ratemaking equation to function properly, the components comprising the equation (i.e., rate base, revenues, expenses and rate of return) must be reasonably representative of ongoing levels, internally consistent and comparable – within the context of test period parameters. To the extent that these components are not properly synchronized, a utility may not have the opportunity to earn its authorized return or, alternatively, may have the opportunity to earn in excess of the return authorized. By synchronizing or maintaining the comparability of revenues, expenses and investment, the integrity of the test year can be maintained with the reasonable expectation that the resulting rates will not significantly misstate the cost of providing utility service. It is critical that the ratemaking process properly synchronize only those known and measurable changes which occur during the test year or within a reasonable defined period subsequent thereto, rather than establish utility rates on

inappropriate factors or inconsistent post-test year events. In this manner, regulators can best be assured that rates are reasonably based on ongoing cost levels.

Over time, each of these elements comprising the revenue requirement formula will and do change – as clearly demonstrated by the earlier charts depicting historical trends in rate base, access lines, employee counts, operating revenues, and operating expenses. There is no question that operating expenses and net investment have increased, but so have operating revenues. Changes in one component of the "formula" that tends to increase revenue requirement could well be offset by decreasing changes elsewhere. For this reason, one of the purposes of a rate proceeding it to analyze and balance these various elements of the revenue requirement formula.

Q. Do you have any direct evidence that increases in one area might be offset by decreases in another?

A. Yes. The Commission need look no further than the two separate test year revenue requirement filings that the Company has submitted in this proceeding. While these two test years were 18 months apart, the Company's overall revenue requirement approach did not change materially. Although the Staff does not concur with the Company's valuation of certain adjustments and overall EOP approach to the test year, the fact remains that a relatively consistent application of USWC's ratemaking theories resulted in a fairly limited change between these two revenue deficiencies filed by the Company. The following table compares the major elements of the revenue requirement formula reflected in these two Company filings:

Element	June 1998	December 1999
Net Rate Base	$1,474,717,000	$1,442,099,000
Total Operating Revenues	$1,110,724,000	$1,190,269,000
Total Operating Expenses	$1,020,578,000	$1,147,198,000
Weighted Cost of Capital	10.74%	10.86%
Revenue Deficiency - Original Cost	$225,878,000	$201,220,000

Sources: Redding GAR-1 & GAR-5 (Direct Exhibits), GAR-S1 (Supplement Exhibits), Data Request No. UTI 56-2

During the intervening 18 month period, the Company's valuation of rate base has declined while revenues, expenses and proposed return have all increased. Despite the dynamics underlying these changes (included the exchange sale), the Company's overall revenue deficiency decreased by almost $25 million. Clearly, there are differences between these test periods. The Staff would likely have proposed any number of ratemaking adjustments to either test year. However, the fact remains that all components of the "formula" have changed, but overall revenue requirement has remained relatively constant.

Q. Do you have any further comments concerning the Company's overall annualization approach in this proceeding?

A. Yes. There are significant differences between the presentations of USWC and the ACC Staff concerning how the test period should be adjusted for ratemaking purposes, as indicated in the Executive Summary section of my testimony. One area of disagreement concerns USWC's concept of annualizing all expenses to EOP levels using the "December times 12" methodology. The following confidential graphs compare historic levels of recorded product and non-product advertising expense with the results from the Company's annualization approach to illustrate the problems inherent with USWC's single-month test year.

1 **CONFIDENTIAL GRAPHS**

Although a subsequent testimony section will address the Staff's proposed disallowance of image advertising costs, these graphs show that the "December times 12" approach results in excessive increases to the historical levels of advertising expense without any evidence or rationale justifying the magnitude of such increases. While advertising expense has been used as an example of Staff's concern with the Company's EOP annualization approach, Mr. Brosch and I will introduce a variety of adjustments which serve to annualize discrete revenue and expense components that merit annualization.

I am fairly confident that the Company will attempt to explain away these significant deviations between historical and annualized advertising expense levels by arguing that its annualization methodology was not designed to focus on this degree of detail, but would have likely identified and eliminated by default any material variations in discrete expense items by "trending" overall expense levels. If such a position is offered, the acceptance of the Company's EOP expense annualization methodology would require adoption of the premise that gross overstatements of some categories of expense are acceptable as long as the Company's method just as materially understates other categories of expense.

In my opinion, the Company's proposal to annualize aggregate expense levels without a detailed evaluation and identification of the specific factors driving changes in incurred costs (i.e., price and quantity changes) is misguided, ineffective and potentially leads to a false sense that USWC's global annualization approach, which couples the "December times 12" with other trending techniques, yields reasonable and consistent results.

Q. Could you briefly identify the areas to which USWC has applied the "December times 12" method?

A. Yes. USWC Adjustment P-01 proposes to annualize the following areas using the "December times 12" method:

- Operating Revenues
- Deregulated Revenues
- Wage & Salary Expense
- Benefits Expense
- Non-Labor Expense
- Property Tax Expense
- Rent Compensation
- Uncollectibles

The Staff has reviewed each of these components of USWC's EOP annualization adjustment and, for most components, offers separate annualization adjustments. With regard to the non-labor EOP annualization, the Staff's reversal of the Company's adjustment will be discussed in a separate section of my testimony.

EOP NONLABOR REVERSAL

Q. Please identify ACC Staff Adjustment C-10.

A. ACC Staff Adjustment C-10 reverses the Company's proposal to annualize miscellaneous non-labor operating expenses using the "December times 12" method. This non-labor annualization in one of several components to USWC's Adjustment P-01.

Q. Why do you believe that this Company adjustment should be reversed?

A. In the test year section of my testimony, I generally discuss the test year concept and the annualization process, including the Company's non-labor annualization adjustment. In many revenue and expense areas, it is possible to analyze data trends, contract or price changes, and/or other underlying statistics so as to identify specific items that merit annualization or normalization adjustments. Mr. Brosch and I have proposed a number of adjustments annualizing various cost of service items, including operating revenues (by category), wage and salary expense, benefits expense, uncollectible expense, depreciation expense, rent compensation and property tax expense.

However, the non-labor expense category is comprised of millions of transactions across a broad assortment of different types of expense. These transactions may reflect costs that are directly incurred by, or allocated to, the Company's Arizona operations and would encompass extremely diverse transactions, including:

- Affiliate transactions
- Operating rental expense (i.e., outside the rent compensation study parameters)
- Non-capitalized software costs
- Janitorial services
- Power expenses
- Outside consulting (auditors and actuaries), legal and security services
- Business travel costs (meals, lodging, etc.)
- Postage (customer bills and notices)

- Facility maintenance (materials and supplies)
- Property and casualty insurance
- Damage claim payments
- Industry association dues and membership fees
- Magazine and periodical subscriptions
- Stockholder services costs
- Advertising costs
- Vehicle leases and operating costs
- Consumable and office supplies

The Company has proposed to increase the test year level of non-labor intrastate expense by almost $11 million, but has not identified any specific changes in the Company's operations or a need to purchase more (or less) of a specific good (or service) at a specific higher (or lower) price in support of this adjustment. The Company did not file or present any analyses or studies that substantiate this method as a viable approach. Instead, the Company has posted a few normalizing adjustments to the non-labor expenses recorded in December 1999, prepared trending comparisons with unadjusted monthly expenses (i.e, late 1999 and early 2000), and multiplied the residual times twelve.

Q. Is there any approach to annualize non-labor expenses that you would have found more acceptable?

A. Yes. If the Company had determined, for example, that the cost of its casualty insurance had increased during the test year, the Staff would have been willing to review the details underlying the Company's workpaper calculations and evaluate the revenue requirement effect thereof. If the Company had annualized the cost of mailing customer bills or other correspondence and concluded that postage costs were increasing because of the greater number of mailings, Staff would have also been willing to review and evaluate those quantification details. Unfortunately, this was <u>not</u> the Company's approach to the annualization of non-labor expense.

Q. Earlier, you presented several graphs regarding advertising expense, including the level of advertising costs included in the Company's EOP non-labor adjustment. Did the Company's adjustment workpapers contain similar information for other specific components of non-labor expense?

A. The Company prepared its non-labor annualization at a high level. So, the Company's non-labor annualization workpapers did not produce data at the detail level necessary to evaluate the reasonableness of a particular cost element. With regard to advertising expense and several other types of cost, the Company did provide a quantification of the annualized "December times 12" amount in response to specific discovery requests. In response to other similar requests, the Company simply stated that its annualization was not prepared in the level of detail requested.

For the reasons noted above, the Staff recommends that the Commission disallow the Company's EOP non-labor annualization adjustment.

YEAR-END WAGE & SALARY ANNUALIZATION

Q. Please describe ACC Staff Adjustment C-11.

A. ACC Staff Adjustment C-11 is necessary to reflect an ongoing level of salaries/ wages in USWC's cost of service and to consistently recognize, or match, employee counts with salary levels/ wage rates actually in effect in late 1999.

Q. Did the Company also propose an adjustment to annualize salaries and wages to test year-end levels?

A. Yes. The Company did quantify a year end annualizaton adjustment using the EOP "December times 12" methodology discussed previously. In my opinion, the simplicity of this approach masks several significant methodology deficiencies and yields unreasonable results. First, the Company's annualization technique does not separately examine the individual components of employee compensation (basic wages, overtime & premium pay, incentive compensation, etc.) and determine an appropriate method to annualize each component. Instead, the Company annualizes all compensation components by multiplying the December 1999 expense amount by 12.

Second, it appears that the Company has only made a limited attempt to evaluate whether the wage and salary expense recorded during December 1999 represents a reasonable relationship with employee levels and workdays to form an appropriate basis for annualization purposes. In my opinion, this has resulted in an overstatement of the annualization adjustment recommended by USWC.

Q. Did USWC adjust the wage and salary expenses recorded in December 1999 prior to the annualization?

A. Yes. USWC did recognize several adjustments in an attempt to normalize the December 1999 wage and salary expense: incentive compensation accruals were adjusted to reflect average test year levels or eliminate out-of-period transactions; clearance journal entries recorded during December were transferred from benefits to salaries expense; and the relationship between paid time off and base wages/ salaries was adjusted to the average amount recorded during September-December 1999.

Q. How do the results of the Company's payroll annualization methodology compare to test year wage and salary levels?

A. The following table compares the salary and wage expense incurred in 1998 and 1999 with the results from the Company's EOP annualization methodology:

	Total Arizona	
	Payroll Expense	Increase
1998	[redacted]	[redacted]
1999	[redacted]	[redacted]
USWC Annualization	[redacted]	[redacted]

Sources: USWC confidential UTI 18-25, UTI 42-5 & UTI 63-5.

Referring to the above table, the Company's annualization adjustment has the effect of recognizing a larger increase in wages and salaries from the test year "recorded" level to the December 1999 EOP level than the entire increase between calendar years 1998 and 1999. In other words, the annualization process is intended to restate test year expense from the average wage/ salary rates and headcounts experienced during the test year to year-end levels. So, a significant portion of these changes (pay rates and headcounts) are already partially included within the test year and tend to lessen the required annualization adjustment. However,

calendar year 1998 does not incorporate any of the changes experienced in calendar year 1999 (i.e., in either rate or headcount changes), so the expectation is that the year-over-year change would be greater than the results from the test year annualization process – absent significant structural changes in the Company's operations.

Q. How does the annualized level of payroll expense proposed by the Staff compare to these levels?

A. Referring to ACC Staff Adjustment C-11, the Staff has proposed an annualized level of payroll expense of about $370.3 million (Total State).

Q. How did you annualize wage and salary expense?

A. After reviewing monthly headcount, workday and payroll data supplied by the Company, I concluded that the annualization of payroll costs should be accomplished in several steps. The annualization of regular, or basic, compensation should recognize year-end 1999 employee levels, wage/ salary rates and a reasonable level of annual workdays. Overtime and premium pay were separately adjusted to capture the effect of the wage and salary increases granted during the test year. The Staff's annualization did not modify the test year level of incentive compensation pay, since the recovery of such costs will be addressed in a separate testimony section. Termination pay and clearances were also not adjusted from test year levels.

Q. Could you explain how you annualized regular, or basic, compensation?

A. For purposes of this proceeding, the annualization of regular compensation for both occupational and management employees, as presented on ACC Staff Adjustment C-11, was based on average basic pay per equivalent employee for the three months of October through December 1999. The resulting three month average pay per employee was multiplied by the December 1999 level of equivalent employees and then by an annualization factor of twelve (12). This methodology consistently recognizes the effect of wage and salary increases

implemented during the test year as well as the interrelationships between changing headcounts and employee compensation levels.

Q. Why did you use the three month average times twelve methodology for regular pay but not for overtime or bonus pay?

A. Regular payroll costs are a direct function of the number of employees, the wage and salary rates in effect and the number of hours or days worked. The level of USWC's Arizona employees increased during the test year, which generally tends to increase payroll costs. The test year wage and salary increases also have the effect of increasing payroll costs. It is my opinion that the use of two or three months of basic pay data for an entity such as USWC tends to help levelize and normalize these items as well as other recorded journal entry transactions that could otherwise improperly impact the annualization process.

Certain forms of compensation such as overtime, incentive compensation and bonus awards are linked to other factors, or cost drivers, which could be seasonal in nature or may fluctuate significantly from month to month. As a result, the process of annualizing such items for inclusion in cost of service should not necessarily focus on a similar EOP annualization approach, because of the possibility that one or two months of data may not be representative of ongoing conditions or annual levels.

Q. How have USWC's employee levels changed during the test year?

A. In the confidential response to Data Request No. UTI 63-2, the Company provided historical information concerning the USWC employees physically located in the State of Arizona (i.e., "situs" employees) as well as "equivalent" employees providing service to USWC's Arizona customers.

CONFIDENTIAL GRAPH

Although the monthly "situs" headcounts show a fairly steady build-up throughout 1999, the "equivalent" headcounts show more month-to-month fluctuation. It should be noted that the annualization adjustments offered by both the Company and the Staff effectively rely on year-end headcount levels.

Q. Could you briefly explain the difference between headcounts that are referred to as "situs" employees and "equivalent" employees?

A. Yes. USWC's workforce is located throughout a fourteen state region. Due to the nature of the work an individual employee might perform, the payroll and benefit costs of that employee could be assigned directly to the Company's operations in the State in which the employee is located or could be allocated between multiple State operations. Headcounts based on the geographic location (e.g., Arizona) of the employee are referred to as "situs" employees. If 100% of a particular employee's time was attributable to work for the State in which he/she was physically located, this employee would be counted as one "situs" employee as well as one "equivalent" employee.

The difference between "situs" and "equivalent" employees comes into play when the payroll and benefit costs of certain employees are allocated or assigned to more than one State's operations. Since payroll costs are typically allocated between multiple States, employee levels that are allocated on the same or similar basis as employee payroll costs are considered to be "equivalent" employees. So, an employee located in one State and partially allocated to another State would be viewed as one "situs" employee, but less than one equivalent employee in the State of assignment.

Q. Is one of these methods of measuring employee levels preferred over the other?

A. Yes, depending on the intended use or application of the employee level data. For purposes of comparing total headcounts or preparing trend analyses, "situs" basis employee levels may be readily available and acceptable, in the absence of other data. When preparing payroll annualizations that partially rely on headcounts, "equivalent" employee levels are generally considered to be superior to "situs" information because of its consistency with recorded payroll expense, which includes a combination of directly assigned and partially allocated costs.

Q. Was ACC Staff Adjustment C-11 based on "situs" or "equivalent" employees?

A. This Staff adjustment was calculated using "equivalent" headcount data.

Q. You previously made reference to employee workdays in the context of the annualization of regular pay. Please explain that reference.

A. Employees are generally paid on an hourly wage rate or monthly salary basis. The number of employee days worked (or workdays) during a particular month provides a general means of comparing the relative time worked by employees on a month to month basis. USWC's response to Data Request No. 63-3 indicated that there were 22 workdays in the month of

December 1999. So, using USWC's "December times 12" methodology, the Company's annualization appears to be based on 264 workdays (22 workdays * 12).

In comparison, the Staff's regular pay annualization was based on the average basic pay per employee for the three months of October through December 1999. The average number of workdays during this period was 21.33 days (i.e., a simple average of 21 + 21 + 22 workdays, respectively), resulting in about 256 annual workdays (21.33 workdays * 12). This level is comparable to the annual workdays actually experienced by USWC over the past several years, which have ranged between 254 and 256 workdays. Based on my calculations, the difference between the Company and Staff proposed levels of regular pay is primarily attributable to this workday effect.

Q. Is a companion adjustment to ACC Staff Adjustment C-11 required to recognize associated employee benefit and payroll tax effects?

A. No. This adjustment already incorporates benefit and payroll tax effects, such that a separate "companion" adjustment would neither be necessary nor appropriate.

INCENTIVE COMPENSATION

Q. Why is ACC Staff Adjustment C-12 necessary?

A. ACC Staff Adjustment C-12 removes a portion of the accruals for the incentive compensation plans offered by the Company during the test year. This adjustment eliminates the Company's test year expense for the Short-Term Incentive Plan ("STIP"), the Long-Term Incentive Plan ("LTIP"), the Annual Bonus Plan ("ABP") and the IT-Career Structure Bonus.

Q. Why have you proposed to disallow costs associated with these incentive plans?

A. In general, there are several reasons why I believe this adjustment is warranted in the current proceeding. First, a significant proportion of the incentive plan targets focus on USWC's corporate-wide financial results. As USWC achieves the higher financial targets, the related cost of the Company's discretionary incentive compensation plans should be funded from the increased levels of net income, net cash flow and revenues, rather than through the prices charged to USWC's Arizona customers.

Second, one of the objectives of these incentive compensation plans is to focus attention on service quality (i.e., using customer value analysis and wholesale service quality measures). As discussed subsequently herein, the Company was unable to meet many of its own service quality targets nation-wide, without regard to the quality of USWC's service in the State of Arizona. In my opinion, these deficiencies do not support the recovery of the costs of incentive compensation programs specifically designed to measure the improvement in quality and cost performance.

Q. What is incentive compensation?

A. In general terms, incentive compensation is a form of monetary reward to company employees who achieve predetermined goals and objectives. This form of compensation is considered to

be discretionary or "at risk" to the employee as the amount paid from year to year is neither fixed, regular nor even certain to occur.

Q. Does USWC view its incentive compensation plans as a discretionary form of compensation?

A. Yes. In response to Data Request No. UTI 2-17, the Company referred to incentive compensation as a fully discretionary component of the employee compensation package. When asked to define the phrase "fully discretionary component" as used in this context, the Company indicated:

> Annual Bonus administrative guidelines explain: THE ANNUAL BONUS PLAN DOES NOT GUARANTEE THAT ANY AMOUNT OF COMPENSATION WILL BE PAID TO ANY EMPLOYEE. U S WEST, AT ITS SOLE DISCRETION, HAS THE RIGHT TO MODIFY, CANCEL, OR WITHHOLD PAYMENTS UNDER THE ANNUAL BONUS PLAN, IN ACCORDANCE WITH APPLICABLE LAW, DUE TO CHANGING MARKET CONDITIONS, INDIVIDUAL PERFORMANCE, AND GENERAL BUSINESS NEEDS.
> [Data Request No. UTI 17-19(a), Original Emphasis]

Q. How much incentive compensation expense has USWC recorded during the test year and proposed to include in the calculation of revenue requirement?

A. The following table sets forth the amount of incentive compensation expense (i.e., on a total Arizona basis) embedded in the test year operating results, as adjusted for the out-of-period correcting entries identified by the Company in response to Data Request No. UTI 43-20:

Description	Total Arizona		
	As Recorded	Out-of-Period Adjustments	Adjusted Test Year
Annual Bonus Plan			
Net Cash Flow	[redacted]		[redacted]
Revenue	[redacted]		[redacted]
USWC Net Income	[redacted]		[redacted]
Business Unit Results	[redacted]		[redacted]
Customer Value Analysis	[redacted]		[redacted]
Total ABP	[redacted]		[redacted]
Performance Bonus Plan	[redacted]		[redacted]
Total Management Team Awards	[redacted]	[redacted]	[redacted]
Occupational Team Awards	[redacted]	[redacted]	[redacted]
Merit Awards	[redacted]		[redacted]
IT-Career Structure Bonus	[redacted]		[redacted]
Short-Term Incentive Plan	[redacted]		[redacted]
Long-Term Incentive Plan	[redacted]		[redacted]
Total	[redacted]	[redacted]	[redacted]

Sources: USWC confidential responses to UTI 60-13, RUCO 29-14S1 UTI 59-25 and response to UTI 43-20.

In comparison, the global EOP annualization of salaries and wages resulted in the inclusion of [redacted] of incentive compensation in the Company's proforma operating expenses. [See USWC confidential response to Data Request No. UTI 63-5.]

Q. Are you proposing the disallowance of all test year expense associated with the Company's incentive programs?

A. No. The Staff is not proposing to eliminate the test year costs associated with Merit Awards or Performance Bonus Plan. Also, ACC Staff Adjustment C-12 only adjusts the occupational team awards to reflect the out-of-period correction identified by USWC. However, ACC Staff Adjustment C-12 does propose that the remaining incentive plan costs be disallowed for ratemaking purposes.

Q. Could you briefly describe the various incentive compensation pay plans available to USWC employees that are the subject of Staff's disallowance recommendation?

A. Yes. USWC maintains several incentive compensation plans that are available to employees. The following general discussion of each plan was supplied in USWC's response to Data Request No. UTI 2-17 and UTI 60-11:

- **Long-Term Incentive Plan** (LTIP). The LTIP bonus opportunity is based on a three-year average of Company performance beginning with the year of the LTIP grant date. This plan was designed to promote long-term strategic behavior.

- **Short-Term Incentive Plan** (STIP). This plan provides incentive pay for officers of the Company. The STIP plan in effect during the test year provided an opportunity for annual cash bonus pay-outs based on Company performance measures approved by the Board of Directors. The pay-outs may be adjusted for personal performance. Any compensation granted pursuant to this plan may be above or below an executive's target opportunity.

- **Annual Bonus Plan** (ABP). The ABP incentive plan is a fully discretionary component of the total compensation package for managers below the officer rank. The ABP promotes the growth and profitability of U S WEST by encouraging employees to strive to produce increasingly successful business results. The Board of Directors approves the corporate component of the bonuses, which uses the same measures as the executive STIP.

The rationale for Staff's proposed disallowance of incentive compensation costs will be discussed in the following testimony subsections.

IT-Career Structure Bonus

Q. Could you explain why your description of the Company's various incentive compensation plans did not discuss the IT-Career Structure Bonus plan?

A. Yes. I recall only recently becoming aware of this particular plan, following the receipt of the Company's responses to Data Request Nos. RUCO 29-14S1 and UTI 53-3 in late July 2000. In addition to the pending Arizona rate proceeding, I participated in a USWC rate case in New Mexico in which hearings were recently completed (NMPRC Utility Case No. 3008). During my review of the Company's incentive compensation plans in both of these proceedings, I do not recall any identification of the existence of this plan, much less the provision of any plan documentation or information concerning related plan costs, until recently.

Q. Do the responses to Data Request Nos. RUCO 29-14S1 or UTI 53-3 provide any narrative information concerning this particular plan?

A. Yes. The non-confidential portion of the response to Data Request No. UTI 53-3 refers to and provides a copy of the business unit component of the IT-CS Bonus Plan and the ABP. The supplemental response to Data Request No. RUCO 29-14S1 contains the following passage:

> In addition, the IT-Career Structure Bonus Plan has also been added for the year 1999. In the year 2000, the IT-Career Structure Bonus Plan transfers to the affiliate.
> [Data Request No. RUCO 29-14S1]

Q. Does ACC Staff Adjustment C-12 eliminate the cost of this particular plan?

A. Yes. This Staff adjustment eliminates the cost of this plan for two reasons. First, as indicated in the preceding quote from Data Request No. RUCO 29-14S1, this plan will be transferred to an affiliate in the year 2000.

1 Second, although the Company has failed to provide detailed plan documentation and other
2 related information concerning the composition of this plan, it appears that the IT-Career
3 Structure Bonus Plan is just another combination of the business unit and corporate
4 components of the ABP, which will be discussed further in a separate subsection. Without
5 additional information beyond that supplied in these responses, it is difficult to engage in any
6 meaningful review of the plan and assess whether the costs thereof should be charged to the
7 Company's regulated ratepayers.

8 **Long-Term Incentive Plan**

9 Q. Could you briefly explain why you have proposed to disallow the test year expense associated
10 with LTIP?

11 A. LTIP was structured as an overlapping three-year plan. For example, the 1997 LTIP
12 encompassed the period 1997-1999, while the 1998 plan covered calendar years 1998-2000.
13 However, according to the response to Data Request No. UTI 60-12, the LTIP terminated with
14 the consummation of the merger and has been replaced with a plan that relies exclusively on
15 stock options, which generates no operating expense. As a result, the Company no longer
16 expects to record any LTIP expense. Because of the LTIP termination, ACC Staff Adjustment
17 C-12 removes the test year recorded expense as a non-recurring cost.

18 Q. If the plan had not been terminated and replaced by a stock plan that does not effect operating
19 expense, do you believe that it would still have been appropriate to remove these costs from
20 the test year?

21 A. Yes. Based on my review if the components of the LTIP, I would nevertheless have
22 recommended the disallowance of these expenses. However, because of the conditions
23 surrounding the termination of this plan, there is no need for a detailed discussion of the
24 various LTIP components.

Short-Term Incentive Plan

Q. Please identify the performance measures that comprise the STIP.

A. The following table summarizes the formula and factors of performance that comprise the 1999 STIP:

Short-Term Incentive Plan

Weight	Component
	Financial:
20%	* Net Income
20%	* Net Cash Flow
20%	* Total Revenue
60%	Total Financial
	Service:
30%	* Consumer CVA (10%) * Small Business Group CVA (10%) * Bus. & Gov't Services CVA (10%)
10%	Wholesale Service Quality Measures
100%	Total

Source: USWC response to Data Request No UTI 60-11.

As indicated in this table, the STIP provides a weighting of 60% for financial measures (net income, net cash flow and total revenue), 30% Customer Value Analysis and 10% Wholesale Service Quality.

Q. Do you recommend that the ACC allow the Company to recover the portion of its STIP costs associated with USWC's financial measures?

A. No. I do not believe that the Commission should allow USWC to recover from ratepayers the cost of incentive compensation plans that focus heavily on the achievement of increasing

financial targets and enhancing corporate profitability. Further, the financial measures included in the STIP and ABP pertain to the Company's operations in all jurisdictions – not just the Company's Arizona operations. Although individual State results are factored into the financial targets and achievement levels, the Company's Arizona operations are not tracked separately or explicitly considered in the incentive compensation calculations. As a result, the opportunity for the Company's Arizona employees to materially influence corporate-wide financial results is limited, since Arizona represents about 15% of the Company's regulated operations.

Q. How have these financial measures changed over time?

A. According to the confidential responses to Data Request Nos. UTI 2-17 and UTI 60-11, the net income targets have increased significantly over the past several years:

($ in millions)	Net Income		Net Cash Flow		Total Revenue	
	Target	Actual	Target	Actual	Target	Actual
1999	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
1998	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
1997	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
1996	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

Sources: Confidential responses to Data Request Nos. UTI 2-17 & UTI 60-11.

During the period 1997 through 1999, USWC has met or exceeded the 100% targets for the applicable financial components.

Q. Could you briefly describe the service quality component of the STIP?

A. Yes. The portion of the 1999 STIP that considers service quality relies heavily (30% weight) on a Customer Value Analysis ("CVA"). The CVA represents the results of [redacted]

[redacted] So, in the traditional sense, the CVA does not directly evaluate the timeliness or adequacy of service installations, changes, repairs or overall quality of the specific service provided to Arizona customers. Instead, the [redacted]. In 1999, the Company only exceeded the minimum target payout level for [redacted] CVA "service" elements. [See confidential Data Request No. 60-11.]

The Wholesale Service Quality Measure addresses USWC's ability to meet [redacted]. According to the 1999 STIP results, USWC's performance achievements [redacted]. Consequently, the Wholesale Service Quality weighted payout level for the 1999 STIP was [redacted]. [See the confidential response to Data Request No. UTI 60-11.]

Q. Do either the CVA or the Wholesale components focus on assessments of service quality in Arizona?

A. No. Like the corporate financial component, both of these service quality measures are based on total Company results. [Data Request No. UTI 18-27.]

Q. What is your recommendation concerning the inclusion of the service quality component of the STIP?

A. During 1999, the Company's confidential response to Data Request No. UTI 60-11 indicates that the STIP achieved a weighted payout of [redacted] as compared to the 100% target level. Concerning the STIP service quality components, the results for [redacted]. This resulted in the financial components contributing [redacted] of the [redacted] pay-out level achieved in 1999, with the service components making up the remaining [redacted]. As a result, the financial components, which constitute only 60% of the STIP weighting, actually comprised [redacted] of the STIP pay-out. Given the heavy financial weighting and the extensive reliance on [redacted] to evaluate service quality, I recommend that the entire cost of the STIP recorded during the test year, including the service quality component, be eliminated for ratemaking purposes.

Annual Bonus Plan

Q. What are the performance measures underlying the ABP?

A. The ABP is comprised of both corporate measures and business unit results, as shown below:

Annual Bonus Plan

Weight	Component
	Corporate Component (aka STIP):
20%	* Net Income
20%	* Net Cash Flow
20%	* Total Revenue
60%	Total Financial
40%	**Individual Business Unit Results**
100%	Total

Source: USWC response to Data Requests UTI 60-11.

As indicated previously, the ABP corporate measures are the same as the executive STIP. So, the Staff proposes to handle the regulatory recovery of the corporate component of the ABP in the same manner as was discussed with the STIP. The individual business unit results component is unique to the ABP.

Q. Should the financial and CVA components of the ABP be disallowed for the same reasons as discussed in the portion of your testimony concerning the STIP?

A. Yes.

Q. Could you explain the "Individual Business Unit Results" which receive a 40% weighting in the ABP?

A. Unfortunately, I can only provide limited information concerning this element of the ABP. For calendar years 1997 through 1999, Data Request Nos. UTI 2-17 and UTI 60-11 sought detailed information for each incentive compensation plan including information presented to employees and other participates as well as plan descriptions and objective measures of performance. Data Request No. UTI 60-14 specifically sought, in part, a copy of the information distributed to employees and other plan participates in 1999 that discuss and describe each individual business unit component of the ABP. With regard to the request for information distributed to plan participates, the response to Data Request No. UTI 60-14 stated:

> Individual business units handle the communication of the ABP to the individual employees. No copies are available. Please refer to response to UTI 53-02 Confidential Attachment B for information provided at employee orientation regarding ABP....
> [Data Request No. UTI 60-14(7)]

The referenced Attachment B (Data Request No. UTI 53-2) is comprised of only four presentation slides that convey general overview information about the structure of the ABP.

This material does not contain any information specific to the goals and objectives for the individual business unit. Rather than supplying documentation that would convey a more comprehensive understanding of the individual business unit process, the Company has represented that "no copies" of the information provided to employees is available in support of this component that receives a 40% weighting in the ABP.

However, the response to Data Request No. UTI 60-14 does provide a general listing by business unit of the performance targets, weighting factors and achieved results for the 1999 plan year. In some instances, this data provides an explanation of the business unit targets while other business unit summaries only provide a "one line" listing of each objective.

Although each individual business unit is responsible for maintaining and communicating their own ABP, USWC has not been able to provide even a representative sampling of any specific employee communications. Without this information, I believe that it is impossible for the Staff or any other party to evaluate the reasonableness of the business unit component of the ABP and consider the propriety of ratemaking recovery of the related incentive compensation costs. As a result, I am recommending full disallowance of this ABP component.

Q. If the Company were to produce the requested employee communications at a later stage of this proceeding, would you be willing to reconsider your proposed disallowance?

A. No. This concern was also raised in the Company's New Mexico rate case. Overall, the Company has now had months to search its records and locate the requested employee communications that should be in USWC's possession and control. For the Staff to have any reasonable expectation to review, evaluate and submit follow-up discovery regarding the business unit target objectives, the Company should have provided such information long ago. I do not believe that USWC should be allowed to gain any advantage, at the expense of the

Staff and the Company's ratepayers, by producing responsive information after the filing of Staff's direct evidence.

Q. Have you attempted to review the confidential business unit information supplied in response to Data Request No. UTI 60-14 in order to evaluate whether some portion of the ABP business unit costs should be allowed?

A. Yes. I have reviewed the confidential information supplied in response to Data Request No. UTI 60-14. Although the information supplied provided less than detailed information in many respects, a significant segment of the business unit objectives were, overall, tied to largely undefined financial performance measures – as contrasted with specific work duties or traditional service quality measures. As a result, ACC Staff Adjustment C-12 proposes a full disallowance of the Business Unit portion of the ABP incentive program.

Additional Considerations

Q. Do you have any other comments for the Commission to consider relative to the treatment of incentive compensation for ratemaking purposes?

A. Yes. In general terms, forms of incentive compensation represent methods of providing monetary compensation to the work force through an unguaranteed bonus or alternative compensation program, in addition to base wages. These programs are typically tied, in part, to targeted financial results, service quality and employee performance. The ratemaking recognition of incentive compensation serves to virtually eliminate company risk of loss for the amounts included in revenue requirement, at ratepayer expense.

Theoretically, employees are motivated to perform well because, if the incentive target levels are not achieved, they will not receive incentive compensation pay. Recognizing that merit increases, workforce reductions and promotions affect a company's total payroll costs, it is generally accepted that employees will continue to receive their base compensation irrespective

of the company's earnings or achieved target levels, provided their work continues to be satisfactory. However, incentive programs require certain conditions other than satisfactory work to precede or trigger the pay-out of the bonus compensation, thereby presumably placing an employee "at risk" for that portion of his/her compensation.

If minimum targets or thresholds are not met, employees do not receive incentive payments and the amount of incentive compensation included in rates only increases the Company's profits. If the targets met are at levels lower than those reflected in rates, employees only receive incentive payments commensurate with levels actually achieved and any difference increases Company profits. Regardless of the level of incentive compensation included in the cost of service, ratepayers would nevertheless be required to fund the allowed level of incentive plan costs – regardless whether the intended benefits were realized or any pay-outs occurred during the period rates were in effect.

Under each of these situations, ratepayers would be "at risk" to fund the incentive plan costs included in regulated rates regardless of pay-out, while employees would be "at risk" because targets might not be achieved for any number of reasons. At the same time, any incentive pay-outs below the levels included in and recovered through revenue requirement would flow through and contribute to the Company's net income.

By setting rates to include incentive compensation, the annual intra-company debate would be who gets the ratepayers' money – the employees or the Company and its shareholders. In my opinion, shareholders benefit through increased profits, revenue and cash flow resulting from employees improving their performance in pursuit of incentive compensation payments. As such, shareholders should be "at risk" or responsible for the potential incentive compensation. In my opinion, the inclusion of incentive compensation in rates would not put shareholders "at risk".

Q. Can the Company decide to forego or reduce plan pay-outs?

A. Yes. USWC has reserved the right to forego or reduce the pay-outs otherwise due under the plan. Although there has not yet been a plan year in which the entire corporation has received no incentive pay-out, the entire corporation has received downward pay-out adjustments based on non-performance. [See USWC response to Data Request No. UTI 25-19]

Q. What has been the annual level of incentive compensation expense over the last several years?

A. In the confidential responses to Data Request Nos. UTI 2-5, UTI 2-17 and RUCO 29-14S1, USWC provided the annual total Arizona amounts of incentive compensation expense, as set forth in the table below:

Period	Amount
1996	[redacted]
1997	[redacted]
1998	[redacted]
1999	[redacted]

Sources: Data Request Nos. UTI 2-5, UTI 2-17 and RUCO 29-14S1

As illustrated by this confidential information, the level of incentive compensation recorded by USWC in Arizona has decreased by 25% since 1997 and is the lowest level in this four year period. Although the Company's response to Data Request No. UTI 43-20, Attachment J, has indicated that the test year accruals should be adjusted to reverse the effect of out-of-period true-ups, the available information does not allow for each prior year to be similarly adjusted to reclassify out-of-period true-ups for consistent comparison purposes.

If existing rates had been set on the levels experienced during 1997, USWC would have continued to collect said amount through rates during the years 1998 and 1999 even though the

actual expenses under the plans were substantially lower. In effect, USWC would retain the difference, while ratepayers would continue to provide funds commensurate with the higher levels. As indicated in the confidential response to Data Request No. UTI 63-5, USWC's EOP annualization approach would result in proforma incentive compensation expense of [redacted], before allocation to intrastate.

Q. Does the Company agree with your views regarding the benefits and costs of incentive compensation?

A. Apparently not. In response to Data Request No. UTI 25-18, USWC provided the following explanation of how customers benefit from incentive compensation:

> As explained in the response to UTI 17-19, the regulatory customer benefits from incentive compensation because such compensation encourages higher levels of performance. There are many ways that high level of performance benefits customers. For example, customers may receive better service or the cost of that service may be lower as a result of employee efficiency. On the other hand, if employees do not earn the incentive compensation, USWC's expenses are reduced. The customer benefits from reduced expenses because reduced expenses ultimately translates into reduced cost of service for rate setting purposes.
> [Data Request No. UTI 25-18(a)]

This response seems to communicate a view that ratepayers stand to benefit regardless whether the incentive plans are successful. On one hand, this response indicates that if the plans are successful in improving service or reducing costs, ratepayers benefit. At the same time, the Company seems to state that even if the goals are not met and employees do not receive any incentive pay, ratepayers would still benefit because expenses are lower due to the non-payment of incentive compensation. This is a classic "heads I win, tails you lose" situation that would seem to benefit ratepayers, using the Company's logic. In fact, this same discovery response goes on to state, in a somewhat contradictory manner, that ratepayer benefits are not

contingent on whether the Company has a rate case pending in which the reduced cost of incentive compensation can be flowed through to ratepayers:

> No, the answer to part a. does not depend on whether USWC has a rate case pending. It may depend on whether the reduced expense is reflected in either a pending rate case or a rate case to be filed.
> [Data Request No. UTI 25-18(b)]

In the absence of a rate proceeding to pass on the reduction in incentive costs to ratepayers, I find it very difficult to envision exactly how USWC's customers could enjoy a potentially multi-million dollar reduction in expense or somehow benefit by the Company not meeting the target objectives. To the extent that ratepayers fail to receive the products/ services or efficiencies that were targeted within USWC's strategic goals, it would seem that ratepayers would be in the unenviable position of: (a) having to fund levels of incentive pay that is not paid out to employees because (b) the target objectives were not met that (c) should have resulted in alleged ratepayer benefits that (d) never materialized. In any event, it is my opinion that the reasoned regulatory approach would be to simply adopt the Staff's proposed disallowance of incentive costs.

Q. Do you believe that the Company should terminate its incentive plans?

A. No. The important point to recognize is that predefined target levels serve as the trigger mechanism for these plans. If these costs are inappropriately included in revenue requirement, the incentive amounts from the ratepayer's perspective become just another form of "base" compensation to employees, or an increased return to shareholders if pay-outs are not made. In other words, assuming rate recovery is allowed, ratepayers would pay the cost of the incentive plans regardless of whether any pay-outs are made to employees or any benefits actually arise.

It is not the Staff's intention or desire to interfere with management's discretion in designing or applying the terms and conditions of employee compensation plans. So, the Staff is not recommending that these incentive plans be terminated. However, the Staff does recommend that the costs associated with certain components of these plans be excluded from the determination of overall revenue requirement in this proceeding.

Q. Do you have any further comments with regard to the incentive compensation expense recorded during the test year?

A. Yes. In response to Data Request No. UTI 43-20, Attachment J identified certain journal entries recorded during the test year that corrected incentive compensation accruals originally booked in calendar years 1997 and 1998. Because these journal entries relate to prior periods, it would typically be appropriate to reverse the effect of those out-of-period true-ups from the test year. The reversal adjustment quantified by the Company would increase intrastate operating expense by about $1.6 million.

In response to Data Request No. UTI 59-24, the Company explained that it accrues for management and occupational team awards in the year prior to actual pay-out. This timing process is necessary because the actual achievements under the various incentive plans are not known or precisely quantifiable until after the close of the plan year. In any event, this response also explained that:

> These accruals are generally based on assumptions that the Company will meet all of its targeted objectives and will, therefore, payout 100% of the team award accruals.
> [Data Request No. UTI 59-24]

On a related matter, the response to Data Request No. 59-23 explains that the Company has not recorded any true-up entries in January through May 2000 that adjust the incentive compensation accruals recorded during the 1999 test year. While I have no reason to question

this response, it does raise questions about the reasonableness of the accruals recorded during the test year.

Q. Please explain.

A. If the incentive compensation accruals recorded during 1999 were based on an assumption that the Company would, on average, achieve100% of the target results, the test year accruals may be excessive. In the confidential responses to Data Request Nos. UTI 60-11 and UTI 60-14, the Company provided specific information regarding the targets and objectives for the various incentive plans. Needless to say, it does not appear that the average levels achieved during the 1999 plan year met or exceeded 100% of the target level.

As a consequence, the Company may yet record correcting or true-up journal entries later in the year 2000 or 2001 with downward revisions to the 1999 accruals for incentive compensation expense. In the event that the Commission does allow the Company to recover the test year levels of incentive compensation "as recorded" during 1999, such amounts may be excessive and overstated.

SOP 98-1 (Internal-Use Software)

Q. Please describe ACC Staff Adjustments C-13 and B-2.

A. ACC Staff Adjustment C-13 recognizes the effect of recent changes in accounting for the cost of computer software developed or obtained for internal use. This adjustment, in conjunction with ACC Staff Adjustment B-2, also reflects the Company's correction to its test year accounting for internal use software.

Q. Please describe this recent accounting change.

A. The following discussions, which appear in USWC's 1998 and 1999 SEC Form 10-K Annual Reports, provide concise summaries of this accounting change and the related effects on the Company's results of operations:

> **1998 SEC 10-K**
> On January 1, 1999, we adopted the accounting provisions required by the American Institute of Certified Public Accountants' Statement of Position ("SOP") 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," issued in March 1998. SOP 98-1, among other things, requires that certain costs of internal use software, whether purchased or developed internally, be capitalized and amortized over the estimated useful life of the software.
>
> Based on information currently available, adoption of the SOP may result in an initial increase in net income in 1999 of approximately $100-$150 [million]. In periods of adoption, if software expenditures remain level, the impact on earnings will decline until the amortization expense related to the capitalized software equals the software costs expensed prior to the accounting change. [USWC 1998 SEC Form 10-K, p.16]

> **1999 SEC 10-K** [all amounts in millions]
> COMPUTER SOFTWARE. On January 1, 1999, we adopted the accounting provisions required by the American Institute of Certified Public Accountants' Statement of Position ("SOP") 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use". SOP 98-1, among other things, requires that certain costs of internal use software, whether purchased or developed internally, be capitalized and amortized over the estimated useful life of the software. Capitalized computer software costs of $544 and $180 at December 31, 1999 and 1998, respectively, are recorded in property, plant and equipment and other assets - net. Amortization of capitalized computer software costs totaled $104, $82 and $78 in 1999, 1998 and 1997, respectively. [USWC 1999 SEC Form 10-K, p. F-6, FreeEdgar.com]

All non-governmental entities were required to implement this accounting change for fiscal years starting after December 15, 1998. Accordingly, USWC adopted SOP 98-1 on January 1, 1999, for financial reporting purposes, but not for regulatory accounting purposes.

Q. Why did SOP 98-1 require the capitalization and amortization of the cost of internal use software?

A. According to the Accounting Standards Executive Committee, the SOP 98-1 project was undertaken because of inconsistent accounting for software costs. The following historical information was extracted from the Introduction and Background section of SOP 98-1:

> 1. The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed*, in 1985. At that time, the FASB considered expanding the scope of that project to include costs incurred for the development of computer software for internal use. The FASB concluded, however, that accounting for the costs of software used internally was not a significant problem and, therefore, decided not to expand the scope of the project. The FASB stated that it recognized that at that time the majority of entities expensed all costs of developing software for internal use, and it was not convinced that the predominant practice was improper.
>
> 2. Because of the absence of authoritative literature that specifically addresses accounting for the costs of computer software developed or obtained for internal use

> and the growing magnitude of those costs, practice became diverse. Some entities capitalize costs of internal-use computer software, whereas some entities expense costs as incurred. Still other entities capitalize costs of purchased internal-use computer software and expense costs of internally developed internal-use computer software as incurred.
>
> 3. The staff of the Securities and Exchange Commission (SEC) and other interested parties have requested that standard setters develop authoritative guidance to eliminate the inconsistencies in practice. In a November 1994 letter, the Chief Accountant of the SEC suggested that the Emerging Issues Task Force (EITF) develop that guidance. However, the EITF and the Accounting Standards Executive Committee (AcSEC) agreed that AcSEC should develop the guidance.
> [SOP 98-1, p.7]

In addition to improving the comparability of financial data between entities, AcSEC expressed the belief that

> "...the costs of computer software developed or obtained for internal use are specifically identifiable, have determinate lives, relate to probable future economic benefits (FASB Concepts Statement No. 6), and meet the recognition criteria of definitions, measurability, relevance, and reliability (FASB Concepts Statement No.5). [SOP 98-1, par.64]

Q. Has the FCC adopted SOP 98-1 for interstate regulatory purposes?

A. Yes. In an order issued on June 30, 1999, the FCC adopted SOP 98-1.

Q. Are you recommending that the ACC adopt capitalization accounting for internal use software because the Company has been required to adopt SOP 98-1 for both external financial reporting purposes and FCC regulatory purposes?

A. No. In general terms, costs which relate solely to the current period should be expensed as incurred. Costs incurred during the current year that relate to prior years should also be expensed. However, those costs that provide identifiable benefits or otherwise relate to more than one future period should be capitalized and amortized over the expected benefit period.

Nevertheless, the mere recognition of a cost as a current period expense does not necessarily equate to inclusion in rates. For example, the regulatory process typically eliminates operating expenses associated with prior periods. Similarly, the level of certain costs recorded as expense in a particular test year may be abnormal (i.e., too high or too low), thereby requiring normalization adjustments to reflect reasonable ongoing levels.

Q. During 1999, did USWC account for the cost of internal-use software differently in its financial accounting records than in its regulatory accounting records?

A. Yes. For financial accounting purposes, the Company capitalized the cost of internal-use software costs, consistent with SOP 98-1 as noted in the earlier SEC 10-K excerpts. At that time, USWC continued to expense the costs of internal-use software in its regulatory books of accounts. However, following the FCC's adoption of SOP 98-1, the Company similarly modified its accounting for the interstate portion of its regulated operations to reflect this change in capitalization, but continued to expense the portion of those same costs allocated to its intrastate operations.

Q. Could you explain how the Company can use different accounting treatments for the same item in its accounting records?

A. Yes. USWC maintains and reports its financial results using accounting methods that may treat certain transactions differently for financial reporting, FCC reporting and State regulatory reporting purposes. The Company's financial reporting records are maintained on what is generally referred to as an "FR" (or financial reporting) basis, consistent with Generally Accepted Accounting Principals (or "GAAP"). The Company's financial results in Arizona are initially prepared and maintained consistent with FCC accounting requirements. These results are generally identified as being presented on an "MR" basis. Any differences in accounting treatments or requirements that exist between the FCC and State regulatory agencies are accounted for in the Company's "offbook" or side records, thereby allowing for

specific tracking and consideration of these differences in State regulatory proceedings. The Company's "JD" reports reflect the accounting presentation that incorporates any "jurisdictional" accounting differences with the FCC and is consistent with State accounting requirements. While it is not as complicated as it may seem, USWC has adopted SOP 98-1 and accounts for the capitalization of internal-use software for both "FR" and "MR" accounting purposes, but continues to expense these costs for "JD" accounting purposes in the absence of a Commission decision adopting SOP 98-1 for intrastate regulatory purposes.

Q. Why does the Company report its operating results to the financial community on a different basis than is reported to the FCC?

A. As indicated in USWC's 1993 annual report to the Securities and Exchange Commission (SEC 10-K), the Company incurred a non-cash, extraordinary charge of $3.0 billion, net of income taxes, in conjunction with its decision to discontinue accounting for its operations in accordance with Statement of Financial Accounting Standards No. 71 (FAS71), "Accounting for the Effects of Certain Types of Regulation." The Company's decision to discontinue the application of FAS71 "was based on the belief that competition, market conditions and the development of broadband technology, more than prices established by regulators, will determine the future revenues of the Company." As a result of this change, the operating results reported to the financial community diverge from the results reported for regulatory purposes, because the Company's regulatory accounting and reporting methods were not affected by this change. So, the Company began maintaining different accounting records for financial reporting purposes than for regulatory purposes.

Q. The earlier quotes from USWC's 1998 and 1999 SEC 10-Ks, indicated that the adoption of the SOP 98-1 would result in increased net income during 1999. Has the Company proposed to reflect the Arizona share of this increase in net income in its proposed revenue requirement?

A. No. According to the response to Data Request No. UTI 13-21, USWC has neither proposed nor intends to seek Commission approval to recognize this accounting change for intrastate regulatory purposes.

Q. What is USWC's current estimate of the annual software costs to be shifted between expense and capital accounts?

A. Initially, USWC's response to Data Request No. UTI 13-21 estimated that, on a total USWC basis, the Company would capitalize between $340-$390 million in 1999. USWC's 1999 SEC 10-K stated that the Company had capitalized $544 million of internal-use software costs. However, the Company's confidential responses to other Staff discovery requests indicate yet a different level, which falls within this range. [See USWC responses to Data Request Nos. UTI 13-21 and UTI 64-4.]

Q. How much of this shift between expense to capital accounts during 1999 occurred on an Arizona intrastate basis?

A. Although USWC began accounting for the effect of SOP 98-1 for MR basis accounting purposes in 1999, the actual test year amounts recorded in Arizona reflect various accruals, reversals and corporate prorate misallocations. Based on the available information, it seemed more appropriate to allocate total USWC amounts to Arizona intrastate operations, rather than rely on questionable test year data.

ACC Staff Adjustment C-13 presents the quantification of this apportionment and allocation process. Using confidential data supplied in response to Data Request No. UTI 64-4, the Arizona intrastate portion of this reclassification between expense and capital accounts would be approximately [redacted].

Q. Do you have any information which addresses why USWC has not sought ACC approval to capitalize internal-use software?

A. Yes. Data Request No. UTI 13-21(d) specifically requested USWC's position regarding whether this change should be reflected in Arizona revenue requirements. The Company's response to this portion of that discovery request is reproduced below.

> The company has not petitioned the Arizona Corporation Commission to adopt the software capitalization accounting. Since the life for the capitalized software is very short, the effect of this accounting on ratemaking is to produce a first year dip in revenue requirements followed by a near term turnaround of revenue requirements and over time, higher revenue requirements. Furthermore, the change from expensing of software to capitalization is not cash affecting, while the ratemaking effect would be cash affecting. Given both the short term revenue requirement profile and the fact that software capitalization is not cash affecting the Company does not intend to petition the Arizona Corporation Commission to adopt this accounting.
> [Data Request No. UTI 13-21(d)]

Q. Do you have any comments on the Company's position, as stated in the response to Data Request No. UTI 13-21(d)?

A. Yes. The Company's "not cash affecting" position is specious. As indicated in the response to Data Request No. UTI 20-12(a), the phrase "not cash affecting" simply means that the change in accounting method will not result in any change in the amount or timing of USWC's cash payments to fund software development and modification efforts. Further, the response to Data Request No. UTI 20-12(b) confirms that changes otherwise "not cash affecting" become "cash affecting" merely by recognizing those accounting changes for ratemaking purposes.

While these statements are technically true, it is important to recognize that this same "not cash affecting" label applies to a variety of other accounting changes for which USWC has previously sought regulatory approval and ratemaking treatment. Such items include:

- capital to expense shifts resulting from the adoption of the "new" uniform system of accounts prescribed by the FCC (i.e., Part 32);
- change in accounting from the cash method to the accrual method of accounting for compensated absences, merit awards and medical/ dental expenses;
- increase in the capitalization rules from $200 to $500, allowing the expensing of qualifying "small value" assets;
- increase in the capitalization rules from $500 to $2,000, allowing the expensing of qualifying "small value" assets;
- adoption of revisions to depreciation accrual rates and depreciation reserve deficiency amortizations;
- adoption of the FAS87 accrual method of accounting for pension costs; and
- adoption of FAS106, which implemented a change from cash to accrual method of accounting for post-retirement benefits other than pensions.

All of these items, but the adoption of FAS87, had the effect of initially increasing the rates charged USWC's ratepayers. Although those changes were "not cash affecting" until included in the ratemaking process, the Company still sought regulatory approval and rate treatment.

Q. Is it true that adoption of SOP 98-1 will produce a first year dip in revenue requirements followed by higher revenue requirements over time?

A. Yes. That is a true statement. However, the capital to expense shifts resulting from the adoption of FCC Part 32 resulted in higher initial revenue requirements followed by lower revenue requirements over time. In order for the Company's regulated customers to receive the full benefit of the capital to expense shift resulting from Part 32 accounting, USWC's intrastate rates would need to continue to be set on the basis of the Company's cost of providing service for at least several more years. Nevertheless, any change in accounting method has revenue requirement trade offs.

Q. Since you are recommending that internal-use software be capitalized, rather than expensed currently, how will the Company recover that investment?

A. With limited exceptions, capital assets are either depreciated or amortized to expense over a reasonable period of time. As a result, the capitalized cost of internal-use software will be recovered through a multi-year amortization to operating expense.

Q. What period are you using to amortize these capitalized software costs?

A. In response to Data Request No. UTI 15-20, the Company provided a calculation estimating the relative revenue requirement effect of adopting SOP 98-1. USWC used a five (5) year amortization period in that calculation, which I propose to use for purposes of amortizing such costs for intrastate ratemaking.

USWC PAYROLL ADJUSTMENT REVERSAL

Q. Please describe ACC Staff Adjustment C-14.

A. ACC Staff Adjustment C-14 reverses a payroll and benefit annualization proposed in the Company's updated filing in this proceeding and identified as USWC Adjustment P-02.

Q. Why is the elimination, or reversal, of this adjustment necessary?

A. The reversal of this adjustment is appropriate for two reasons. First, as discussed previously, ACC Staff Adjustment C-11 already has the effect of annualizing payroll and benefit expense to consistently recognize both wage/salary rates and employee headcounts to levels at year-end 1999. Second, as discussed herein, this Company adjustment has the effect of inconsistently and inappropriately reaching out beyond test year-end to solely recognize two price level changes occurring in the year 2000, without similarly reflecting other post-test year changes such as growth in revenue levels.

Q. Could you identify these price level changes?

A. Yes. The specific price changes underlying USWC Adjustment P-02 include an increase for management employees effective March 1, 2000, and an increase for occupational employees effective August 15, 2000.

Q. Why do you believe that it is inappropriate to recognize the effect of these post-test year increases on wage/ salary expense for ratemaking purposes?

A. The ratemaking process in the State of Arizona is predicated on the concept of a historic test year. Although annualization and normalization adjustments are common in establishing the rates charged for regulated service, I do not believe that the Company should be allowed to selectively recognize the effect of post-test year changes when the annualized amounts, by definition, represent funds which were neither incurred nor expended during the historic test

year. In my opinion, it is one thing to annualize payroll expense to recognize the ongoing effect of cost changes implemented during the historic test year, but totally inappropriate to inconsistently capture isolated events as suggested by the Company.

Q. Would you agree that the Company will actually be paying the higher wage and salary rates by the time the Commission issues its final order in this proceeding?

A. Yes. One of the increases has already been implemented and the second will be implement shortly after the Staff files its direct testimony. There is no question that the higher wage and salary rates will be effective on a prospective basis. However, this does not justify the retrospective imposition of this effect on the 1999 test year.

As discussed in the test year section of my testimony, the revenue requirement formula is a combination of various elements: rate base, operating revenues, operating expenses and capital cost rates. When determining the valuation for each of these elements, it is imperative that the approach be internally consistent and comparable. Otherwise, any rate change could be seriously misstated.

My test year testimony section contains a series of charts that generally show increasing trends in rate base, access lines, employee counts, operating revenues, and operating expenses. Certainly, operating expenses and investment have increased, but so have operating revenues. Changes in one area that increase revenue requirement might be offset by decreases in other areas. A rate proceeding must balance these various elements of the revenue requirement formula and avoid the piecemeal recognition of only certain items to the exclusion of others.

In order to avoid such piecemeal distortions, there are two basic options available in setting rates. First, the various components of cost of service can be valued using a relatively stringent test year cut-off, as proposed by the Staff. Second, a specific post-test year known and

measurable period can be selected which allows all parties to identify the various adjustments that might be required in order to consistently match any number of changes occurring outside the test year. In a sense, the update of the test year from June 1998 to calendar year 1999 is an exercise encompassing an 18 month known and measurable period update. Unfortunately, USWC responds, in part, by continuing to reach out well beyond December 1999 into August 2000 to capture piecemeal wage and salary increases.

Q. Referring to the test year section of your testimony, you refer to and compare the Company's two revenue requirement filings. Do you believe that this comparison helps illustrate why the piecemeal recognition of post-test year changes should be avoided?

A. Yes. These two Company filings employ test years that were 18 months apart, but do not support a material change in overall revenue requirement. Although the Staff does not concur with the Company's EOP annualization approach in many areas, the fact remains that a relatively consistent application of USWC's ratemaking theories did result in a fairly limited change in the Company's filed revenue deficiencies – evidence demonstrating why piecemeal ratemaking should be avoided.

Obviously, these two Company test year filings employ different valuations for rate base, revenues and expenses. While the Staff would likely have proposed any number of ratemaking adjustments to either test year, the fact remains that all components of the ratemaking formula had changed during this 18 month period – but overall revenue requirement was relatively constant. Although there may seem to be some compelling need to reach out in a piecemeal fashion to selectively capture post-test year changes, the passage of time does <u>not</u> guarantee that revenue requirement will only go upward.

PROFORMA DEPRECIATION ANNUALIZATION

Q. Please describe ACC Staff Adjustments C-15 and B-5.

A. ACC Staff Adjustment C-15 represents the annualization of depreciation expense based on the depreciable plant included in rate base and the test year update to the depreciation accrual rates that were the subject of the Commission in Decision No. 62507 dated May 4, 2000 (Docket No. T-01051B-97-0689). This Staff adjustment represents an incremental change to the adjustment quantified in USWC's update filing.

USWC's update also reflected a proforma adjustment to rate base to recognize the depreciation reserve and deferred income tax reserve effects of the increase in depreciation expense due to the Commission's May 2000 represcription order. Because USWC did not commence booking these revised depreciation rates reflected in ACC Staff Adjustment C-15 until subsequent to the 1999 test year, ACC Staff Adjustment B-1 excludes the proforma effect of USWC's capital recovery adjustment from rate base (i.e., accumulated depreciation reserve and accumulated deferred income tax reserve).

Q. How was ACC Staff Adjustment C-15 quantified?

A. Book depreciation was annualized by multiplying the intrastate investment in depreciable plant as of December 31, 1999, by the updated test year accrual rates (i.e., by plant account) discussed by Staff witness Dunkel. The aggregate amount of the proforma depreciation was then compared to the sum of USWC's updated annualization adjustment and the amount of depreciation expense recorded in Account 6561 during the test year.

Q. Why did you quantify the Staff Adjustment C-15 in this manner?

A. USWC update Adjustment P-03 contained several errors that were corrected by Staff Adjustment C-15. First, the Company's annualization of the proforma effect of the change in

book depreciation rates was quantified improperly in USWC's update filing. Instead of quantifying the increment of annualized depreciation on year-end depreciable plant in excess of the as recorded or per book amount, the Company effectively multiplied the change in book depreciation rates by the end-of-period depreciable investment. The annualization approach used in the Company's update filing failed to capture the full annual depreciation effect of the increase in depreciable plant during the test year. Staff Adjustment C-15 corrects this error, which USWC also corrected in its response to Data Request No. UTI 52-14.

Second, USWC update Adjustment P-03 also had the effect of including above-the-line the depreciation on FCC Deregulated Services twice. In determining the "per book" test year starting point for the update test year, USWC recognized and included about $4.5 million of depreciation expense on the FCC Deregulated Services. However, when USWC prepared update Adjustment P-03, the Company's calculations also included an additional $4.1 million of annual depreciation without recognizing that the test year already included $4.5 million. Staff Adjustment C-15 corrects this error, which USWC also corrected in its response to Data Request No. UTI 52-14.

Q. Were there any other errors in quantifying depreciation expense in the Company's update filing that the Staff has corrected?

A. Yes. USWC update Adjustment P-03 also had the effect of annualizing the incremental effect of the higher depreciation rates on the depreciable plant associated with the access lines being sold to Citizens Utilities Company. Unfortunately, the Company's quantification of the adjustment to remove the access line sale from revenue requirement did not capture the effect of this increase in depreciation expense due to represcription. Although USWC did quantify the necessary correction in its response to Data Request No. UTI 52-14, the Company's filed update depreciation adjustment is misstated.

Q. Did ACC Staff Adjustment C-15 also correct the depreciation associated with the access line sale?

A. No. ACC Staff Adjustment C-15 does quantify, but does not post, the amount of the updated depreciation accrual rates applicable to the depreciable plant sold. In order to more readily identify the various components of the access line sale, Mr. Brosch has included the effect of this correction in the quantification of ACC Staff Adjustment No. C-29.

Q. In your opinion, is USWC in agreement with these various corrections or modifications?

A. Based on my review of the Company's responses to Data Request Nos. UTI 52-14 and UTI 58-18, it is my opinion that USWC does concur with these corrections.

Q. Did the correction of the errors in the Company's annualization methodology have the effect of increasing or decreasing revenue requirement?

A. In general terms, the correction of the Company's annualization methodology by Staff Adjustment C-15 had the effect of increasing intrastate revenue requirement.

Q. Why do you believe that it would not be appropriate to reflect the annual effect of the proposed depreciation rate increase in the quantification of rate base?

A. By Decision No. 60928 (Docket No. T-01051B-97-0689), the Commission denied USWC's request for a waiver from A.A.C. R14-2-102 and required the Company to file a rate application to enable the Commission to examine all of the Company's costs, expense and revenue levels including the effect of potential changes in depreciation rates. While the annualization of depreciation expense for ratemaking purposes should synchronize the new depreciation rates with the level of depreciable plant included in rate base, the determination of rate base should be valued at December 31, 1999 – as appropriately adjusted for eliminations, corrections or other valuation issues. In my opinion, the Commission should <u>not</u> reach out more than twelve months beyond test year-end to capture, in isolation, the full

proforma annual effect of the change in depreciation rates on the December 31, 1999, year-end balances for the accumulated depreciation reserve and the accumulated deferred income tax reserve. Otherwise, test year distortions and mismatched components of the ratemaking equation would yield improper results.

Q. As a result of reversing USWC's proforma effect on the accumulated depreciation reserve and the accumulated deferred income tax reserve, did Staff Adjustment B-5 have the effect of increasing or decreasing overall revenue requirement?

A. As indicated on ACC Staff Schedule F, Staff Adjustment B-5 increased intrastate revenue requirement by about $9 million.

Q. How does the value of the Staff's annualized depreciation expense compare to the level of depreciation actually recorded by the Company during the 1999 test year?

A. Referring to ACC Staff Adjustment C-15, the annualized level of intrastate depreciation expense (i.e., using the Staff's updated test year depreciation accrual rates as applied to year-end 1999 depreciable plant) is approximately $323.7 million. During the test year, the Arizona intrastate portion of the book depreciation expense actually recorded by USWC was about $222.9 million. In effect, the year-end annualization process yields about $100.8 million more depreciation expense than was actually recorded during the test year.

Q. Is the entire increase in depreciation expense of $100.8 million related solely to the change in book depreciation rates?

A. No. During 1999, the amount of book depreciation expense actually recorded by the Company is based on average depreciable investment. As the Company's investment in depreciable plant increases, so does the amount of related depreciation expense. Since USWC has increased the level of depreciable investment during the test year, the annualization of depreciation expense on year-end investment would be higher than recorded amounts – even if the Commission had

not authorized any changes in book rates. So, a portion of the $100.8 million increase in depreciation is related to the growth in depreciable plant with the balance due, in theory, to the change in depreciation rates.

Q. Do any of these depreciation amounts consider the offsetting effect of the pending sale of USWC's Arizona access lines?

A. No . As discussed previously, the amounts discussed in this section of my testimony are based on plant investment prior to the effect of the exchange sale. The direct testimony of Staff witness Dunkel will discuss other issues related to the magnitude of the depreciation rate change and Staff witness Brosch will apply the depreciation effect of the exchange sale.

INTEREST SYNCHRONIZATION

Q. Please describe ACC Staff Adjustment C-16.

A. ACC Staff Adjustment C-16 synchronizes the interest deduction for income tax purposes with the weighted cost of debt and the rate base recommendation of the ACC Staff. This method of annualizing interest expense is commonly referred to as interest synchronization.

Q. Please define interest synchronization.

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

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

A. Yes. USWC Adjustment C-06 adjusts income tax expense to synchronize the amount of interest expense with the Company's proposed rate base and weighted average cost of debt.

Q. If the Company employed interest synchronization in developing its revenue requirement, why is it necessary for the Staff to separately quantify an adjustment for interest synchronization?

A. Had the Staff concurred in the Company's valuation of both rate base and cost of capital, a separate adjustment for interest synchronization would not have been necessary. However, the Staff's rate base recommendation differs from the Company's proposal. Consequently, it was necessary for the Staff to quantify a separate adjustment to recognize the ratemaking deduction for interest expense. In the event that the Commission ultimately adopts different rate base or capital cost valuations than presented by the Staff or the Company, interest synchronization should be recalculated using the Commission's findings, thereby appropriately synchronizing these revenue requirement elements.

FCC DEREGULATED SERVICES IMPUTATION

Q. Please describe Staff Adjustment No. C-17.

A. In the development of its updated revenue requirement filing, the Company has proposed to include above-the-line (or impute for intrastate ratemaking purposes) all revenues, expenses and investment associated with the provision of FCC deregulated services (except for Payphone, Wireless and Video Dialtone services) in the State of Arizona. Staff Adjustment C-17 imputes additional revenues above-the-line in order to ensure that the earnings deficiency associated with these FCC deregulated services are not borne (or cross-subsidized) by the remainder of USWC's Arizona customers subscribing to the Company's intrastate regulated products and services.

Q. Please describe the reference to FCC Deregulated Services.

A. In general, USWC provides a variety of services in Arizona that fall into one of three "jurisdictional" categories: interstate FCC regulated services; intrastate ACC regulated services; and services that have been either deregulated or never regulated by either the FCC and/or the ACC.

USWC maintains its Arizona accounting records pursuant to FCC Part 32 (the system of accounts) on a "total" State basis. FCC Part 36 governs the jurisdictional separation (i.e., allocation) of the "total" State amounts between interstate and intrastate operations. However, the Part 36 separations rules require that nonregulated results be determined (for the FCC Deregulated Services) pursuant to FCC Part 64 rules and be removed before the jurisdictional separation process allocates the remaining costs between the interstate and intrastate spheres of USWC's Arizona operations.

FCC deregulated services are considered to be enhanced services, pursuant to FCC definitions and rules, and are specifically excluded from interstate results. The following example illustrates how the FCC Deregulated services would be excluded from the jurisdictional separation of operating expense, assuming an interstate gross allocator of 25%:

Jurisdictional Separations	Interstate Regulated	Intrastate Regulated
"Total" AZ Expense	$100,000	$100,000
Less: FCC Dereg Expense (per FCC Part 64 Rules)	-10,000	-10,000
Expense Subject to Separations	90,000	90,000
Interstate Separation (per FCC Part 36)	25.00%	
Interstate Regulated	$22,500	-22,500
Intrastate Regulated ("total"-FCC dereg-interstate)		$67,500

Jurisdictional Expense Recap:	
FCC Deregulated Services	$10,000
Interstate Regulated Services	22,500
Intrastate Regulated Services	67,500
"Total" AZ Expense	$100,000

However, for the purpose of assembling its overall revenue requirement in the current rate proceeding, USWC has not limited its calculation of the intrastate cost of service to the $67,500 shown in the above example. Instead, the Company has proposed to include the FCC Deregulated Services (revenues, expenses and investments) above-the-line for intrastate ratemaking purposes. Using the above example, the Company's proposal has the effect of recognizing operating expense of $77,500 ($67,500 Intrastate plus $10,000 FCC Deregulated

Services) in the calculation of overall revenue requirement, not the $67,500 resulting from the jurisdictional separations process.

Q. In the aggregate, does USWC's proposal to include the FCC Deregulated Services above-the-line for intrastate ratemaking purposes have the effect of increasing or decreasing the overall revenue requirement presented in the Company's update filing?

A. Referring to the Company's revenue requirement workpapers and ACC Staff Adjustment C-17, USWC has proposed to increase rate base by approximately [redacted] and decrease net operating income by about [redacted]. In the aggregate, USWC's proposed inclusion of the FCC Deregulated Services above-the-line has the effect of increasing overall revenue requirement by about $3.5 million.

Q. How does Staff Adjustment No. C-17 ensure that the aggregate earnings deficiency of the FCC deregulated services is not borne or cross-subsidized by the balance of USWC's Arizona ratepayers?

A. The Company's proposal has the effect of increasing revenue requirement to recover the imputed revenue deficiency (associated with the above-the-line inclusion of the FCC deregulated service net operating loss and rate base investment) through its intrastate regulated rates. The proposed Staff adjustment imputes the additional revenues required for these FCC deregulated services to generate an above-the-line return on investment, or net operating income, equivalent to the weighted cost of capital return proposed by ACC Staff witness Hill for the Arizona regulated services.

Therefore, by allowing the FCC deregulated services above-the-line in conjunction with this Staff adjustment, the Company's FCC deregulated services would be recognized in the intrastate ratemaking process as if those services were generating sufficient revenues to cover

the related expenses and provide a return on the associated rate base investment equivalent to the regulated return adopted by the Commission in this proceeding.

Q. If the Commission's final order adopts a weighted cost of capital different than that proposed by the ACC Staff, would it be necessary to recalculate ACC Staff Adjustment C-17 to reflect such change?

A. Yes. If the Commission were to adopt different levels of FCC Deregulated Services rate base, revenues, or expenses than proposed by Staff or a different capital structure or cost rates than recommended by the Staff, it would be necessary to recalculate the effect of ACC Staff Adjustment C-17, unless such changes had an immaterial effect on the calculation of imputed revenues.

Q. Are you recommending that the Company not continue to provide these services?

A. No. The purpose underlying the Staff's recommendation is to ensure that regulated ratepayers do not fund the earnings deficiency resulting from the Company's decision to provision the FCC Deregulated Services. If USWC desires to provide these various services in this manner, the Staff is not seeking to interfere with that management discretion.

USWC's Above-The-Line Rationale

Q. Why has USWC proposed to include the earnings deficiency associated with these FCC deregulated services above-the-line for ratemaking purposes?

A. Since USWC's direct testimony does not specifically discuss or reference its position on this issue, a series of data requests were submitted to explore the rationale for the Company's proposed treatment. Generally, USWC has taken the position that these services are intrastate regulated services which must be included above-the-line for intrastate ratemaking purposes, in the absence of specific ACC findings that serve to deregulate such services. The following

excerpts from USWC discovery responses provide further rationale for the Company's position:

- **UTI 3-19**: The ACC regulates all FCC deregulated products with the exception of Interstate Billing & Collection. Additionally payphone and wireless were premptively [sic] deregulated by the FCC and the Telecommunications Act of 1996.

- **UTI 14-14**: USWC refers to Part V, paragraph A5 of ACC Decision 58927, indicating that the Commission continues to regulate certain products that the FCC has deregulated. Further, in Decision 58927, the Commission recognized the confusion in this area and ordered a separate proceeding to further investigate how to handle services deregulated by the FCC. USWC correctly observed that no such proceeding has been undertaken.

- **UTI 14-15**: U S WEST favors State deregulation of FCC deregulated products. However, in the current proceeding, the Company has chosen not to contest the past practice of the Arizona Commission to include these items in the revenue requirement determination.

- **UTI 14-18**: ACC Decision No. 58927 attempted to address the confusion around this issue by directing that a proceeding be instituted for the purpose of investigation how to handle FCC deregulated services in Arizona. However, no such proceeding has ever taken place.

- **UTI 24-8**: All USWC rationale for the inclusion of the FCC deregulated services above-the-line for Arizona intrastate ratemaking purposes was provided in the response to UTI 14-14, UTI 14-15 and UTI 14-18. No other support exists for the Company's proposed ratemaking treatment.

These USWC discovery responses essentially contend that the Commission has previously included the FCC Deregulated Services above-the-line for intrastate ratemaking purposes – a practice the Company decided to not contest in this proceeding. ACC Decision 58927 and the Company's position on this issue will be addressed in a following subsection.

Products and Services

Q. Could you briefly identify the various products and services which are included in the category of FCC deregulated services that are at issue in this proceeding?

A. Yes. The following table briefly lists the general FCC deregulated product categories that USWC has proposed to include in the intrastate ratemaking process, as part of its update filing:

- Protocol Conversion
- Customer Telecom Services
- Information Services (Enhanced Fax, E-911)
- Temporary Cellular Service
- Account Recording
- Buyer's Advantage
- Alarm Services
- Electronic Directory Assistance
- Information Storage Forward and Retrieval System (Voice Messaging)
- Planning for Nonregulated Services
- Joint Marketing

Sources: Data Request Nos. UTI 1-15 and Confidential UTI 42-6.

Q. Is USWC losing money on the FCC deregulated services offered in Arizona?

A. Yes. This fact is evident from the financial data supplied in the confidential responses to Data Request Nos. UTI 3-19, UTI 20-27 and UTI 42-6 as well as the simple admission provided in response to RUCO 4-25.

In the aggregate, the thirteen (13) FCC deregulated service categories that USWC has proposed to include above-the-line for ratemaking purposes operated at a net loss during the test year. Comparing the Company's original filing with the test year update, the net loss and rate base investment USWC has proposed to include above-the-line has declined. However, these services continue to be provided at a loss.

In contrast, [redacted] is the only FCC deregulated service category that generated significant positive income during the test year, thereby minimizing the net loss from all other FCC Deregulated Services. However, the Company has filed a petition with the ACC to deregulate this service in the State of Arizona. Absent the positive earnings generated by this

service, the revenue imputation amount presented on ACC Staff Adjustment C-17 would be substantially larger.

Q. What steps has USWC undertaken to ensure that the prices charged for other regulated telephone services do not subsidize the losses from the Company's FCC deregulated lines of business?

A. Other than the possibility of State deregulation, USWC has not identified any steps that it has taken to avoid cross-subsidization from its intrastate regulated telephone operations. USWC responded to such a question posed by Data Request No. RUCO 4-25 by simply referencing to its earlier responses to UTI 14-14(a) and UTI 14-15(a) as well as RUCO 4-24. Interestingly, Data Request No. UTI 14-14 refers to the ACC's decision to continue to regulate these FCC deregulated services in the Company's last Arizona rate case, while UTI 14-15 conveys USWC's preference for State deregulation.

In responding to the inquiry by RUCO 4-24(a) about the steps taken by USWC to protect against cross-subsidies of its payphone and wireless lines of business (preemptively deregulated by the FCC) by regulated telephone services, the Company surprisingly states that it follows Part 64 accounting rules, which prevent cross subsidization. As I indicated previously, USWC has not proposed to include these preemptively deregulated services above-the-line for Arizona ratemaking purposes. However, the Company has chosen to ignore the Part 64 rules, designed to prevent cross subsidization, for all other FCC deregulated services by reflecting the aggregate losses experienced by those services and related net investments above-the-line without any revenue imputation – contrary to the ACC's order in USWC's last Arizona rate case.

Q. Why do you believe that revenue imputation is the appropriate response to the Company's request to include the losses from the FCC deregulated services above-the-line?

A. There are several reasons why I believe that full revenue imputation proposal offered by the ACC Staff is the only rational approach to this issue.

First, USWC has discretion over the pricing of these services or whether to seek price increases for other services still provided pursuant to tariffs filed with the ACC. If the Company believes that deregulated product revenues are unacceptably insufficient to cover the recorded cost of a service or group of services, the appropriate response would be for the Company to either decrease costs or increase the price charged – not shift responsibility for the losses incurred to USWC's intrastate customers taking regulated service. To the extent that USWC exercises discretion over the pricing of its FCC deregulated services, it should be shareholders, not ratepayers, who are accountable for the losses from such operations.

Second, USWC can (and has) significantly increase(d) the prices charged for certain FCC deregulated services, while reducing or restructuring the prices charged for others. In doing so, the operating loss recorded during the test year could change and not be representative of ongoing conditions. The combination of post-test year price increases <u>and</u> Commission adoption of USWC's above-the-line recommendation could result in the double-recovery of a portion of the losses experienced by USWC on its FCC deregulated services. In other words, the test year losses could be recovered through: (a) higher post-test year prices charged for the FCC deregulated services and (b) the increased revenue requirement borne by regulated customers due to the adoption of USWC's above-the-line recommendation.

Third, USWC may petition the ACC at any time seeking the State deregulation of any (or all) FCC deregulated products/services – comparable to the petition currently pending before the Commission. In the event that the Commission adopts USWC's above-the-line recommendation in the rate case and then subsequently authorizes the State deregulation of one or more of those FCC deregulated services, the tariff rates charged to the customers of

USWC's intrastate regulated services will subsidize the operations of those Arizona services explicitly deregulated by the Commission as a direct result of allowing recovery of related losses above-the-line – absent downward rate adjustments outside the context of a rate case.

Fourth, USWC may choose to provision financially promising FCC deregulated services through a separate affiliate, rather than by USWC pursuant to Part 64 rules. This could result in all FCC deregulated services that are "losing" money being provisioned by USWC and included above-the-line for ratemaking purposes, while potentially profitable FCC deregulated services could be provisioned by a separate affiliate and insulated from USWC's proposed above-the-line treatment. Under such a scenario, USWC's above-the-line recommendation without revenue imputation would result in the Company's regulated customers providing direct subsidies to the FCC deregulated services, through higher regulated rates.

Fifth, FCC Part 64 [47 CFR 64.901] requires carriers, such as USWC, to separate their regulated costs from nonregulated costs using the attributable method of cost allocation. Part 64, which resulted from FCC orders in CC Docket No. 86-111, established procedures intended to protect interstate regulated operations from cross-subsidizing the nonregulated activities of the telecommunications industry. All nonregulated revenues and costs, consistent with Part 64, are removed from a carrier's operating results prior to the jurisdictional separation of the remaining regulated costs between interstate and intrastate operations. In my opinion, the Company's above-the-line ratemaking proposal has the effect of shifting 100% of the cross-subsidy to those customers subscribing to USWC's Arizona <u>intrastate</u> regulated services. I do not believe that such a shift in cost responsibility is the appropriate or intended result of the FCC's actions to protect <u>interstate</u> regulated services.

Q. Would it be possible to achieve a result comparable to above-the-line imputation by simply moving the FCC deregulated services below-the-line?

A. Yes. The revenue requirement impact of these two alternatives would be identical. However, I have not proposed an adjustment moving the FCC deregulated services below-the-line out of concern whether Commission adoption of such treatment could possibly be construed as the intrastate deregulation of those individual services. The Commission may wish to investigate through a separate proceeding the form or extent of regulatory oversight it wishes to exercise on any or all of these services.

Q. Have you conducted any legal research on that concern?

A. No. I am not an attorney and have not researched this issue from a legal perspective. However, it is my opinion that if any of the FCC deregulated services were to be deregulated by this Commission such action should occur through a docket specifically focused on the policy considerations of deregulation. I do not believe that a deregulatory action should simply be implied from a Commission rate order based, in part, on maintaining FCC deregulated services as below-the-line activities for intrastate ratemaking purposes to protect against cross-subsidy concerns. If the Commission were to conclude that below-the-line treatment would not convey an approval of State deregulation of these services, the Commission would then be able to simply choose between the two identical revenue requirement alternatives (i.e., above-the-line with revenue imputation or below-the-line).

ACC Decision 58927, Docket No. E-1051-93-183

Q. Are you familiar with that portion of ACC Decision 58927 which addresses the issue identified as FCC Deregulated Services?

A. Yes. I sponsored testimony on behalf of the ACC Staff on that issue. The Commission discussed the FCC deregulated services issue at pages 21-23 of ACC Decision 58927, including the following excerpts:

> ...Prior to FCC deregulation, these services were subject to the separation process. As a result of deregulation, the FCC has ruled that the services must be excluded from

> interstate costs and ratemaking. In this case, U S West has proposed to include all of the revenues, expenses and investment associated with its FCC deregulated services above-the-line for intrastate ratemaking purposes. According to the Company, the prices for these services are market based but do not cover their fully distributed costs.
>
> According to Staff, interstate deregulation should not by itself increase expenses to the intrastate jurisdiction. The services in question have expenses of approximately $7 million more than the associated revenues. Hence, the Company's proposal will result in other Arizona customers bearing the burden of the $7 million deficiency....As part of its case, the Company requested a $5,356,330 increase in revenues for inside wire charges. Staff concurred with the Company's proposed increase as part of its overall rate design in the case. Staff then imputed additional revenues of $1,662,000 to offset the remaining deficiency for the FCC deregulated services.
> [ACC Decision 58927, p. 21-22]

With the exception of the Payphone and Wireless services preemptively deregulated by the FCC, USWC's recommendation in the current proceeding has not changed from its position in the last rate case. The Company has once again proposed to include the net loss and rate base investment associated with the remaining FCC deregulated services above-the-line for intrastate ratemaking purposes. Except for changes in the dollar values contained in the above excerpts, the summary of this issue from the last Arizona rate case continues to apply today.

Q. Did ACC Decision 58927 adopt the Staff's revenue imputation proposal?

A. The Commission did adopt the concept of revenue imputation, but not the full amount recommended by the Staff. The following discussion appears at page 22 of Decision 58927:

> ...As to the remaining revenue deficiency for the FCC deregulated services in the amount of $1,662,000 we concur with Staff that interstate deregulation should not by itself increase expenses to the intrastate jurisdiction. On the other hand, we don't find Staff's method of simply imputing revenues to offset the entire deficiency provides an overall just result either. The fact that both the Company and Staff have recommended a separate proceeding to further investigate how to handle services deregulated by the FCC indicated the confusion in this area. Accordingly, we will order such an investigation to be part of the current generic investigation into competition in telecommunications services (Docket No. U-000-93-259). In addition, in order to

> recognize that neither the interstate nor intrastate jurisdictions should bear the entire deficiency of the deregulated services, we will approve 50 percent of the Staff's recommended imputed revenues or $831,000.
> [ACC Decision 58927, p. 22-23]

Interestingly, the Company has now chosen to not contest the Commission's inclusion of the FCC deregulated services above-the-line, but continues to argue against the imputation of any additional revenues.

Q. Has the Staff proposed to limit its revenue imputation to only 50% of the deficiency, as adopted by the Commission in the last rate case?

A. No. In the last rate case, the Staff believed that the correct remedy for the above-the-line ratemaking treatment was full revenue imputation. Based on the information gathered through discovery in the current proceeding, the Staff is even more convinced today that the full imputation recommendation was and still is the proper remedy. I continue to believe that interstate deregulation should not, by itself, increase costs to the intrastate jurisdiction.

Revenue Imputation

Q. Could you describe your use of the phrase "revenue imputation" as it applies to FCC deregulated services?

A. Yes. USWC has proposed to include the net operating loss and the related rate base investment for these FCC deregulated services above-the-line for intrastate ratemaking purposes. As used in this context, the concept of "revenue imputation" refers to the recognition of sufficient additional revenues for ratemaking purposes so that, in the aggregate, the FCC deregulated services will earn the same overall return on investment that the ACC ultimately adopts for USWC's intrastate regulated services. By imputing additional revenues, USWC's Arizona regulated customers will not be required to subsidize the earnings deficiency experienced by the Company's FCC deregulated services.

If the ACC were to determine that, for example, USWC should be allowed to earn a return on rate base of 10% (i.e., the weighted cost of capital), the Staff's recommendation would impute additional revenues sufficient to result in the FCC deregulated services achieving the same 10% return on investment.

Q. By proposing a "revenue imputation" adjustment, are you suggesting that USWC increase the prices charged for its FCC deregulated services to collect those additional revenues from the customers subscribing to those services?

A. No. I am not suggesting that USWC should change its method or approach to the pricing of its FCC deregulated services. By recommending the imputation of additional revenues, I am suggesting that those customers subscribing to USWC's intrastate regulated services should <u>not</u> be required to subsidize the Company's FCC deregulated offerings.

Q. In ACC Decision 58927, the Commission adopted 50% of the Staff's revenue imputation adjustment. Could you please summarize the revenue requirement effect of the Company's above-the-line proposal in the current proceeding and compare that effect with the issue presented to the Commission in USWC's last Arizona rate case?

A. Yes. During the test year in the last rate case, USWC's FCC deregulated services experienced a revenue deficiency of approximately $7 million. Because USWC had proposed to increase its inside wire charges by $5.4 million as part of its overall rate design in that case, the Staff's revenue imputation totaled $1,662,000 to offset the remaining deficiency for the FCC deregulated services. However, the ACC only adopted 50% of the imputation, or $831,000. [ACC Decision 58927, p. 21-23]

In comparison, Staff Adjustment No. C-17 has the effect of imputing additional revenues of approximately $3.5 million. Obviously, the value of the imputation adjustment has more than doubled since USWC's last Arizona rate case. I believe that any imputation of less than 100%

would be a disservice to those Arizona customers subscribing to the Company's intrastate regulated services.

Q. Has USWC proposed to increase the prices charged for any of the FCC deregulated services in the current proceeding in order to decrease or eliminate the net operating losses experienced by these services during the test year?

A. No. As indicated in the response to UTI 16-7(d), USWC has not proposed price changes to any of the FCC deregulated services in the pending rate proceeding – in contrast to the inside wire increases proposed by USWC in the last rate case. However, the Company has already increased the prices charged for the following FCC Deregulated Services during the 1999 test year:

Service Category	Effective Date
Enhanced Fax – Fax Power	4/1/99
Premises Services:	1/1/99
Business Unistar Business Trouble Isolation Business Time & Materials Line-Backer Line-Backer Plus Wire Maintenance	

Source: Data Request No. UTI 16-5.

Q. In the response to UTI 3-19, the Company has represented that the ACC regulates all FCC deregulated products – except for interstate Billing & Collection and those services which have been preemptively deregulated by the FCC. Do you have any comments on the conceptual characteristics of regulated services?

A. Yes. In my opinion, there are several characteristics which should reasonably be expected to apply to a regulated product or service:

- Product (or service) prices would be supported by tariffs, schedules, price lists or contracts filed with and approved by the Commission.
- Under flexible pricing options, the Commission would at least set minimum price floors, but could also set maximum prices and oversee the frequency and/or degree of price changes – due to cross-subsidization concerns.
- The Commission and/or the Commission Staff would be notified of and possibly participate in resolving customer billing, service quality and/or service provisioning complaints.
- The Commission would be notified of and/or approve the introduction or termination of individual product/service offerings.
- Commission authority would be sought as to whether a new service would be provisioned by USWC pursuant to Part 64 accounting rules or by a separate subsidiary or fully deregulated for intrastate purposes – to mitigate cross subsidization concerns.

Depending on the degree of authority conferred by the applicable statutes or constitutional provisions, the ACC could have broad latitude in deciding how closely it desires to oversee the FCC deregulated services allegedly "regulated" by the Commission. For comparison purposes, USWC has provided the following information through Staff discovery regarding the ACC's past practice of "regulating" the FCC deregulated services:

- Except for Premises Services, the ACC has not ordered USWC to submit pricing bands/ ranges, price lists or notices of price changes to either the Commission or the ACC Staff. [UTI 16-5 and UTI 16-8]
- Historically, the ACC has not directly regulated service quality in connection with USWC's FCC deregulated services. [UTI 20-31]
- USWC does not have any ongoing contact with the Commission or ACC Staff representatives regarding customer issues with service quality, product pricing, billing and/or service provisioning as it relates specifically to USWC's FCC deregulated services. [UTI 24-10]

Q. Does USWC believe that any revenue imputation is appropriate for ratemaking purposes?

A. No. According to the response to RUCO 8-5, USWC holds the "...opinion that deregulated products are priced on a competitive basis and that the imputation of additional revenues to these products cannot be supported." Further, the response to RUCO 10-11 further disagrees

with the concept of revenue imputation, indicating that "the deregulated products are appropriately priced based on TSLRIC and competitive forces" and that "fully distributed cost, is not an appropriate basis for pricing."

Interestingly, USWC does not recognize that its own approach to quantifying overall revenue requirement in this proceeding relies on fully distributed cost (FDC) for pricing purposes, albeit not for the FCC deregulated services. Under the Company's proposal, the revenue deficiency attributable to the difference between FDC based costs and the prices charged for the FCC deregulated services have been recognized above-the-line and are residually included in the prices USWC proposes be charged to those customers subscribing to USWC's intrastate regulated services.

The FCC Cost Allocation Manual ("CAM") resulting from Part 64 emphasizes direct cost assignment and "...allocates common cost to the nonregulated sector but leaves it wholly to the business judgment of the company and to the market place to determine how the company recovers (or fails to recover) those costs." [Report and Order CC Docket No. 86-111 (or R&O 86-111), par. 115] Discretionary pricing flexibility, dependent on market conditions, provides little certainty of the ongoing losses (or profits) of the FCC deregulated services that USWC has proposed be absorbed by regulated ratepayers.

As outlined in the table presented earlier in my testimony, USWC currently offers a variety of products/services generally identified as FCC deregulated services. The remainder of this testimony section will briefly discuss certain other related topics in order to further illustrate why the Staff's revenue imputation proposal has merit and should be adopted by the ACC.

Voice Messaging Service

Q. The earlier excerpt from the response to UTI 14-15 indicates that U S WEST favors State deregulation of FCC deregulated products. Has USWC undertaken any initiatives or filed any pleadings to seek the explicit deregulation of individual FCC deregulated services in Arizona?

A. On September 25, 1998, USWC filed a petition with the ACC requesting the deregulation of its voice messaging service (VMS), a copy of which was provided to Utilitech by the ACC Staff. Other than VMS, USWC has not sought and currently has no plans to seek explicit State deregulation of any other FCC deregulated service in Arizona – at lease according to USWC's response to UTI 24-5.

Q. What is the status of USWC's petition to deregulate VMS?

A. It is my understanding that USWC's petition is currently pending further action. I am not aware of any steps taken by USWC, the Staff or the ACC subsequent to the filing of this petition.

Q. So, is it correct that USWC has proposed State deregulation of VMS in Arizona at the same time that it is recommending above-the-line treatment of VMS for intrastate ratemaking purposes?

A. Yes. The Company's Confidential response to Data Request No. UTI 42-6 indicated that, during the 1999 test year, VMS reported [redacted] and experienced [redacted], representing a significant improvement in financial condition from the net operating loss reported for the original test year ended June 1998. [See Data Request Nos. UTI 3-19 and UTI 20-27.] Consequently, USWC's proposed inclusion of VMS above-the-line for ratemaking purposes has the effect of [redacted] the overall revenue requirement otherwise generated by the remaining FCC Deregulated Services, even though the Company is seeking State deregulation of this service.

Tariffs and Pricing

Q. Does the ACC require USWC to file tariffs for any of the FCC deregulated services?

A. According to the response to UTI 14-17, the ACC has not required USWC to file and maintain tariffs on the various FCC deregulated services, with the exception of Inside Wire Maintenance and related charges. In addition, USWC's response to UTI 16-8 states:

> The Company is not required, pursuant to ACC order, to submit pricing bands / ranges, price lists, or notices of pricing changes to either the Arizona Commission or the ACC Staff relative to FCC Deregulated Services.
>
> USWC does not provide such information because the Commission has neither ordered nor requested USWC to do so.
> [Data Request No. UTI 16-8]

Q. Could you generally describe the tariffs USWC has filed with the ACC for Inside Wire Maintenance and related charges?

A. USWC's inside wire services are "flexibly priced." While Commission rules require USWC to price all service above TSLRIC, there are no ACC rules which establish a procedure for setting maximum rates. Since January 1997, USWC has changed the price of Inside Wire Maintenance on three separate occasions – November 1, 1997; January 1, 1998; and January 1, 1999. [Data Request Nos. UTI 14-14, UTI 16-5 and RUCO 5-12]

Q. Do you have any estimates of the revenue effect of these three inside wire rate increases?

A. Yes. The following table summarizes USWC's Confidential responses to Data Request Nos. RUCO 5-12 and RUCO 10-1, which contain estimates of the annual revenue effect of each increase:

Wire Maintenance Rate Increases

Effective Date	Annual Revenue Estimate
November 1, 1997	[redacted]
January 1, 1998	[redacted]
January 1, 1999	[redacted]
Total	[redacted]

Fortunately, each of these changes have been in effect for the entire updated test year (i.e., calendar year 1999), thereby avoiding any need to annualize the effect of these increases. However, the existence of this pattern of changing the rates charged for the FCC Deregulated Services outside the context of a rate case underscores the need for Staff's proposed imputation adjustment.

If the test year net loss for the FCC Deregulated Services is recognized above-the-line for ratemaking purposes and the Company continues to increase the prices for such services subsequent to the test year, it is possible that such increases could shift the net operating loss experienced during the test year to a positive net operating income.

Accounting for FCC Deregulated Services

Q. You previously referred to the FCC's accounting for these deregulated services. Could you briefly explain the background of this accounting?

A. Yes. In April 1986, the FCC issued a Notice of Proposed Rulemaking concerning the methods of separating the costs of regulated telephone service from the costs of the nonregulated or deregulated activities of telephone companies and their affiliates. In a REPORT AND ORDER issued in CC Docket No. 86-111 [released February 6, 1987], the FCC adopted a fully distributed costing method which emphasized direct assignment based on cost causation,

required the development of Cost Allocation Manuals by the Bell operating companies, and segregated the costs of nonregulated services from the regulated costs subject to jurisdictional separations. The following excerpt appears in the introduction section of the REPORT AND ORDER in CC Docket No. 86-111:

> We proposed to develop a system of accounting separation that would inhibit carriers from imposing on ratepayers for regulated interstate services the costs and risks of nonregulated ventures. Our ultimate, statutory goal was to promote just and reasonable rates for services in the interstate jurisdiction. [footnote omitted] We tentatively concluded that, to achieve our purposes, it would be necessary to deter cost shifting both in the form of misallocation of joint and common costs and in the form of improper intracorporate transfer pricing. In this Order we affirm that conclusion by adopting (1) cost allocation standards and, for certain carriers, a requirement that a cost allocation manual be filed with this Commission; (2) rules for recording transactions between regulated telephone companies and their corporate affiliates, and (3) accounting procedures, audit requirements, and other implementation and enforcement mechanisms.
> [R&O 86-111, par. 1]

In the introduction to the U S WEST Cost Allocation Manual provided in response to Data Request No. UTI 1-15, the Company provided the following description of this allocation process implemented by the FCC:

> In its Joint Cost Order, the Commission [FCC] established a mechanism for separating the costs of providing regulated telephone service from the costs of providing Nonregulated products and services. The "primary purpose" behind the establishment of this mechanism was to "protect.. ratepayers from unjust and unreasonable interstate rates[.]" Joint Cost Order, 2 F.C.C. 2d at 1303. The Commission noted the necessity of "guarding against cross-subsidy of Nonregulated ventures by Regulated services, and that cross-subsidy can result either from the misallocation of common costs or from improper intracorporate transfer pricing."
> [Data Request No. UTI 1-15]

Q. Could you explain what is meant by a service being "subsidized" by other services?

A. It is my opinion that a subsidy or cross-subsidy occurs in situations in which one or more services derive benefits from other services without assuming adequate responsibility for the associated costs. Under residual pricing, the failure of a service to assume adequate cost responsibility can result in the shifting of costs to other services which, in turn, inappropriately assume responsibility for providing a subsidy, absent specific regulatory treatment to provide otherwise.

Q. Would the above-the-line recognition of the FCC deregulated services, as proposed by USWC, constitute a cross-subsidy of such services by the balance of the Company's Arizona intrastate regulated services?

A. Yes. In my opinion, the imputation of additional revenues as proposed by the Staff will protect against this cross-subsidy.

FCC DEREG – SEPARATIONS ADJUSTMENT

Q. Please describe ACC Staff Adjustments B-7 and C-18.

A. As a direct result of USWC's proposal to include the FCC Deregulated Services above-the-line for ratemaking purposes, the Company calculated higher composite, intrastate separation factors for use in allocating test year adjustments. These higher separation factors have been used by the Company and the Staff to compute the intrastate share of the individual adjustments posted to rate base and operating income. ACC Staff Adjustments B-7 and C-18 correct the intrastate separation of those adjustments to reflect the lower separation factors resulting from the exclusion of the FCC deregulated operations from the development of jurisdictional separations.

Q. Why are these adjustments necessary?

A. Because USWC has chosen to directly assign 100% of the revenues, expenses and net investment of certain FCC Deregulated Services to its Arizona intrastate operations, the composite separations factors computed and applied by the Company has the effect of over-allocating individual ratemaking adjustments to intrastate operations. These ACC Staff Adjustments B-7 and C-18 are necessary in order to correct this over-allocation.

Ultimately, the Commission will decide how to treat the FCC Deregulated Services for ratemaking purposes. If the Commission agrees with the Staff's FCC Deregulated Services revenue imputation approach or simply moves such services below-the-line, then ACC Staff Adjustments B-7 and C-18 are necessary to reflect the revised separation effect on all other revenue requirement adjustments.

However, the quantification of ACC Staff Adjustments B-7 and C-18 assume that the Commission would adopt all adjustments proposed by the Company and the Staff. In the event

that the Commission ultimately rejects certain adjustments or adopts revisions to other adjustments, it would be necessary to recalculate ACC Staff Adjustments B-7 and C-18 for consistency with the Commission findings.

Q. ACC Staff Adjustment C-18 decreases net operating income in excess of $2 million. Why does the change in composite intrastate separation factors have such a large impact on net operating income?

A. ACC Staff Adjustment C-18 was determined by applying the change in composite intrastate separation factors to the total adjustments proposed by USWC and the ACC Staff. As the net effect of the various adjustments grows larger in amount (either positively or negatively), the value of the separations change also increases.

For example, ACC Staff Adjustment C-13 recommends the capitalization of internal-use-software (SOP 98-1). Because of the magnitude of the decrease to expense associated with this adjustment, a decrease in the composite intrastate separation factor translates into a smaller allocation of the SOP 98-1 expense reduction to intrastate operations by increasing ACC Staff Adjustment C-18.

This example illustrates the interaction between the ratemaking adjustments and the jurisdictional separations process. For this reason, ACC Staff Adjustments B-7 and C-18 should be updated to reflect all applicable adjustments ultimately adopted by the Commission.

PROPERTY TAX CORRECTION

Q. Please describe ACC Staff Adjustment C-24.

A. ACC Staff Adjustment C-24 represents the correction required to the Company's proposed EOP property tax annualization included in USWC Adjustment P-01.

Q. How do the calculations underlying ACC Staff Adjustment C-24 compare the Company's annualization approach?

A. The two computational methods are very similar. USWC based its annualization on the 1999 final full combined cash value (not December 1999 times twelve), as determined by the Arizona Department of Revenue for property tax assessment purposes. USWC then applied an assessment ratio and average tax rate to determine the Arizona annualized property tax expense, which was then allocated to the Company's intrastate operations.

In the confidential response to Data Request No. UTI 45-11, the Company indicated that its annualization had used an incorrect weighted assessment ratio. ACC Staff Adjustment C-24 uses the correct assessment ratio.

Q. Are there any other differences between the Staff and Company annualization adjustments?

A. USWC's annualization calculation employs an unexplained intrastate separation factor of 71.77%. However, the Company's update rate filing is based on a composite intrastate factor of 72.49% for property and other tax expense, which is primarily property tax expense. ACC Staff Adjustment C-24 is calculated using the higher test year intrastate separation factor of 72.49%. This Staff adjustment then compares the intrastate portion of the revised annualized level to the amount of property tax expense included in the Company's update filing, plus the out-of-period correction to property tax expense discussed in ACC Staff Adjustment C-25.

TAX TRUE-UP ADJUSTMENTS

Q. What is the purpose of ACC Staff Adjustments C-25 and C-26?

A. During the 1999 test year, USWC recorded certain journal entries that had the effect of correcting or truing-up certain accruals for property and other taxes (excluding income taxes) originally booked in calendar years 1994 through 1997. In addition, the Company also recorded true-up entries in January and February 2000 that related to calendar year 1999. ACC Staff Adjustment C-25 recognizes the test year effect of reversing the prior period entries and including the post-test year true-up entries for these other tax accounts.

ACC Staff Adjustment C-26 is similar to ACC Staff Adjustment C-25, but relates to income tax expense rather than other tax expense items. During the 1999 test year, USWC recorded certain journal entries that had the effect of correcting or truing-up certain income tax accruals originally booked during calendar years 1994 and 1998. This Staff adjustment recognizes the test year effect of reversing these true-up accounting entries related to prior periods.

Other Tax Accruals

Q. How did you determine that this adjustment was necessary?

A. Data Request No. UTI 43-20 sought the identification any adjustments that would be necessary to correct or normalize test year operating results, including the elimination of out-of-period and/or abnormal transactions, in a manner consistent with USWC's original filing. The Company's response identified and quantified an adjustment in other tax expense through Attachment E. However, in response to Data Request No. UTI 59-16, the Company supplied a revised quantification that further corrected Attachment E. ACC Staff Adjustment C-25 is based on the response to Data Request No. UTI 59-16.

Q. Is this adjusted necessary, regardless of the Commission's adoption of the Company's EOP or Staff's annualization adjustments?

A. Yes. Both the Company and Staff have proposed adjustments to annualize property tax expense (see USWC Adjustment P-01 and ACC Staff Adjustment C-24). So, in theory, the property tax portion of this adjustment could be avoided if the Commission adopted the Company's annualization without Staff's correction. However, ACC Staff Adjustment C-24 was assembled in a manner which corrects the Company's annualization of property tax expense and also considers the effect of the correction to property tax expense included within ACC Staff Adjustment C-25. So, in Staff's presentation, the property tax component of ACC Staff Adjustment C-25 is both necessary and appropriate.

With regard to the "other" tax corrections, the Company's response to Data Request No. UTI 59-17 confirms the Company's agreement that the remaining out-of-period adjustments are necessary, as USWC's Adjustment P-01 does not annualize Accounts 7240.2 through 7240.9. The calculations set forth on ACC Staff Adjustment C-25 provide further information concerning these tax accounts.

Income Tax Accruals

Q. What tax accruals are the subject of ACC Staff Adjustment C-26?

A. In November and June of 1999, the subject journal entries adjusted, or corrected, federal and state/ local income tax expense associated with periods prior to the test year.

Q. How did you determine that this adjustment was necessary?

A. As indicated previously, Data Request No. UTI 43-20 requested the Company to identify the various adjustments that would be necessary to correct or normalize test year operating results, including the elimination of out-of-period and/or abnormal transactions, in a manner consistent

with USWC's original filing. The Company's response provided an Attachment H, which documented and quantified this adjustment.

Q. Is this adjustment necessary, regardless of the Commission's adoption of the Company's EOP annualization adjustments?

A. Yes. The Company Adjustment P-01 does not adjust recorded income tax expense in a manner that would result in the elimination of these out-of-period transactions. Consequently, this adjustment should be recognized for ratemaking purposes irrespective of the test year annualization approach adopted by the Commission.

Q. Does the Company concur with that assessment?

A. Yes. USWC has expressed its concurrence in the response to Data Request No. UTI 59-12.

IMAGE ADVERTISING, OLYMPIC/SPORTS SPONSORSHIP

Q. Please briefly explain the nature of ACC Staff Adjustment C-27.

A. ACC Staff Adjustment C-27 excludes test year expenses related to non-product related corporate image advertising as well as the test year cost of USWC's sports sponsorships (i.e., the Olympic Games, Diamondbacks and Phoenix Suns) from the determination of overall revenue requirement.

Q. Could you describe image advertising?

A. Image advertising refers to forms of non-product related advertising activities intended to stimulate goodwill, build name recognition or create a favorable public image of USWC and its family of products and services. Examples of image or non-product advertising would include sponsoring:

- an event when the Company's name or logotype is prominently displayed in programs, brochures, banners, etc.;
- the publication cost of pamphlets, brochures, or other literature that prominently displays the Company's name or logotype; or
- television or radio programs or generic advertisements that identify USWC as a sponsor.

USWC's "Life's Better Here" brand campaign is a specific example of non-product advertising designed to build brand awareness and corporate recognition. Olympic and other sports sponsorships also serve to improve the public's awareness of U S WEST.

Q. How does USWC account for the costs that you propose to disallow?

A. USWC generally records the cost of these types of image building efforts in Account 6722, External Relations Expense. However, a very small portion of the test year cost of Olympic sponsorship has been recorded in Account 6535 (Engineering Expense), Account 6611 (Product Management Expense) and Account 6612 (Sales Expense).

Q. What is the amount of the proposed disallowance of image building costs?

A. Including both image advertising and sports sponsorships, the Staff's Arizona intrastate adjustment would decrease operating expense by about [redacted] [See USWC responses to Data Request Nos. UTI 64-22, UTI 65-8 and RUCO 28-14.]

Q. Has the Commission previously disallowed image advertising costs?

A. Yes. At page 25 of his direct testimony, Company witness Redding recognizes that the Commission has disallowed image advertising in the past, but offers the following explanation for not proposing a similar disallowance:

> In a competitive environment a company's "brand" is an important segment of its competitive success. Because of these changed conditions I am not removing image advertising from the calculation of the revenue requirement.
> [Redding Direct, p.25]

During the 1999 test year, the focus of the Company's "brand" promotion concerned the image of U S WEST. However, with the consummation of the recent merger, Qwest is the surviving entity, not U S WEST.

Q. Was the U S WEST "brand" an important ingredient to the merger with Qwest?

A. Apparently so. The Company specifically discusses the value of the U S WEST brand to Qwest in response to Data Request No. UTI 62-7:

> The U S WEST brand is one of the foundations on which the merger with Qwest was predicated. It is a valuable name with a valuable heritage. The merger with Qwest builds on that for the future.
> [Data Request No. UTI 62-7]

In the context of the merger, the Company's response to Data Request No. UTI 62-6 seems to convey a somewhat different impression upon consummation of the merger:

> The Company's brand and identity strategy is a corporate-wide effort that is not unique to a particular segment of the business. Effective with the merger with Qwest, it focuses on the transition from the U S WEST brand to that of Qwest over a 90 day period. This includes changing building and vehicle signage, logos on customer bills and stationary, sponsorships, and similar activities. It focuses on the evolution of the company from a voice and data to an integrated voice, data and internet/broadband service provider. Documents in the company's possession associated with the underlying strategic decisions are highly proprietary, highly confidential and commercially sensitive. As such, they are not provided herewith.
> [Data Request No. UTI 62-6]

For a valuable "brand" that was one of the foundations on which the merger was predicated, Qwest seems intent to quickly and expeditiously cleanse the U S WEST name and logo from the surviving corporation's image – an image that U S WEST has spent millions of dollars to build and maintain.

Q. Why should the costs of such institutional/goodwill advertising be excluded from the determination of the Company's regulated rates?

A. In my opinion, the cost of this type of advertising should be excluded from the ratemaking process because ratepayers do not receive any direct tangible benefit from such advertising.

Q. Why might USWC decide to incur potentially unrecoverable image building costs, particularly in light of past regulatory decisions disallowing such costs?

A. U S WEST, now Qwest, is a diversified company serving fourteen western states and seeking growth into new markets. Because of the visibility of the Company's regulated telephone operations, it is possible for the Company to leverage its brand name and business reputation to benefit the entry into new markets or the introduction of new services. Image advertising and branding campaigns provide a controllable opportunity to get the corporate name, business reputation and logotype before the public and favorably position the Company for new opportunities. It is difficult to quantify any tangible benefits that consumers of the Company's

regulated services might receive. After all, the money spent on image advertising during 1999 was for U S WEST, not Qwest.

Q. Has the Company allocated the cost of its image advertising to its unregulated affiliates?

A. No. Several discovery requests have been submitted in order to evaluate whether and to what extent USWC's affiliates may have helped fund the costs of the U S WEST image advertising campaigns. The following excerpts address this subject:

- USWC does not assign or allocate the expenses incurred for brand advertising to any regulated products or business units. Some portion of the brand advertising expenses are assigned to Part 64 deregulated products. The brand advertising expenses are budgeted and funded on a corporate level. USWC's brand advertising expenses are not billed to any other affiliates.
  [Data Request No. UTI 7-15]

- USWC does not allocate or assign its non-product advertising costs to other companies. Each Company does their own non-product advertising.
  [Data Request No. UTI 15-15]

- Each of U S WEST's affiliates, e.g., U S WEST Advanced PCS and U S WEST DEX, do their own product line awareness, or brand advertising. This advertising includes the "U S WEST" name; therefore, it would be improper to allocate part of the U S WEST only brand advertising to these affiliates.
  [Data Request No. UTI 26-6]

- U S WEST DEX does not separately identify product vs. non-product specific advertising expense.

  U S WEST Wireless does some awareness campaigns, which would be considered brand-type advertising. There expenses are not tracked separately from their product advertising expenses.

  None of the other USW affiliates perform any non product specific advertising.
  [Data Request No. UTI 19-10]

Although U S WEST DEX and U S WEST Wireless may do some undisclosed level of brand-type advertising, it is possible that the Company's unregulated affiliates derive indirect benefits from USWC's past image advertising efforts without helping to fund the cost thereof.

Q. The response to Data Request No. UTI 7-15 indicated that a portion of the brand advertising expenses incurred by USWC are assigned to Part 64 deregulated products. Does ACC Staff Adjustment C-27 have the effect of eliminating the portion of image advertising costs attributed to the FCC Deregulated Services?

A. No. Staff Adjustment No. C-27 only reverses the image advertising and Olympic sponsorship costs associated with USWC's regulated Arizona intrastate operations. In a separate testimony section, I discuss the Staff's recommended treatment of FCC Deregulated Services which would incorporate these brand related costs.

Q. Has USWC contended that its customers receive benefits from image or brand advertising?

A. Yes. Mr. Redding also states:

> To the extent U S WEST is successful in promoting its brand and loyalty to that brand, it means lower losses to competition. To the extent the Company can retain customers, the less likely it is to suffer revenue shortfalls and have to come to this Commission for additional revenues. Image advertising is done by all of the Company's competitors and is a normal part of advertising in a competitive environment.
> [Redding Direct, p.25]

It is possible, but not proven, that USWC's more competitive services could indirectly benefit from image advertising. However, 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. Has USWC incurred product-specific advertising costs in addition to the image advertising that Staff proposes to disallow?

A. Yes. USWC has incurred substantial product-specific advertising costs, which have been fully reflected in Staff's revenue requirement proposal. Over the past several years, the Company significantly increased its expenditures on regulated product advertising, as illustrated by the following graph:

CONFIDENTIAL GRAPH

Clearly, the Company's test year expenditures for product-related advertising are significant and have increased dramatically over the past several years. The following table further demonstrates the substantial product advertising amounts USWC has expended historically and the uncontested amounts recorded during the 1999 test year:

USWC-AZ
Product Advertising Expense
Regulated Operations

Year	Amount
1996	[redacted]
1997	[redacted]
1998	[redacted]
1999	[redacted]

Confidential UTI 11-16 & 60-4.

On a total State basis, the test year advertising expense recorded in Account 6613, Product Advertising, is approximately [redacted] on regulated products, which the Staff has not proposed to reduce or disallow.

Q. How does the Company's test year expenditures on image advertising compare to prior years?

A. According to the response to Data Request No. UTI 19-8, USWC did not have a brand advertising campaign prior to 1997. As indicated by the following graph, the Company has also substantially increased its expenditures on non-product image advertising since 1997.

CONFIDENTIAL GRAPH

In my opinion, the Staff's proposal to allow the significantly higher test year product advertising costs and disallow the image advertising costs reasonably balances the Company's need to market its products and get its name before the consuming public, without requiring ratepayers to fund unsupported levels of image advertising. It should be noted that this graph specifically applies to image advertising costs and does not include expenses incurred by the Company for the Olympic Games or other sports sponsorships.

Q. Should the Commission adopt your recommendation to disallow the image and brand advertising costs, is it possible that the Company might still be able to indirectly recover those costs?

A. Yes. In his direct testimony, Staff witness Brosch discusses the continued growth in revenues and margins realized by USWC in the State of Arizona. Under traditional regulation as well as some forms of alternative regulation, the Company retains all margin growth realized between rate case test years due to what is commonly identified as regulatory lag. So, to the extent that the Company's product advertising is successful in helping grow margins between rate cases, those additional margins will be retained by USWC and mitigate the disallowance of image advertising costs.

Q. Why do you believe that the cost of Olympic sponsorship represents a form of image advertising?

A. U S WEST (now Qwest) will present itself to the global community and enhance its public image through linkage with the Olympic games, much like non-product image advertising. Research results indicate that Olympic sponsorship bestows benefits important to sponsor companies. According to the forward to the "Olympic Market Research Analysis Report" supplied in response to Data Request No. UTI 26-10, "[p]ublic opinion of such companies is positive and sponsors derive highly prized image values and other commercial benefits."

The following excerpts from this same report further discuss the relationship between Olympic sponsorship and public opinion:

> **Sponsorship of the Olympic Games raises the public's opinion of the sponsoring company**
> Sponsorship of the Olympic Games has always been seen very favourably, and has not declined over the years - on average, around 30% of respondents feel more favourable towards a company because they are an Olympic sponsor. This means that Olympic sponsorship actually creates a positive impact for the companies involved among one-third of the population and offers quite a competitive point-of-difference.
>
> . . .
>
> Not only does Olympic sponsorship increase favourability towards the sponsoring company, but it also raises the public's opinion of that company. Almost one third of respondents in the 1996 nine country study said that their opinion of the sponsoring company was raised as a result of their Olympic sponsorship. Among spectators interviewed at the Atlanta Summer Games, this factor was even higher - 45% of spectators said that their opinion of the sponsoring companies was raised because they were associated with the Olympic Games.
>
> **Public Opinion of Olympic Sponsor Companies is positive**
> Olympic sponsorship bestows many positive attributes on the companies involved. They are perceived as being highly reputable (57% of respondents from the 1996 nine country study agreed) and leaders within their industries (59% agreement, 1996 nine country study). Olympic sponsor companies are also seen as being dedicated to excellence (53% agreement) and offering the highest quality products (46%). More importantly, this imagery has remained fairly consistent over the last eight years.
>
> . . .
>
> Almost eight in ten of the general public interviewed in the nine country study (1996) understood that the use of the Olympic Rings on product packaging or in advertising indicated that the company had paid money for the right to do so, and there is evidence to suggest that awareness among the general public of payment for acquisition of rights has been high for the last five years.
>
> . . .
>
> However, there is less agreement as to whether the rights acquisition has impacted on product price. Less than half of the general public agreed that the price was impacted

> by Olympic sponsorship, and again, this finding has been fairly stable over a five year period, or has in fact, declined.
> [Data Request No. UTI 26-10]

I do not question that Olympic sponsorship will enhance the public image of the Company. In my opinion, the issue instead focuses on whether regulated ratepayers should be required to fund the cost of sponsoring the Sydney Olympic Games. While the general public may be uncertain as to whether the cost of Olympic sponsorship serves to increase the price of a sponsor's products, there is no question that the Company seeks explicit ratemaking recovery of the Arizona allocated share of its sponsorship costs through the rates to be charged regulated customers – even though any favorable image enhancement may serve to benefit Qwest in unregulated markets.

Q. What quantifiable ratepayer "benefits" are expected to result from the use of the Olympic Rings in U S WEST advertising campaigns, which would not have occurred in the absence of such sponsorship?

A. This very question was posed to the Company through Data Request No. UTI 4-15(a). The Company's response to this question is reproduced below:

> The benefit ratepayers receive from U S WEST's Olympic sponsorship is a more competitive and financially healthy U S WEST. Market research supports that customers want to do business with Olympic sponsors and view these companies as leaders in their industries which offer high quality products and services. The Company's sponsorship was entered into for competitive purposes and for customer loyalty purposes.
> [Data Request No. UTI 4-15]

USWC did not provide any quantification of the economics of engaging in this form of image enhancement.

In contrast, the Company does undertake marketing effectiveness analyses to evaluate the relative benefits of specific consumer product marketing campaigns. [See USWC's response to UTI 11-21 and UTI 17-15.] Those analyses evaluate the economics of individual product campaigns by comparing incremental revenues with the related marketing costs. As indicated in the response to Data Request No. UTI 17-14, the marketing effectiveness analyses encompass product promotion costs, but do not consider "non-product brand marketing costs."

Q. You previously indicated that the Company was undertaking a variety of steps to replace the U S WEST name and logo with that of Qwest. Do these steps include a change in Olympic sponsorship so as to further remove U S WEST from public view?

A. Yes. According to the response to Data Request No. UTI 66-3, Qwest will not change the terms of the Olympic sponsorship agreement, but will change the name promotion to "Qwest" – in order to "be in the marketplace with one single brand."

Q. In your opinion, do other sports sponsorships represent a form of image advertising?

A. Yes. I believe that sports sponsorships should generally be considered a form of image advertising, comparable to the Olympic sponsorship costs. The level of costs incurred by the Company for sports sponsorships has also increased dramatically in recent years. On an Arizona intrastate basis, the confidential response to Data Request No. RUCO 2-24 indicated that USWC incurred [redacted] for the sponsorship of the Diamondbacks and Phoenix Suns during the test year encompassed by the Company's original filing (i.e., the twelve month period ended June 1998). In comparison, the Company's update to calendar 1999 contains [redacted] of intrastate sponsorship expense (confidential response to Data Request No. UTI 65-8). Using the Company's December 1999 times 12 annualization methodology, USWC has only sought to recover [redacted] (per UTI 65-8). ACC Staff Adjustment C-27 recommends the elimination of all sports sponsorship costs recorded during the test year.

FAS87 PENSION ASSET

Q. What is the purpose of ACC Staff Adjustment B-3?

A. Staff Adjustment No. B-3 represents the elimination of the Company's proposal to include a pension asset in rate base. Referring to USWC Adjustment P-04, the Company has proposed to include a pension asset of $66,221,000 in rate base for intrastate ratemaking purposes.

Q. If USWC has proposed to include a $66.2 million pension asset in rate base, why does Staff Adjustment No. B-3 remove only $42.3 million from rate base?

A. The amount shown on USWC Adjustment P-04 as the Company rate base allowance does not recognize, or is shown gross of, the related deferred income tax reserves. While the deferred income tax reserves are not included within, or netted against, the Company's specific pension asset rate base adjustment, these amounts were nevertheless reflected in the quantification of rate base through the deferred income tax reserves employed as a rate base offset. If the Company's proforma pension asset adjustment is to be excluded from rate base, I believe that the companion deferred income tax reserves should be similarly reversed.

Pension Cost Accounting

Q. Could you please describe the events or circumstances which gave rise to the recording of a pension asset?

A. Yes. In December 1985, the Financial Accounting Standards Board (FASB) issued FAS87 concerning employers' accounting for pension costs. Although issued in 1985, FAS87 was first effective for fiscal years beginning after December 15, 1986, which the Company adopted for financial accounting purposes effective January 1, 1987.

Prior to FAS87, the amount of pension costs distributed to expense and capital accounts was equal to the level of contributions actually made to the pension fund. It was only after the

adoption of FAS87 that pension costs expensed/capitalized and pension contributions began to diverge.

Q. Since the adoption of FAS87, has the company continued to record positive pension expense in its accounting records?

A. No. Beginning with the adoption of FAS87 in 1987, the Company began recording negative pension costs (a pension credit) instead of positive pension costs. It is several years' accumulation of this pension "credit" which has resulted in the pension asset the Company now seeks to include in rate base.

Q. How have negative pension costs resulted in a pension asset?

A. Pension costs are normally thought of as being positive (or an added cost) in determining a company's total cost of providing service. However, as implied by the reference, negative pension costs are actually recorded as a credit or a decrease to the appropriate expense and capital accounts, thereby resulting in a corresponding debit (or increase) to the pension asset account.

On a total State basis, the following table summarizes the annual pension credits to expense and capital accounts recorded by USWC since the adoption of FAS87:

Total Arizona – Net Pension Credits
(000's)

	Qualified Pension Credit				
Year	Expense	Capital	Total	NonQualified Expense	Net Pension Credits
1987	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
1988	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
1989	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
1990	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
1991	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
1992	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
1993	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
1994	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
1995	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
1996	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
1997	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
1998	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
1999	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Total	($101,004)	($12,525)	($113,529)	$9,152	($104,377)

Sources: USWC confidential responses to UTI 20-5 and UTI 46-13S1.

Q. Why do the net pension credits shown in the above table not tie to the $66.2 million pension asset that the Company has proposed to include in rate?

A. The above table reflects annual pension credits on a total Arizona basis, including the cost of the Company's non-qualified retirement plan. One major difference between the amounts included in this table (Total State) and the amount the Company has proposed to include in rate

base (Intrastate) is the jurisdictional separation process which apportions the pension costs between the interstate and intrastate jurisdictions. In addition, the response to Data Request No. UTI 54-4 indicates that, at least for 1999, the capitalized pension credit represents an estimate based on the percentage of payroll costs capitalized. In any event, I have not attempted to reconcile these amounts with the Company's rate base recommendation.

Staff Approach

Q. Could you briefly outline the rate base concept?

A. Yes. Rate base is commonly viewed as being comprised of net utility asset investments used to provide service to ratepayers, which have not yet been recovered from ratepayers. When utility investors provide the necessary funds to support these company investments, those amounts are generally included in rate base to allow the investors an opportunity to earn a return on invested capital. Similarly, funds advanced, reimbursed, or otherwise paid for by ratepayers are properly excluded from rate base.

With respect to the pension asset, the initial direct testimony of Company witness Redding (page 15) represents that its investors have effectively "contributed the cash" associated with the reduction in revenue requirements resulting from the inclusion of the pension credit in the ratemaking process – thereby justifying the inclusion of the pension asset in rate base.

Q. In your opinion has the existence of a pension credit resulted in a substantial decrease to the cost of service in each year since 1987?

A. No. For that to be the case, negative pension costs would need to have been included in the cost of service or somehow separately flowed through to customers "as recorded" each year since the adoption of FAS87. In my opinion, the Company needs to demonstrate that cumulative pension credits of at least $66.2 million (intrastate), from 1987 through the 1999 test year, have been flowed through to its ratepayers to support its pension asset request.

1 Q. Do you believe that ratepayers have received the benefit of these pension credits merely as a
2 result of the Company recording the negative pension costs?
3 A. No. To the extent that the Company's rate base treatment is premised on the "as recorded"
4 benefit concept, I disagree with that premise for several interrelated reasons. First, I do not
5 believe that it is possible to accurately quantify the accumulated net pension recoveries from
6 or benefits provided to ratepayers. In order to prepare such a calculation, I believe that it
7 would be necessary to reconcile the amount of actual pension costs recovered from ratepayers
8 with the amounts actually contributed to the pension fund since the establishment of the
9 pension plan. Such a quantification would be significantly complicated by the fact that the
10 level of pension costs charged to expense over the years does not necessarily equate to the
11 amount of pension costs recovered from ratepayers (i.e., included in cost of service) or
12 contributed to the pension plan.

13 Second, the Company's pension plan and pension accounting have existed for decades. By
14 focusing on the accounting entries underlying the "pension credits the Company recorded in
15 the late 80's and early 90's" that result in the pension asset balance, the Company has excluded
16 from consideration a substantial portion of the history which underlies the pension fund,
17 pension accounting and cost of service. Assuming that net recoveries from ratepayers can be
18 accurately quantified, the Company appears to have inappropriately relied on its balance sheet
19 accounting records for purposes of determining the amount that is includable in rate base.
20 From a cost of service perspective, data provided by the Company for the period 1987 through
21 1999 does not appear to support the position that ratepayers have substantially benefitted from
22 the pension credits, at the expense of the Company's investors, from a cost of service
23 perspective.

24 Third, USWC has sought to include the entire pension asset balance in rate base even though
25 the Company has not demonstrated that 100% of these benefits have been actually flowed

through to its ratepayers. Unless the Company can somehow demonstrate that the negative pension costs have unquestionably been flowed through to its customers, USWC's rate base proposal would charge ratepayers with a return on funds they never received -- thereby, unnecessarily benefitting Company investors.

Q. Why did you conclude that the Company inappropriately relied on its accounting records for purposes of determining the rate base allowance for pension credits?

A. In my opinion, the ratemaking treatment of pension credits, or negative pension costs, did not commence in 1987 with the adoption of the FAS87 and is not fully reflected in the Company's accounting records. In many situations, it may be possible to clearly point to an occurrence or event and establish whether ratepayers or investors have paid for or benefitted from a particular transaction. However, in this case, it is my opinion that the overall evidence does not support the Company's contention that investors have "contributed the cash required to fund this reduction in revenue requirements generated by the pension credits" in the amount of the $66.2 million (intrastate) included in rate base.

For ratepayers to have benefitted from the recording of negative pension costs, it is my opinion that the Company would have to allege that costs are recovered from ratepayers as recorded or that the ratepayers have benefitted through reduced revenue requirements to the detriment of its investors. I do not accept, nor do I believe that the Company can sustain either representation. The question of cost recovery with regard to negative pension expense has a substantial historical context which, if ignored, could lead to inappropriate conclusions.

Q. Please explain.

A. Prior to FAS87, the amount of pension costs charged to expense/capital accounts and contributed to the pension fund were equal. Subsequent to FAS87, the Company has recorded negative pension costs and made no further contributions to its pension fund. In order to

establish whether ratepayers have inappropriately benefitted to the investors detriment, neither the act of recording costs nor making contributions necessarily establish the pension cost amount that ratepayers have "invested" in or "benefitted" from through the cost of service.

Pension funding is basically determined from a comparison of pension plan assets with the expected pension liability. The pension plan assets are comprised of prior contributions to the fund plus the actual returns received on the plan assets. Once the plan assets exceed the expected liability and meet certain provisions of the Internal Revenue Code, the plan is considered overfunded and no further tax deductible contributions can be made. However, the plan assets have accumulated over a long period of time, not just the last few years.

Since the adoption of FAS87, the Company has recorded negative pension costs for all plan years, but one, primarily due to the pension fund's favorable investment experience. The annual returns on pension plan assets have ranged from about 13% to over 23% in nine (9) of the thirteen (13) years since the adoption of FAS87 [USWC responses to Data Request Nos. UTI 20-7 and UTI 47-5]. It is these "stellar" returns that have primarily contributed to the negative pension expense being recorded by the Company, in accordance with FAS87, since 1987.

In order to establish that ratepayers have benefitted to the investors' detriment, it is my opinion that the Company would need to clearly demonstrate that the amount of pension credits flowed through to USWC's Arizona intrastate customers equal or exceed the cumulative pension asset the Company has proposed to include in rate base. However, I do not believe that such a situation can be demonstrated with regard to this issue.

Q. How does this position differ from the Company's presentation on this issue?

A. Although the Company's allegation of ratepayer benefits will be discussed later in more detail, there are two major differences. First, USWC's filed evidence does not address or evaluate the value of pension credit benefits that customers are alleged to have received. Second, it appears that the Company has effectively assumed that the recording of negative pension costs equates to ratepayer benefits. While this theory has some limited application in situations where alternative forms of regulation are based on a sharing of earnings above predetermined thresholds, I do not believe that this process would apply to the Company's Arizona operations.

Q. In your opinion, has the Company taken the position with regard to these pension credits that ratepayers have benefitted at the expense of its investors?

A. Yes. However, I do not believe that ratepayers have thus far received substantial benefits that would justify the inclusion of a significant pension asset in rate base.

Q. Since the Company's adoption of FAS87 in 1987, how does the amount of pension costs included in cost of service compare to the pension credits recorded by the Company?

A. While the Company seems to argue that costs or benefits are recovered from or provided to ratepayers when the expense is booked in order to support including the pension asset in rate base, the amount of pension costs actually recorded by the Company varies significantly from year to year, as previously shown. Although I do not believe that it is possible to accurately quantify the accumulated net pension recoveries from or benefits provided to ratepayers, I have prepared a series of calculations which attempt to estimate the level of pension credit benefits ratepayers might have received since the adoption of FAS87.

Relying on USWC responses to Staff/UTI discovery in Docket E-1051-93-183 (Staff Data Request Nos. 191, 386-388) and Data Request No. UTI 20-5 in the pending proceeding, the following table was assembled to show the amount of pension credits allegedly flowed through

to ratepayers in each proceeding immediately preceding or following USWC's adoption of FAS87.

Arizona Intrastate – Net Pension Expense
(000's)

ACC Docket	Order Date		Ratemaking Pension Expense
84-100	1/10/86		$12,200
88-146	3/01/89	(a)	(600)
91-004	7/15/91	(a)	(9,900)
93-183	1/03/95		(9,000)

Sources: USWC response to UTI 20-5.
Note (a): Resolved by negotiated settlement.

On its face, this table would seem to indicate that the rates in effect since early1989 have resulted in pension credits being flowed through to ratepayers. However, after further review and analysis, I do not believe that this information demonstrates that ratepayers have materially benefitted from the pension credits.

Q. Please explain.

A. Appendix SCC-1 represents an analysis of the amount of pension expense explicitly included in the Company's rates, starting with the rate case immediately preceding the adoption of FAS87. Recognizing that two of the rate cases before this Commission in the late 1980's - early 1990's (i.e., E-1051-88-146 and E-1051-91-004) were resolved by negotiated settlement, I have estimated that ratepayers may reasonably be assumed to have provided USWC with cumulative positive pension expense up to $64.8 million, as compared to the negative $66.2 million of pension credits that the Company proposes to include in rate base as a pension asset.

Q. How does Appendix SCC-1 quantify the amount of pension cost included in the cost of service resulting from Dockets E-1051-88-146 and E-1051-91-004?

A. Because these two Dockets were stipulated settlements, Appendix SCC-1 assumes that the amount of pension cost included in the preceding litigated rate case continued in full force and effect.

Q. Why was the analysis presented by Appendix SCC-1 start in 1986?

A. Calendar year 1987 represents the year in which USWC adopted FAS87. The rate order immediately preceding the adoption of FAS87 was implemented by order dated January 10, 1986. [Decision No. 54843, dated December 31, 1995, Docket No. E-1051-84-100.] By starting the analysis in 1986, it is possible to capture the transition to FAS87 and recognize that customer rates did not change immediately upon adoption of this accounting change. Consequently, it would be possible to examine how closely the cost of service allowance for this item has followed the recorded pension credits (or alleged ratepayer "benefits") the Company seeks to include in rate base.

Since the test year in Docket No. E-1051-84-100 was calendar year 1984 and the next rate case was Docket No. E-1051-84-100 with an order issued March 1, 1989 adopting a negotiated resolution, any rates in effect during the intervening period (i.e., calendar year 1986, 1987, 1988 and through February 1989) would not have reflected any pension credits associated with FAS87. Consequently, any positive pension costs included in the development of the rates effective during this period would tend to offset or mitigate the net amount of pension credits included in the cost of service since the FAS87 adoption.

Q. In describing Appendix SCC-1, you indicated that two of the rate cases (i.e., E-1051-88-146 and E-1051-91-004) were resolved by negotiated settlement. Why do you believe that this is important?

A. In assessing the amount of pension credits flowed through to ratepayers, it is imperative that only those orders which specifically address the various components of cost of service be considered.

- Docket No. E-1051-88-146 represented an earnings complaint proceeding that was styled as a Commission examination of the Company's rates and charges. By Decision 56471, the Commission rescinded its earlier order finding for an interim rate reduction of $33.4 million and adopted a negotiated settlement offered by the parties to implement a permanent rate reduction.

- In Docket No. E-1051-91-004, the parties again presented the Commission with a negotiated settlement agreement, which contained the following provision:

> 23. Except as otherwise expressly provided in this Agreement, all the provisions of this Agreement have been negotiated for Settlement purposes only, and no party to this Agreement has approved, accepted, agreed to or otherwise consented to any method for determining return on equity or investment, rate base, cost of service, or any allocation method or rate design formula underlying any of the rates, charges, terms and conditions set forth in this Agreement.
> [Settlement Agreement appended to Decision 57462]

Settlement agreements are typically non-specific, by design. The negotiation process entails any number of compromises by each participant in the interest of reaching a resolution or common ground that each party finds acceptable. Such settlements leave the Commission unaware of important details, instead only presenting the final outcome as set forth in the agreement. By its very nature, a settlement agreement reflects a compromise that can be valued in various ways, not necessarily reflecting the filed positions of any particular party. As a result, I am unable to conclude what amount of any pension credits were embedded within the test years used in either of these proceedings or whether any credits were partially or fully flowed through to benefit ratepayers, to the detriment of the Company's investors.

Q. If the assumption were to be made that it was reasonable to go behind these negotiated settlements in order to identify the amount of pension costs included in rates, have you attempted to estimate that effect on the calculations set forth in Appendix SCC-1?

A. Yes. Appendix SCC-2 attempts that very calculation. If the Commission were to conclude that it was proper to step behind the explicit language and basic underpinnings of settlement agreements, Appendix SCC-2 would indicate that ratepayers may have participated in cumulative negative pension expense of approximately $42 million. If the Commission were to endorse this premise, the amount of the net pension asset (net of related deferred income tax reserves) included in rate base should not exceed 63% of the amounts set forth on ACC Staff Adjustment B-3, supported as follows:

Description	Ref.	Pension Asset
Cumulative Pension Credits Included In Rates	**(a)**	$42,029
USWC's Proposed Pension Asset	**(b)**	66,221
Ratepayer Percentage of Pension Credits		63.47%

Note (a): Appendix SCC-2.
Note (b): USWC Adjustment P-04.

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

A. No. As a matter of ratemaking policy, I do not recommend that the Commission rely solely on or otherwise reconcile past decisions in establishing cost of service for future periods. However, it is my opinion that the consideration of past Commission rate orders are indeed relevant in demonstrating the Company's failure to meet its burden to establish that investors have some claim to inclusion of the pension asset in rate base.

If the funded status and related earnings of the pension plan were created solely with investor funds, I could understand the Company's concerns on this issue. On the other hand if ratepayers are assumed to have substantially funded the Company's past pension contributions with USWC retaining a material portion of the pension credits, then the inclusion of the Company's "pension asset" in rate base would improperly charge ratepayers a return on funds retained by the Company and would result in a windfall to investors. As discussed above, I do not believe that the Company has demonstrated that ratepayers have benefitted from the pension credits to the detriment of investors. For these reasons, the Commission should reject the Company's rate base request.

Company Position

Q. What is the basis for the Company's claim that the pension asset should be included in rate base?

A. At pages 15-16 of his initial direct testimony filed in this proceeding, Company witness Redding briefly discusses USWC's rationale for including the pension asset in rate base. Mr. Redding generally refers to the test year pension credits as a "non-cash" item, which should be treated consistently with the pension asset. The following excerpt appears in this portion of Mr. Redding's testimony, further explaining why the Company has proposed that the pension asset be included in rate base:

> The customer will benefit from the pension credit in the form of reduced revenue requirements, similar to the past when they benefited [sic] from pension credits the Company recorded in the late 80's and early 90's. Pension credits, which are a non-cash item, reduce the revenue requirement. However, this reduction is a cash item. By this I mean that the revenues collected from customers are lower because of the inclusion of the pension credit in the development of the revenue requirement. Since the earnings of the pension plan cannot be withdrawn, the Company's investors have to contribute the cash required to fund this reduction in revenue requirements generated by the pension credits. The equitable balance between the Company's customers and its investors is to flow through the pension credits to the

> customers and to allow the accumulated pension asset resulting from the pension credits to earn a return as part of the rate base. This reimburses the investors. [Redding Direct, pages 15-16]

As indicated above, it is the Company's view that the pension asset represents investor supplied funds. In essence, the Company has proposed rate base inclusion of the pension asset on the basis that ratepayers have benefitted through a lower cost of service because the pension credits reduced revenue requirements and because the Company recorded pension credits in the late 80's and 90's. Accordingly, the Company has proposed that the recorded pension asset should be included in rate base as ratepayer compensation for the use of investor funds.

Q. Do you agree with the Company that its investors have contributed the additional cash required to "fund" reduced revenue requirements generated by the pension credits?

A. No. Other than providing a general reference to customers benefitting from "reduced revenue requirements, similar to the past when they benefited [sic] from pension credits the Company recorded in the late 80's and early 90's," Mr. Redding does not provide any definitive or comprehensive analysis of the amount of pension credits ratepayers are alleged to have actually received through the ratemaking process. Instead, I believe that the Company seeks to generally and improperly combine its historical accounting for pension costs with presumed ratemaking effects in an attempt to convince the Commission that USWC's customers have benefitted to the detriment of its investors.

Q. Have you made any further inquiries into the details underlying the Company's position on this issue?

A. Yes. Data Request No. UTI 20-4 was submitted specifically to obtain additional information regarding the Company's position on ratepayer benefits. The following passage was provided in partial response to this discovery request:

> Mr. Redding and Mr. Grate subscribe to the generally accepted ratemaking principle that rates based on sound cost-of-service ratemaking principles will, nonetheless, likely be either inadequate or excessive because revenues actually collected during a rate effective period will likely be, respectively, either less than costs actually incurred or more than costs actually incurred. If utility rates are inadequate, then the available remedy is for the utility to file for a rate increase. Conversely, excessive utility rates may require the filing of a complaint-style investigation by the regulatory agency, its staff or another party. Ratepayers benefit from the recordation of expense credits because they reduce costs actually incurred which, in turn, cause a revenue requirement reduction that helps to either obviate the need for a rate increase filing by the utility or to support a complaint of excessive rates by a regulator or other party.
> [Data Request No. UTI 20-4(a)]

Based on this theory, the Company then postulates that the potential for rate increase filings or complaint reductions effectively serves as the balance to ensure that ratepayers benefit from cost reductions (i.e., pension credits) as they arise. The response to Data Request No. UTI 20-4 further discusses this point, as follows:

> For the reason stated in response to subpart "a," Mr. Redding and Mr. Grate believe that ratepayers receive the benefit of reduced expenses (i.e. pension credits) regardless of whether a specific year's reduced expenses are used to establish cost of service in ratemaking proceeding. Specifically, reduced expenses reduce revenue requirement and reduced revenue requirement benefits ratepayers.
> [Data Request No. UTI 20-4(b)]

Using this logic, the Company essentially concludes that the pension asset must have been funded by its investors – since ratepayers have benefitted from negative pension costs, while investors were required to absorb the resulting short-fall in earnings.

Q. Do you agree with this premise?

A. I understand the Company's position, but respectfully disagree. Anticipating the Company's position on this subject, subpart (d) to Data Request No. UTI 20-4 asked whether it would then follow that ratepayers immediately incur or fund increases in expense that are recorded by the

Company, regardless of the extent to which those amounts are explicitly recognized in the ratemaking process. Not too surprisingly, the Company's response, reproduced below, declined to symmetrically apply its theory of ratepayer benefit to also apply to funding costs increases:

> No. Ratepayers do not immediately incur or fund increases or decreases in expenses (or revenues or ratebase for that matter) because changes in the elements of revenue and cost that comprise revenue requirement do not reflect themselves in rate immediately. See the response to part "a."
>
> So long as the parties to the ratemaking process are vigilant, however, all changes in expenses, revenues and ratebase are recognized in the cost-of-service ratemaking process because once known and measurable, they can be included in a measurement of revenue requirement. From that measurement, the parties to the ratemaking process can determine whether filing a rate case or complaint is justified.
> [Data Request No. UTI 20-4(d)]

It is true that a common simplifying assumption in the ratemaking process is that costs are recovered as expensed. If this premise of cost recovery was globally applied and true without exception, utilities would have absolutely no need to obtain regulatory authority to defer or seek explicit recovery of any incurred cost, as the act of recording such costs as a current period expense would provide the needed recovery. Under such a theory, the Company would not have needed to seek Commission authority in prior dockets to defer and amortize one-time transition costs (e.g., compensated absences, merit awards, medical & dental costs) or request the explicit recovery of costs associated with FAS112 or FAS106. Even the Company's response to Data Request No. UTI 20-4(c) recognizes the limitations of this argument and seems to undermine any symmetry to its position.

Nevertheless, I do not believe that one can simply assume that an ever vigilant ratemaking process will ensure that "all changes in expenses, revenues and ratebase are recognized in the cost-of-service ratemaking process." All parties including the Commission have competing

demands for limited resources. As interested as regulatory commissions are in ensuring that regulated rates are no higher or lower than necessary, it has been my experience that regulatory agencies are often hesitant to commit the required resources to pursue and process formal earnings complaint cases – particularly in the context of the likely discovery challenges surrounding a complaint investigation and the obligation to process other filed applications within more typically stringent time frames.

Q. In your opinion, how does this theory of "as recorded" cost recovery relate to the traditional ratemaking process?

A. Whenever a rate case is filed by a utility, it assumes a risk that the rates filed and ultimately approved will either be inadequate or excessive, no matter what test year approach or series of adjustments are proposed by the parties. Generally, utility rates are authorized based on a known and measurable test year cost of service regardless of the actual level of costs which might be incurred during the rate-effective period. If utility rates are inadequate, then the available remedy is to timely file for a rate increase. Conversely, excessive utility rates normally require the filing of a complaint-style investigation by the commission staff or a consumer group, as utilities are rarely willing to voluntarily initiate base rate reductions.

It is widely accepted that cost based utility rates, once established by a ratemaking body, are deemed to be just and reasonable until such time as a moving party carries its burden of proof to establish that said rates are no longer just and reasonable. Costs incurred by the utility are often presumed to be covered by existing rates, regardless of whether the cost of service study underlying said rates included a specific allowance for that unique cost. Otherwise, the result could entail an endless reconciliation process comparing each element of actual costs during the rate-effective period with the cost of service details underlying the preceding rate case order. However, this presumption does not extend to the actual adjustment of utility rates

charged ratepayers between rate cases to track specific cost levels, such as negative pension expense or represcription changes.

It is also generally recognized that to allow utilities to collect additional funds from ratepayers in the future simply because expenses were incurred which had not been specifically provided for in the determination of the existing base rates is considered retroactive ratemaking. While past expenses are frequently employed in quantifying or developing the prospective cost of service on which overall rates are based, it is improper to establish future rates at levels intentionally designed to recover past losses or under-recoveries due to historical imbalances in the matching of rates and actual expenses.

In spite of the realities of the ratemaking process, the Company has basically relied on an "as recorded" cost recovery theory to support an allegation that the prospective ratemaking process should be modified to recognize that past accounting practices have allegedly benefitted ratepayers (i.e., negative pension costs) to the detriment of its investors. In my opinion, the Company must assume an even greater burden to demonstrate the existence of the alleged "investor contribution" than has been presented in this proceeding.

Q. Do you have any further comments on this issue?

A. Yes. In Docket No. E-1051-93-183, the Commission was presented with a very similar ratemaking issue associated with the pension asset and FAS87 pension credits. The ACC adopted the Staff's recommendation in that rate case. The following excerpt appears at page 5 of the Decision No. 58927:

> 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. However, at the same time it would be equally unfair to include the overfunded pension assets in rate base if ratepayers have previously

> provided those funds to the Company. 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 pensions 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 excess pension amounts from the inception of the pension account. Based on all the above, we find the Company has not presented sufficient evidence to clearly demonstrate that its shareholders have advanced the excess pension amounts. Accordingly, we must deny the Company's request to include the net amount of overfunding of $36,213,000 in rate base.
> [Arizona Docket No. E-1051-93-183, Decision No. 58927, page 5]

In spite of this language, the Company declined to directly address this issue in direct testimony.

Conclusion

Q. Please summarize your recommendation on this issue.

A. I do not believe that the Company has adequately demonstrated that ratepayers have received substantial pension credit benefits to support the inclusion of the entire pension asset in rate base. Although some pension credits have been returned to ratepayers through a reduction in revenue requirements, it is my opinion that the amount of any such benefits are relatively limited in comparison to the pension asset balance. For the reasons previously set forth, the Commission should deny the Company's request to include a pension asset in rate base and similarly remove the related deferred income tax reserves from rate base.

Q. Does this conclude your direct testimony?

A. Yes.

U S WEST COMMUNICATIONS, INC.
DOCKET NO. T-1051B-99-105
Analysis of Pension Costs Included in Revenue Requirement

				Arizona Intrastate (000's)	
Year	ACC Docket	Order Date	Assumed Months in Effect	Ratemaking Pension Allowance	Estimated Pension Credit in Rates
1986	84-100	1/10/86	12	$12,200	$12,200
1987	84-100		12	12,200	12,200
1988	84-100		12	12,200	12,200
1989	84-100		2	12,200	2,033
	84-100 (a)	3/01/89	10	12,200	10,167
1990	84-100 (a)		12	12,200	12,200
1991	84-100 (a)		6.5	12,200	6,608
	84-100 (b)	7/15/91	5.5	12,200	5,592
1992	84-100 (b)		12	12,200	12,200
1993	84-100 (b)		12	12,200	12,200
1994	84-100 (b)		12	12,200	12,200
1995	93-183	1/03/95	12	(9,000)	(9,000)
1996	93-183		12	(9,000)	(9,000)
1997	93-183		12	(9,000)	(9,000)
1998	93-183		12	(9,000)	(9,000)
1999	93-183		12	(9,000)	(9,000)
					$64,800

Note (a): The pension costs from Docket 84-100 are assumed to continue due to the settlement in Docket 88-146.

Note (b): The pension costs from Docket 84-100 are assumed to continue due to the settlement in Docket 91-004.

If negotiated settlements are treated as resolutions without any finding on specific costs and/or recoveries, a reasoned assumption would look to the results from the previous most recently litigated case to determine the amount of pension expense.

U S WEST COMMUNICATIONS, INC.
DOCKET NO. T-1051B-99-105
Analysis of Pension Costs Included in Revenue Requirement

				Arizona Intrastate (000's)	
Year	ACC Docket	Order Date	Assumed Months in Effect	Ratemaking Pension Allowance	Estimated Pension Credit in Rates
1986	84-100	1/10/86	12	$12,200	$12,200
1987	84-100		12	12,200	12,200
1988	84-100		12	12,200	12,200
1989	84-100		2	12,200	2,033
	88-146 (a)	3/01/89	10	(600)	(500)
1990	88-146		12	(600)	(600)
1991	88-146		6.5	(600)	(325)
	91-004 (a)	7/15/91	5.5	(9,900)	(4,538)
1992	91-004		12	(9,900)	(9,900)
1993	91-004		12	(9,900)	(9,900)
1994	91-004		12	(9,900)	(9,900)
1995	93-183	1/03/95	12	(9,000)	(9,000)
1996	93-183		12	(9,000)	(9,000)
1997	93-183		12	(9,000)	(9,000)
1998	93-183		12	(9,000)	(9,000)
1999	93-183		12	(9,000)	(9,000)
					($42,029)

Note (a): Per USWC response to UTI 20-5, booked amount assumed as pension credit included in both settlements.

If negotiated settlements are not treated as resolutions without any finding on specific costs and/or recoveries, the above tabulation would reflect the net pension expense credits conveyed to ratepayers – even though two of the proceedings that involved the introduction of negative pension costs were negotiated settlements.

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

Q. Please state your name and business address.

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

Q. By whom are you employed?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

EXECUTIVE SUMMARY

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

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

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

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

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

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

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

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

The Company's testimony argues that it should now be excused from even the minimal $43 million imputation it had previously agreed upon with the Commission. According to Company testimony, the cost of publishing white pages that is incurred by Dex should now be treated as a "value" reducing the amount of imputation. Another "value" in the form of white pages revenues already recorded on USWC's books is also proposed as a reduction to imputation. Staff rejects these arguments since they completely ignore the large revenue stream realized and retained by Dex from publishing white pages and yellow pages. My testimony explains that the market value of U S West's official directories far exceeds the costs of publishing them, such that Dex, USWC or another publisher could readily publish the directories without charging the telephone company such costs. Even the white pages in

isolation produce large revenue streams that serve to offset much of the costs of publishing white pages, revenues that are ignored in the Company's analysis. It must be recognized that any prudent incumbent Bell telephone company would also to realize the large yellow pages profits achievable from the exclusive right to publish the "official" directories. Imputation is required to capture some of this profit opportunity for customers. Schedule C-5 sets forth Staff's imputation amount.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Q. How is reciprocal compensation treated in your testimony?

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

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

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

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

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

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

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

Q. Does this conclude your executive summary?

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

REVENUE ADJUSTMENTS

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

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

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

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

In general, Staff has annualized the revenue accounts that are exhibiting meaningful trends and for which reliable adjustments can be calculated. In certain instances, the observable trends and relative stability in specific revenue sub-accounts caused Staff to concur with USWC's

proposed December 1999 times 12 calculation. In other instances, variability in monthly recorded revenues or the absence of meaningful trends in the data suggested either no annualization or an alternative calculation approach.

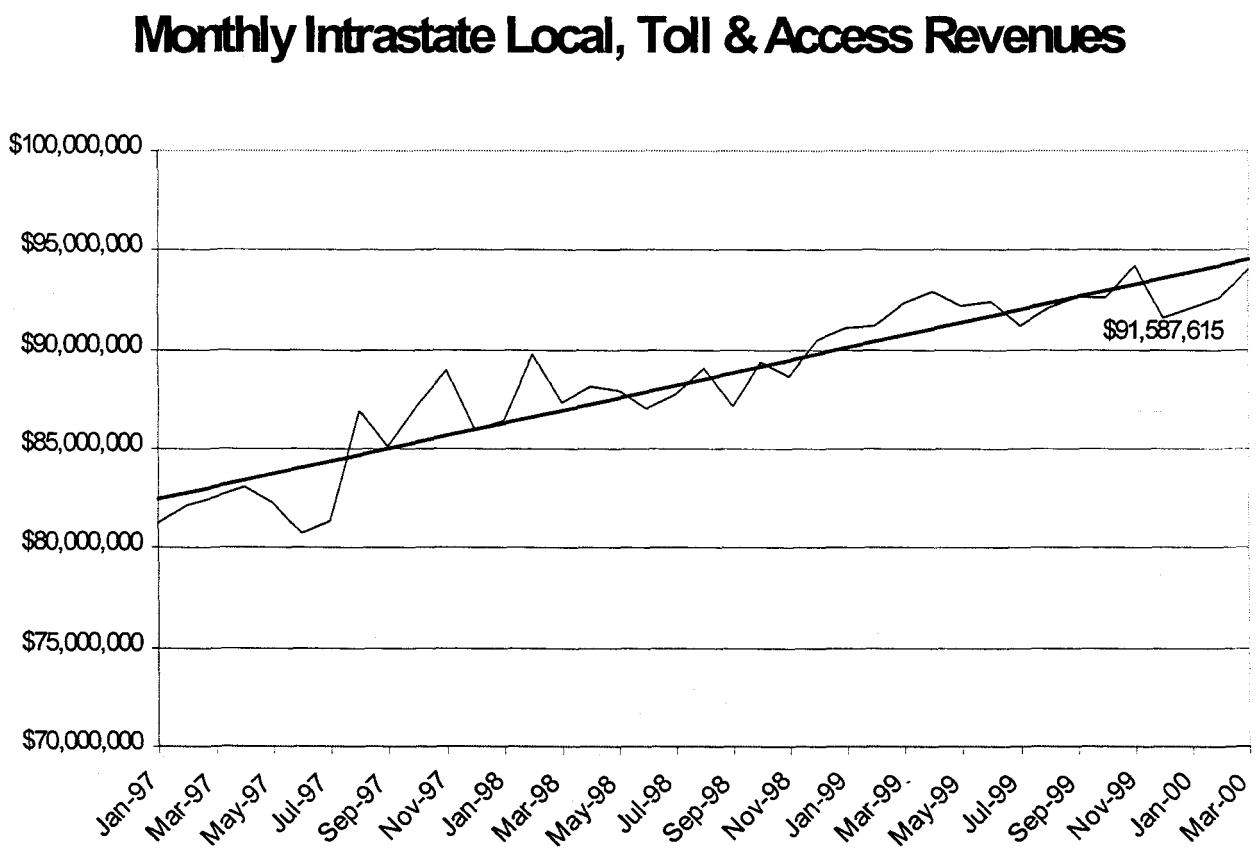
Q. Are certain types of revenues amenable to the Company's proposed "one month times twelve" methodology for annualization?

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

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

A. Yes. I have prepared a graph to illustrate the problems associated with assuming that a December 1999 times twelve approach will always produce reasonable results. The Company's revenue annualization adjustment includes recurring, non-recurring, local message, toll, access and all other types of revenues for adjustment purposes. The recorded monthly local, toll and access revenue accounts subject to this process are set forth in the following

graph containing amounts from January 1997 through April 2000. A linear trend line has been superimposed on the data, to illustrate the overall trend in recorded intrastate local, toll and access revenues within the revenue accounts subjected to the Company's adjustment methodology.



What is obvious from this overall view of the unadjusted, per-books revenue data is that the Company's selection of December 1999 as the starting point for the annualization is unlikely to yield reasonable results because the December 1999 data point of $91.6 million is significantly below the trend line for the entire period. Even with the several attempts made by USWC to normalize the December values prior to multiplying by twelve, the Company's

results are unreliable and inconsistent with observable revenue trends. It should also be noted that the trend line shown above tends to understate revenue volume growth, because of the large price reductions implemented in October 1999 (upon termination of the directory surcharge) that reduce subsequent months' recorded revenues and the slope of the trend line.

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

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

Local Service Revenues

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

A. Yes.

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

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

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

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

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

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

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

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

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

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

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

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

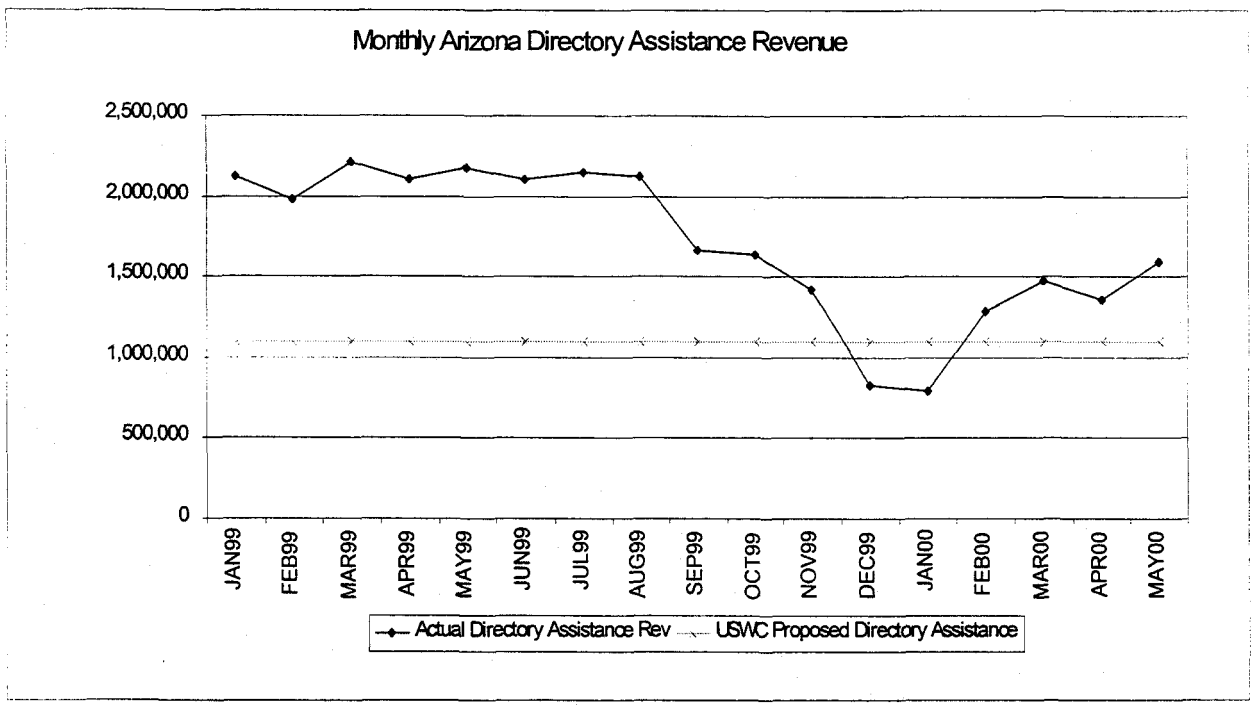
Q. What is proposed by Staff with respect to annualization of local service revenues in this Docket?

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

local service revenue annualization, to yield the net adjustment proposed by Staff to the Company's prefiled case.

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

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



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

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

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

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

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

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

Toll Revenues

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

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

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

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

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

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

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

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

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

Access Revenues

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

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

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

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

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

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

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

As a result, Staff recommended reversing the Company's upward adjustment to TY revenues.

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

Miscellaneous Revenues

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

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

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

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

SERVICE QUALITY PENALTIES

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

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

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

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

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

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

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

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

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

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

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

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

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

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

detail. Therefore, it is necessary to estimate the expense portion of service quality costs that should be attributed to exchanges being sold.

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

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

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

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

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

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

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

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

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

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

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

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

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

DIRECTORY IMPUTATION

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

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

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

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

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

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

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

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

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

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

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

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

Background Information

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

A. No.

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

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

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

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

Rebuttal to Ann Koehler-Christensen

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

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

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

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

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

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

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

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

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

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

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

A. If considered in isolation, yes, significant costs are incurred to publish the books and distribute them. However, these costs are more than offset by selling advertising in the white and yellow pages directories at prices that are reflective of the market dominance of the directories produced by the incumbent telephone company. In other words, the direct costs of the directory books is much less significant than the market value of the books in the advertising marketplace. The net cost of producing and distributing white and yellow pages is considerably negative, when the offsetting yellow page advertising revenues are properly considered. In addition, the Settlement Agreement requires consideration of the value of services provided to the regulated business by the publishing affiliate and publishing and distributing white and yellow pages has a value of zero or less, since any informed and capable

directory publisher would eagerly accept the opportunity to serve as USWC's official publisher and publish its directories at no cost.

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

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

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

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

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

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

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

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

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

"received" by USWC, but is not received under the existing affiliate contracts or the Company's proposed ratemaking approach.

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

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

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

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

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

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

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

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

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

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

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

Value of Fees and Services

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

A. The Settlement Agreement requires:

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

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

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

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

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

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

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

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

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

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

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

A. According to the Court's Order:

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

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

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

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

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

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

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

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[4] 915 P.2d 1232, 1237

[5] Ibid.

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

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

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

UNCOLLECTIBLE REVENUES

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

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

Q. Has Staff prepared a comparable uncollectible annualization adjustment?

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

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

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

EMPLOYEE CONCESSION SERVICE

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

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

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

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

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

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

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

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

Q. Please explain your adjustment Schedule C- 21.

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

RENT COMPENSATION

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

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

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

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

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

3 Q. Does Staff agree that the January 2000 rent compensation study should serve as the basis for
4 the test period annualized level of this cost to Arizona?
5 A. Yes. Since the basic test period ends December 31, 1999, the January 2000 study represents
6 the best accounting "match" with the test year and actually employs 1999-vintage data. More
7 current rent compensation studies are now available, but recognizing them would introduce a
8 distortion in test period matching because revenue growth and rate base changes have not also
9 been updated into 1999. However, even though Staff agrees with the January 2000 study used
10 by USWC, it is necessary to make two specific adjustments to the rent compensation test
11 period amounts so as to correct the Company's overlapping adjustment error and to reflect
12 more reasonable rates of return on investment within the study.

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

18 Q. What rate of return is included in the January 2000 rent compensation study, for determination
19 of charges for Arizona's use of shared assets in other states?
20 A. The rent compensation study uses a weighted average of the allowed rates of return from the
21 state commissions that regulate USWC. In the January 2000 study, the overall rate of return
22 across all states for rent compensation purposes is 10.17 percent. Since several of the states
23 involved have not issued a rate order in many years, some of the "allowed" return amounts
24 embedded in the rent compensation study date back many years. For example, the Arizona

authorized rate of return used in the study was determined in 1994, while the returns in other states may be even more dated. A more current rate of return determination would reduce the amount of rent compensation that is "paid" by Arizona to more current cost levels.

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

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

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

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

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

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

part because such changes are not applicable to the other states' assets subject to rent compensation. According to the Company's response to Data Request UTI 30-03:

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

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

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

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

PUBLIC AFFAIRS/ RELATIONS EXPENSES

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

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

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

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

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

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

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

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

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

1 Q. Why should a significant portion of the public affairs and public relations functions within the
2 USWC Public Policy organization be accounted for below the line, rather than collected from
3 ratepayers?
4 A. Some larger fraction of such expenditures should be accounted for below the line because
5 ratepayers derive no direct tangible benefits from legislative/public affairs and image
6 enhancement expenditures made by the Company. Public affairs and public relations
7 expenditures are generally not necessary to provide telephone service to Arizona ratepayers.
8 Moreover, when such costs are incurred by the Company to further its public relations and
9 political agenda, it is likely that such agenda is designed specifically to be more favorable to
10 the Company's shareholders than its ratepayers. USWC management can reasonably be
11 expected to pursue public policy issues in the manner most beneficial to the Company's
12 investors, since investor interest are most directly represented by the US West, Inc. Board of
13 Directors who appoint and direct the actions of management.

14 Q. Have you prepared an adjustment based upon a conclusion that the Accounting Standards
15 described above and USWC's resulting eight percent Public Policy cost assignment below the
16 line is unreasonable?
17 A. Yes. Certain personnel within the USWC Public Policy organization are heavily involved with
18 legislative affairs and public relations activities which appear to be of little or no direct benefit
19 to ratepayers. However, the Company's proposed accounting treats the majority of such
20 personnel and costs as above the line recoverable expenses. Staff Schedule C-19 restates the
21 Company's per books assignment of Public Policy costs, so as to classify below the line 50
22 percent of the costs of Corporate Public Policy and Arizona Public Affairs organizations.

23 Q. Why do you propose to increase the percentage booked below the line to 50%?
24 A. The adjustment I propose is based primarily upon the position descriptions for each of the
25 Public Policy position/job descriptions provided in response to Data Requests, which are

included in Appendix MLB-3. These documents describe the relative importance of various responsibilities of each such position. For example, the responsibilities of USWC's Director of Public Affairs- Managing includes:

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

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

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

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

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

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

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

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

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

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

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

CASH WORKING CAPITAL

Q. What is cash working capital?

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

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

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

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

A. Yes. A lead lag study exists to support the Company's proposed cash working capital allowance in rate base. The Company's updated test period study supports a rate base amount of negative $46.2 million. However, in preparing its update filing, the Company posted an incorrect adjustment amount for cash working capital that results in an incorrect amount of

negative $39.2 million actually being included in USWC's proposed rate base. This problem was disclosed in the Company's response to RUCO Data Request 28-07.

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

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

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

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

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

A. Schedule B-4 is the lead lag study proposed by Staff. It employs the adjusted income statement revenue and expense amounts for each line item that are consistent with other Staff

ratemaking adjustments. In addition, some of the lag day revisions are evident from the study Schedule B-4, while others are embedded within composite lag day values for expense line items that are different from the values proposed by USWC.

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

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

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

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

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

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

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

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

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

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

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

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

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

PLANT RECORDS ADJUSTMENT

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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MICHAEL L. BROSCH

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

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

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

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

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

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

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

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

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

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

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

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

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

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

SALE OF EXCHANGES

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

percent corporate operations expense allocation reflects, in an indirect manner, such recognition.

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

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

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

A. No.

BROADBAND CABLE TRANSACTIONS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

A. Yes. However, despite conversations with Company personnel, considerable discovery problems and delays in this area, information in usable form was difficult to obtain. With respect to the 1999 information relied upon in the Company's proforma adjustment, requests for detailed monthly transaction support yielded only high-level accruals that were reversed

in the following month and non-informative invoice and journal details (UTI 53-08, 62-15 and 62-16). Year 2000 information was received for Arizona transactions with BSI only the week before testimony was due to be filed, precluding any detailed follow-up analysis.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

RECIPROCAL COMPENSATION

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

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

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

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

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

A. At page 15 of his supplemental testimony, Mr. Redding states, "Right now net reciprocal compensation is growing very rapidly. In the future, as agreements are modified or renegotiated, this level may drop. In other words, the situation is very volatile. An automatic adjustment mechanism would ensure that the Company received no more in rates than it is entitled to, whereas inclusion in the base revenue requirement would ensure that the Company

would either over or under collect in the future." Mr. Redding's proposed automatic rider would be changed every six months or quarter based upon reported amounts to the Commission that would be subject to audit at any time.

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

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

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

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

- It is improper, piecemeal ratemaking to single out one isolated element of the overall revenue requirement for rate adjustments, while ignoring other changing revenues and costs that may tend to offset the isolated element.
- Other elements of USWC's revenue requirement are more significant and more variable, yet are not proposed for automatic rate adjustments, causing the Company's proposal to be asymmetrical and distortive of the overall cost of service.
- The costs in question are not significant enough to materially impact USWC earnings if automatic rate adjustments are not approved.
- The incentives for USWC to prudently negotiate and administer reciprocal compensation agreements is diminished if the costs of reciprocal compensation can simply be passed through to ratepayers.
- The administrative cost and complexity of introducing quarterly or semi-annual filings, audits and rate adjustments for reciprocal compensation are not justified in light of the relative importance of such costs to the accurate measurement of USWC's revenue requirement in Arizona.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

AFFILIATE TRUE-UP ADJUSTMENTS

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

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

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

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

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

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

U S WEST INC. DISALLOWANCES

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

A. Because of its large relative size, compared to the other affiliated entities, USWC was charged about [redacted] percent of the allocable costs of this RC (UTI 49-03), which exceeded $[redacted] million

in the test period. The Arizona intrastate share of such costs exceeds [redacted] million, as shown at line 1 of Schedule C-20.

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

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

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

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

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

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

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

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

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

A. Yes. Prior to June of 1998, the President/CEO costs were allocated among USWC and the Media Group entities that were controlled by U S West until the corporate separation of Media Group occurred. This caused a much smaller share of President/CEO costs and other RC's costs to be allocable to USWC prior to June 1998. After the corporate separation occurred, USWI senior executive management costs became primarily allocable to USWC, due to the absence of Media Group support of such costs. However, senior executive management costs

in 2000 and beyond will again be spread more broadly across the consolidated Qwest business, of which USWC is a much smaller component for purposes of cost allocations. The 1999 test period is an anomaly in that U S West, Inc. was temporarily a smaller firm for only a brief period of time.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

A. USWI executive management oversees a portfolio of regulated and non-regulated businesses, including wireless, data communications, long distance, publishing and communications hardware subsidiaries. Analysis and decision making related to management of this portfolio,

by merger, acquisition, asset sales or divestiture, are not appropriately included in the determination of regulated telephone company revenue requirements, since ratepayers do not participate in the market gains and losses or financial results of such diversified business activities. By way of analogy, if an institutional investor retained consultants to build and manage a portfolio of businesses, that investor would have no opportunity to charge his analysis and transaction costs to the businesses that are owned. However, because USWI is the owner of a regulated telephone subsidiary, it does allocate and recover the majority of such costs to USWC's regulated operations.

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

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

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

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

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

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

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

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

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

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

FAIR VALUE

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

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

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

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

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

A. Yes. To the extent the valuation of rate base is increased to account for estimated fair value, a corresponding reduction in the required rate of return is necessary to recognize that the income required to meet investors' requirements does not change when property valuation approaches are changed. Said differently, USWC creditors and shareholders don't require more interest and dividend income or cash flow in fair value jurisdictions like Arizona, than

they require in other states. The business income required to attract capital on reasonable terms is the same, irrespective of the basis of property valuation. No bonus income is required or warranted by the Company as a result of its fair value.

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

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

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

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

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

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

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

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

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

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

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

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

Q. Does this conclude your direct testimony?

A. Yes.

BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission
DOCKETED
JUN 13 1988
DOCKETED BY Ca

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

IN THE MATTER OF THE COMMISSION'S COMPLAINT AND ORDER TO SHOW CAUSE AGAINST MOUNTAIN STATES TELEPHONE AND TELEGRAPH COMPANY REGARDING THE PUBLISHING AGREEMENT.	DOCKET NO. E-1051-86-252 DECISION NO. 56020 ORDER

OPEN MEETING
June 8, 1988
Phoenix, Arizona

BY THE COMMISSION:

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

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

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

FINDINGS OF FACT

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

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

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

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

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

CONCLUSIONS OF LAW

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

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

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

. . .

. . .

. . .

[redacted]

E-1051-86-252

ORDER

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

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

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

IT IS FURTHER ORDERED that this Order shall become effective immediately

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN COMMISSIONER COMMISSIONER

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

JAMES MATTHEWS
Executive Secretary

DISSENT
SJG/mm

0 0 4

SETTLEMENT AGREEMENT

This agreement is entered into this 27th day of April, 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 NO. 1

transfer.

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

(d) Mountain Bell agrees that in subsequent Mountain Bell rate cases the Commission will be provided with reasonable access to the financial records of USWD (hereinafter "USWD" includes any U S West subsidiary or affiliate made a party to the publishing agreement or a successor to the directory publishing activities on behalf of Mountain Bell) for the purpose of verifying the amount of fees received by Mountain Bell from USWD under publishing agreements with USWD and the value of services

provided by/to Mountain Bell to/by USWD. "Financial records" as used in this paragraph, shall include, but not be limited to, financial statements, books, records and related supporting documents. Further, if the records of USWD are not maintained on a basis comparable to that of a regulated utility, Mountain Bell agrees that the Commission will be provided with any available accounting records reconciling or relating the fees and the value of services received by Mountain Bell from USWD under publishing agreements with USWD to the accrual basis of accounting.

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

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

ARIZONA CORPORATION COMMISSION

By _____
Steve Glaser
Its Attorney

THE MOUNTAIN STATES TELEPHONE AND TELEGRAPH COMPANY

By _____
C. Webb Crockett
Its Attorney

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

INTERVENOR: Arizona Corporation Commission Staff (Utilitech)

REQUEST NO: UTI007

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

RESPONSE:

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

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

UTI02-007
ATTACHMENT: A

M E M O R A N D U M

DATE: May 6, 1998

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

FROM: Mike Paradis MP

RE: Cross Charging Lobbying Efforts

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

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

March 27, 1998

MEMO TO:
Northern Region State VPs
Northern Region PA Contacts

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

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

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

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

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

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

Keep up the GREAT work!

Enclosure

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

ACCOUNT 7370
SPECIAL CHARGES

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

Includes work and costs associated with:

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

Cost Consideration:

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

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

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

Exclusion:

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

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

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

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

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

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

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

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

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

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

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

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

Includes work and costs associated with:

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

Exclusion:

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

Cost Consideration:

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

CONFIDENTIAL - DISCLOSE AND DISTRIBUTE SOLELY TO
U S WEST EMPLOYEES HAVING A NEED TO KNOW

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Revised 3/98
(Attachments A and B Update)

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

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

Background Information

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

State Lobbyists

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

"In Session" Guidelines

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

"Out of Session" Guidelines

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

Non-Lobbying Employees Who Perform Lobbying Work Activities

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

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

INTERVENOR: Arizona Corporation Commission Staff (Utilitech)

REQUEST NO: UTI008

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

RESPONSE:

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

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

DOCKET NO. T-1051B-99-105
UTI02- 008
ATTACHMENT: A

U S West Communications

Director Job Description

Director Grade	010	Director DJE Number	D092197
Position Title:	Dir. Public Affairs Managing	Date:	4/1/91

Incumbent Name

Business Unit: State Public Policy Org.

SSN:

Position Reports to: State Vice President

Completed BY: Date:

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

Approved BY: Date:

Summarize in one paragraph the primary purpose of this position.

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

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

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

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

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

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

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

MJE:0120297 Administrative Assistant

Summary:

POSITION SUMMARY:

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

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

INTERVENOR: Arizona Corporation Commission Staff (Utilitech)

REQUEST NO: 026

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

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

RESPONSE:

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

Supplemental Response: 05/06/99

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

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

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

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

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

INTERVENOR: Arizona Corporation Commission Staff (Utilitech)

REQUEST NO: 010

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

RESPONSE:

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

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

MANAGEMENT JOB EVALUATION SUMMARY

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

Date: 22 Oct 97

JOB CATEGORY: REGULATORY

JOB SUB CATEGORY: PUBLIC POLICY (09.30)

JOB TITLE: Director - Public Policy

SALARY GRADE: 010

POSITION TITLE: Director - Public Policy MJE#: D093097

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

File: all other

U S West Communications

Director Job Description

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

Summarize in one paragraph the primary purpose of this position.

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

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

1. Analysis, review and advice on pertinent state and federal legislation that could impact the business climate for SBS. This includes review of proposed legislation; determination of impact; suggestions for changing, opposing or supporting the legislation and working with state public affairs groups and the corporate office of public policy to advise on appropriate action.

2. Interfaces with Market Managers, Product Directors to ensure marketing issues are considered in regulatory, legislative and public policy arenas. Will speak for the Market Managers and Product Managers of SBS in dealings with the MIG and Corporate Pubic Policy group to ensure continuing support of the market unit concept and SBS goals and objectives. Provides direction and coordination to resolve conflict in the legislative and regulatory arenas to ensure consistency with in the fourteen state operating region.

3. Develops SBS strategies in support of AFOR to provide pricing and market flexibility in all fourteen states. The objective is to have pricing ranges that allow us to meet changes in customer expectations without costly rate cases. Represents the market place demands to the appropriate legislative or regultory groups.

4. This corporation is an advocate of the market unit needs with the Corporate Public Policy organization. It presents the ongoing need to focus on regulatory changes that allow market trials, promotions and integrated solutions to be presented to our customer without additional rate cases. This position is also responsible for the privacy of customer information and meeting legal requirements.

5. This position is responsible for writing and negotiating service agreements with the state regulatory organizations to ensure that they understand the SBS mission, will incorporate market based solutions into rate cases and resolve conflicts between both organizations. This position is also the PAC (Political Action Committee) representative for SBS. Incumbent serves on the U S WEST PAC and is responsible for disbursal of PAC funds to appropriate individuals. Respresents the Vice President/General Manager SBS and provides access for the VP/GM to the legislative/regulatory activities in our fourteen state region.

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

Establishes and implements Small Business Services' public policy strategies and objectives. Ensures stakeholder representation in all regulatory policy and legislative involvement. Pubic policy issues are multi-state and precedent setting. Legislative relationships are established and maintained on a national level through U S WEST, Inc. Office of Federal Relations. Manages the relationships between SBS and the public affairs offices to insure the market unit

position is represented effectively in all state legislative and regulatory actions. Position the market unit to act as an advocate for small business issues by impacting state and national organizations that have legislative interest.

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

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

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

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

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

ORGANIZATION STRUCTURE:

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

B. Title of this position: Director-Public Policy

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

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

Total Number of employees Supervised (if appropriate):

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

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

Name	SSN	RC

ORGANIZATION: PUBLIC POLICY, U S WEST COMMUNICATIONS

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

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

The job will include the following responsibilities:

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

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

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

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

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

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

ORGANIZATION: PUBLIC POLICY, U S WEST COMMUNICATIONS

(POSITION TITLE:

JOB DESCRIPTION: Director - Wholesale Advocacy (Interconnection)

MGE #: D093297

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

The job will include the following responsibilities:

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

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

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

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

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

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

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

ORGANIZATION: U S WEST COMMUNICATIONS
PUBLIC POLICY

JOB TITLE: EXECUTIVE DIRECTOR - WHOLESALE ADVOCACY

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

ORGANIZATION: U S WEST COMMUNICATIONS
PUBLIC POLICY

JOB TITLE: EXECUTIVE DIRECTOR - RETAIL ADVOCACY

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

ORGANIZATION: U S WEST COMMUNICATIONS
PUBLIC POLICY

JOB TITLE: EVEC DIRECTOR - LEGISLATIVE ADVOCACY

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Region Vice President

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

Responsibilities

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

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

Job Description

- Direct administration of the U S WEST Pioneer Organization:
  - Coordinate volunteer leaders of the Chapters Councils and Clubs;
  - Develop, track and control budget;
  - Communicate with senior management of U S WEST about Pioneers;
  - Coordinate with community relations, foundation, internal communications and media relations to maximize business value of Pioneers;
  - Track key measurements and implement action to maximize results of U S WEST Pioneers;

- Plan and moderate U S WEST Pioneer annual conference.
- Serve on the Telephone Pioneers of America (TPA) Executive Committee, which is the TPA policy making body.
- Represent the Pioneers to external organizations.
- Personally become involved in Pioneer community service efforts.
- Direct the solicitation of eligible U S WEST employees for membership in the U S WEST PAC:
  - Determine the policies and procedures to be utilized in the solicitation of contributions to U S WEST PAC;
  - Supervise or conduct all solicitation activity.
- Oversee the preparation and distribution of any printed or graphic material to be used in connection with the activities of U S WEST PAC.
- Request disbursements from the U S WEST PAC at the direction of the Contributions Committee.
- Provide regular reports on U S WEST PAC activities to senior management and PAC members.

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
INDEX TO ACC STAFF JOINT ACCOUNTING EXHIBIT
AND SUPPORTING SCHEDULES

08/07/00
05:01 PM

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A-1	REVENUE CONVERSION FACTOR	S. Carver
B	**SUMMARY OF JURISDICTIONAL RATE BASE**	S. Carver
B-1	UNRECORDED RETIREMENTS	M. Brosch
B-2	SOP 98-1 (INTERNAL-USE SOFTWARE)	S. Carver
B-3	FAS87 PENSION ASSET	S. Carver
B-4	CASH WORKING CAPITAL	M. Brosch
B-5	PROFORMA DEPRECIATION -- RESERVE REVERSAL	S. Carver
B-6	BROADBAND CABLE TRANSACTIONS (ASSET TRANSFER)	M. Brosch
B-7	FCC DEREG -- SEPARATIONS ADJUSTMENT	S. Carver
C	**SUMMARY OF OPERATING INCOME**	S. Carver
C-1	REVENUE ANNUALIZATION - RECURRING LOCAL SERVICE	M. Brosch
C-2	ANNUALIZATION OF INTRASTATE TOLL REVENUES	M. Brosch
C-3	REVERSAL OF ACCESS ANNUALIZATION	M. Brosch
C-4	MISCELLANEOUS REVENUE NORMALIZATION	M. Brosch
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F	**SEPARATION FACTOR COMPOSITES**	S. Carver

Witness: S. Carver
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
CHANGE IN GROSS REVENUE REQUIREMENT
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

ACC Staff
Schedule A
Page 1 of 1

LINE NO.	DESCRIPTION	SOURCE	COMPANY PROPOSED AMOUNT ORIGINAL COST	COMPANY PROPOSED AMOUNT FAIR VALUE	ACC STAFF PROPOSED AMOUNT ORIGINAL COST	ACC STAFF PROPOSED AMOUNT FAIR VALUE
	(A)	(B)	(C)	(D)	(E)	(F)
1	Adjusted Rate Base	Sch. B	$1,422,100	$1,772,112	$1,435,287	$1,445,779
2	Required Rate of Return	Notes (a) & (b)	10.86%	10.86%	9.68%	9.61%
3	Required Operating Income	Line 1 * Line 2	154,440	192,451	138,936	138,936
4	Adjusted Net Operating Income	Sch. C	43,833	43,833	134,271	134,271
5	Operating Income Deficiency	Line 3 - Line 4	110,607	148,618	4,665	4,665
6	Gross Revenue Conversion Factor	Sch. A-1	1.7056	1.7056	1.6995	1.6995
7	Increase in Gross Revenue Requirements	Line 5 * Line 6	188,655	253,488	7,928	7,928
8	Add: Bellcore 3 Year Adjustment		(686)	(686)	(686)	(686)
9	Automatic Adjustment Revenue Req.	Note (c)	13,252	13,252	----Included in Line 7, above----	
10	Total Increase/(Reduction) in Gross Revenue Requirement		**$201,221**	**$266,054**	**$7,242**	**$7,242**
			Note (d)			

FOOTNOTES:

(a) USWC provided no information in its updated filing regarding fair rate of return on fair value, but in response to UTI 43-21S1, assigned the same cost of capital to both original cost and fair value rate base.

(b) Staff proposes rate of return on fair value at level required to earn required operating income and cost of capital

(c) Staff has included Reciprocal Compensation costs in the basic revenue requirement and opposes USWC proposed Automatic Adjustment mechanism for such costs (See testimony of M. Brosch)

(d) Revenue Requirement of $201,220,000 per USWC Exhibit GAR-S1 (Redding Supplemental Exhibits). Difference due to rounding.

Witness: S. Carver
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
REVENUE CONVERSION FACTOR
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

ACC Staff
Schedule A-1
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LINE NO.	DESCRIPTION	COMPANY REFERENCE	FACTOR PER COMPANY	STAFF REFERENCE	FACTOR PER ACC Staff
	(A)	(B)	(C)	(D)	(E)
1	Gross Intrastate Revenue		100.000000%		100.000000%
2	Less: Uncollectible Revenue	(a)	1.850900%	See Sched. C-7	1.490000%
3	Total Revenue	Ln1-Ln2	98.149100%		98.510000%
4	Less: Taxes on Local Revenue	(b)	0.106600%		-0.113700%
5	Taxable Income	Ln3-Ln4	98.042500%		98.396300%
6	Less: Effective State Income Tax	Line 5 * 8.00%	7.843400%		-7.871704%
7	Less: Effective Federal Income Tax	Line 5 * 32.2%	31.569685%		-31.683609%
8	Net Operating Earnings	Ln5-Ln6-Ln7	58.629415%		58.840987%
9	GROSS REVENUE CONVERSION FACTOR	Ln 1/Ln 8	1.7056		1.6995

FOOTNOTES:

(a) Based on Test Year End of Period Adjustment at Schedule C-7 and UTI 48-13.
(b) Includes Franchise and License taxes and Sales tax assumed.

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
SUMMARY OF JURISDICTIONAL RATE BASE
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION		COMPANY PROPOSED RATE BASE	ACC STAFF TEST YEAR ADJUSTMENTS	ACC STAFF PROPOSED RATE BASE
	(A)		(B)	(C)	(D)
	Original Cost				
1	Telephone Plant In Service	Note (a)	$3,566,015	($35,254)	$3,530,761
2	Short-Term Plant Under Construction		0	0	0
3	Materials and Supplies		18,386	0	18,386
4	Allowance for Cash Working Capital		(39,211)	(9,469)	(48,680)
5	Accumulated Depr & Amort Reserve		(1,923,025)	144,140	(1,778,885)
6	Accumulated Deferred Income Tax		(240,535)	(20,009)	(260,544)
7	Customer Deposits		(7,711)	0	(7,711)
8	Land Development Agreement Deposits		(18,040)	0	(18,040)
9	Other Assets & Liabilities		66,221	(66,221)	0
10	**END OF PERIOD RATE BASE - ORIGINAL COST**		$1,422,100	$13,187	$1,435,287
11	**Fair Value Rate Base**		$1,772,112		
12	Staff Rate Base Accounting Adjustments	Note (b)		13,187	
13	Staff Witness Dunkel RCND Study Adjustme	Note (c)		(339,520)	
14	Total Staff Fair Value Adjustments			(326,333)	
15	**END OF PERIOD RATE BASE - FAIR VALUE**				$1,445,779

FOOTNOTES:

(a) SOURCE: Adjusted Test Year per USWC Exhibit GAR-4 (Redding Supplemental Exhibit). Fair Value from UTI 58-02, Att. A. Staff adjustments at original cost also posted at fair value.

(b) SOURCE: Schedule B, page 2 of 2.

(c) SOURCE: Testimony/Exhibits of William Dunkel.

Witness: S. Carver
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
SUMMARY OF ACC STAFF RATE BASE ADJUSTMENTS
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	ADJUSTMENT NUMBER / SCHEDULE REFERENCE							TOTAL
		B-1	B-2	B-3	B-4	B-5	B-6	B-7	
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)
1	Telephone Plant In Service	($40,076)	($7,417)				$10,191	$2,048	($35,254)
2	Short-Term Plant Under Construction							0	0
3	Materials and Supplies							0	0
4	Allowance for Cash Working Capital				(9,469)			0	(9,469)
5	Accumulated Depr & Amort Reserve	40,076				107,968	(3,400)	(504)	144,140
6	Accumulated Deferred Income Tax			23,877		(43,403)		(483)	(20,009)
7	Customer Deposits							0	0
8	Land Development Agreement Deposits							0	0
9	Other Assets & Liabilities			(66,221)				0	(66,221)
10	**End-of-Period Rate Base**	$0	($7,417)	($42,344)	($9,469)	$64,565	$6,791	$1,061	$13,187

ADJUSTMENTS:

B-1 UNRECORDED RETIREMENTS
B-2 SOP 98-1 (INTERNAL-USE SOFTWARE)
B-3 FAS87 PENSION ASSET
B-4 CASH WORKING CAPITAL
B-5 PROFORMA DEPRECIATION -- RESERVE REVERSAL
B-6 BROADBAND CABLE TRANSACTIONS (ASSET TRANSFER)
B-7 FCC DEREG -- SEPARATIONS ADJUSTMENT

Witness: M. Brosch
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
UNRECORDED RETIREMENTS
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION			PROPERTY VINTAGE	ARIZONA VINTAGE INVESTMENT AMOUNT	%INTRASTATE	INTRASTATE UNRECORDED PLANT RETIREMENT AMOUNT	INTRASTATE ACCUMULATED DEPRECIATION AMOUNT
	(A)			(B)	(C)	(D)	(E)	(F)
1	General Purpose Computers	361C	Account 2124	1989	$24,060	0.7089	$17,056	$17,056
2	Digital Switching Equipment	DEZ	Account 2212	1955	397	0.7996	317	317
3	Digital Circuit Equipment	CRD	Account 2232	1955	737	0.6673	492	492
4	Underground Metallic Cable	UGM	Account 2422	1925	10,104	0.7380	7,457	7,457
5	Buried Metallic Cable	BCM	Account 2423	1925	16,781	0.7380	12,384	12,384
6	Intra-Building Metallic Cable	IBM	Account 2426	1925	3,211	0.7380	2,370	2,370
7	Total				$55,290		$40,076	$40,076
					(a)	(b)		(c)
8	STAFF ADJUSTMENT TO RATE BASE FOR UNRECORDED RETIREMENTS				TELEPHONE PLANT IN SERVICE		($40,076)	
9					ACCUMULATED DEPRECIATION			$40,076
10					- NET PLANT			$0

FOONOTES:

(a) Source: USWC's RCND study, Exh. NHH-1, pages 26, 29, 34, 45, 48 and 53.
(b) Source: ACC Staff Schedule C-15.
(c) Accumulated Depreciation is reduced in same amount as retired Plant in Service under normal mass asset accounting pursuant to FCC Part 32.

Witness: S. Carver
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
SOP 98-1 (INTERNAL-USE SOFTWARE)
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	SOURCE	AMOUNT
	(A)	(B)	(C)
1	USWC Proposed Adjustment to Correct Plant Investment for Out of Period Software Capitalization	Note (a)	($7,417)
2	ACC STAFF ADJUSTMENT TO RECOGNIZE COMPANY PROPOSED CORRECTION ADJUSTMENT		($7,417)

FOOTNOTE:
(a) Source: USWC response to UTI 43-20, Attachment G.

Witness: S. Carver
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
FAS87 PENSION ASSET
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	SOURCE	INTRASTATE AMOUNT
	(A)	(B)	(C)
1	USWC FAS87 Pension Asset Included in Rate Base	Note (a)	$66,221
2	Less: Accumulated Deferred Income Tax Reserve, Rate Base Offset	Note (b)	(23,877)
3	Net Pension Asset in USWC's Proposed Rate Base		$42,344
4	ACC STAFF ADJUSTMENT TO ELIMINATE USWC'S PROPOSED PENSION ASSET		($42,344)

FOOTNOTE:
(a) Source: USWC workpapers and Updated Adjustment P-04.
(b) Source: USWC response to UTI 43-10.

Witness: M. Brosch
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
CASH WORKING CAPITAL
TEST YEAR ENDING DECEMBER 31, 1999

Calculation of Composite Net Revenue Lag Days:

LINE NO.		Test Year Adjuste Revenues $000 (A)	Weighted Factor (B)	Revenue Lead (C)	Weighted Lead (D)	
1	Local Revenue	$937,608	74.45%	19.4	14.4	
2	Network Access Service	113,428	9.01%	42.0	3.8	
3	Long Distance Network Service	22,773	1.81%	42.5	0.8	
4	Billing and Collection Revenue	6,725	0.53%	42.0	0.2	
5	Miscellaneous Revenue	178,929	14.21%	24.6	3.5	
6	TOTAL REVENUE	$1,259,464	100.00%		**22.7**	Composite Revenue Lead/Lag Days

Calculation of Cash Working Capital Requirement:

		Test Year Adjuste Expenses $000 (A)	Expense Lag Days (B)	Net Lag Days (col B - rev. lag) (C)	Net Lag Factor (col C / 365 days) (D)	CWC Requirement (col D * col A) (E)
7	Maintenance	261,129	23.8	-1.1	-0.0030	(787)
8	Engineering Expense	10,079	27.3	-4.6	-0.0126	(127)
9	Network Operations	44,184	27.2	-4.5	-0.0123	(545)
10	Network Administration	1,894	25.3	-2.6	-0.0071	(13)
11	Access Expense	37,116	43.8	-21.1	-0.0578	(2,146)
12	Other Expense	960	33.7	-11.0	-0.0301	(29)
13	Customer Operations	187,393	29.1	-6.4	-0.0175	(3,286)
14	Corporate Operations	134,129	32.2	-9.5	-0.0260	(3,491)
15	Property Taxes	45,659	206.6	-183.9	-0.5038	(23,005)
16	Other Taxes (excluding Income Taxes)	3,231	-25.6	48.3	0.1323	428
17	Uncollectibles	16,000	22.7	0.0	0.0000	0
18	Depreciation Expense	325,396	22.7	0.0	0.0000	0
19	Current Federal Income Taxes	65,464	36.0	-13.3	-0.0364	(2,385)
20	Current State Income Taxes	16,830	61.1	-38.4	-0.1052	(1,771)
21	Deferred Income Taxes	(52,783)	22.7	0.0	0.0000	0
22	TOTAL OPERATING EXPENSES & INCOME	1,096,681				(37,157)
23	Interest Expense	50,522	92.7	-70.0	-0.1918	(9,689)
24	Federal Excise Taxes	20,796	N/A	-0.2	-0.0005	(11)
25	Sales Tax	62,755	N/A	-10.6	-0.0290	(1,822)
26	Average Benefit Liability					0
27	TOTAL MISCELLANEOUS ITEMS	$134,073				(11,523)
28	CASH WORKING CAPITAL REQUIREMENT - PER STAFF					(48,680)
29	CASH WORKING CAPITAL - PER USWC					(39,211)
30	STAFF ADJUSTMENT TO CASH WORKING CAPITAL					($9,469)

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
PROFORMA DEPRECIATION -- RESERVE REVERSAL
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	SOURCE	USWC PROPOSE ADJUSTMENT	ACC STAFF REVERSAL
	(A)	(B)	(C)	(D)
1	Accumulated Depr & Amort Reserve	(a)	($107,968)	$107,968
2	Accumulated Deferred Income Tax	(a)	43,403	(43,403)
3	Net Rate Base Effect		($64,565)	
4	ACC STAFF ADJUSTMENT TO REVERSE THE EFFECT OF USWC'S PROFORMA ADJUSTMENT TO RATE BASE FOR THE CHANGE IN BOOK DEPRECIATION RATES AUTHORIZED IN MAY 2000			$64,565

FOOTNOTE:
(a) Source: USWC workpapers and Updated Adjustment P-03.

Witness: M. Brosch
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
BROADBAND CABLE TRANSACTIONS (ASSET TRANSFER)
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

ACC Staff
Schedule B-6
Page 1 of 1

LINE NO.	DESCRIPTION	SOURCE	USWC ADJUSTMENT AMOUNT	STAFF ELIMINATION ADJUSTMENT AMOUNT
	(A)	(B)	(C)	(D)
1	Plant in Service Adjustment for Proposed Cable Asset Transfe	Co. WP's & RUCO 26-3A	($10,191)	$10,191
2	Accumulated Depreciation Reserve		(3,400)	3,400
3	Net Plant In Service	Line 1 - Line 2	(6,791)	6,791
4	STAFF ADJUSTMENT TO REVERSE/ELIMINATE USWC'S CABLE ASSET TRANSFER ADJUSTMENT			$6,791

Witness: S. Carver
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
FCC DEREG -- SEPARATIONS ADJUSTMENT
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	Intrastate Adjustments			Composite Separation Factors			Ratio	ACC Staff Adjustment
		USWC Proposed	Staff Proposed	Total	USWC Proposed (incl. FCC Dereg)	Staff Proposed (excl. FCC Dereg)	Net Change	(H=G/E)	(I=H*D)
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)
	Original Cost								
1	Telephone Plant In Service	($133,092)	($37,302)	($170,394)	0.7230	0.7143	-0.0087	-1.20%	$2,048
2	Short-Term Plant Under Construction	0	0	0	0.0000	0.0000	0.0000	n/a	0
3	Materials and Supplies	0	0	0	0.7252	0.7029	-0.0223	-3.08%	0
4	Allowance for Cash Working Capital	(14,813)	(9,469)	(24,282)	1.0000	1.0000	0.0000	n/a	0
5	Accumulated Depr & Amort Reserve	(104,538)	144,644	40,106	0.7192	0.7102	-0.0090	-1.26%	(504)
6	Accumulated Deferred Income Tax	68,525	(19,526)	48,999	0.7452	0.7379	-0.0073	-0.99%	(483)
7	Customer Deposits	(2,015)	0	(2,015)	0.7387	0.7121	-0.0266	n/a	0
8	Land Development Agreement Deposits	0	0	0	0.7315	0.7315	0.0000	n/a	0
9	Other Assets & Liabilities	66,221	(66,221)	0	0.0000	0.0000	0.0000	n/a	0
10	END OF PERIOD RATE BASE AMOUNT	($119,712)	$12,126	($107,586)	0.7119	0.7031	-0.0087		$1,061
		(a)	(b)		(c)	(c)			

FOONOTES:
(a) Source: USWC Exhibit GAR-S4A and GAR-S4B, Company witness G. Redding.
(b) Source: ACC Staff Schedule B (excluding B-7).
(c) Source: ACC Staff Schedule F.

Witness: S. Carver
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
SUMMARY OF OPERATING INCOME
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	COMPANY ADJUSTED OPERATING INCOME	ACC Staff PROPOSED ADJUSTMENTS	ACC Staff ADJUSTED OPERATING INCOME
	(A)	(B)	(C)	(D)
	Revenues			
1	Local Service Revenues	$920,762	$16,846	$937,608
2	Network Access Service Revenues	115,252	(1,824)	113,428
3	Long Distance Network Service Rev.	22,413	360	22,773
4	Miscellaneous	131,842	53,812	185,654
5	Total Operating Revenue	$1,190,269	$69,195	$1,259,464
	Expenses			
6	Maintenance	262,322	(1,193)	261,129
7	Engineering Expense	10,745	(666)	10,079
8	Network Operations	49,225	(5,041)	44,184
9	Network Administration	2,212	(318)	1,894
10	Access Expense	1,423	35,693	37,116
11	Other	1,271	(311)	960
12	Total Cost of Svcs & Products	$327,198	$28,164	$355,362
13	Customer Operations	219,291	(31,898)	187,393
14	Corporate Operations	206,976	(72,847)	134,129
15	Property and Other Taxes	48,017	873	48,890
16	Uncollectibles	16,101	(101)	16,000
17	Tot Selling, General & Administrative	$490,385	($103,973)	$386,412
18	Other Operating Income & Expense	847	(366)	481
19	Depreciation Expense	328,884	(3,488)	325,396
20	Universal Service Fund	0	0	0
21	Link Up America	(117)	29	(88)
22	Total Operating Expense	$1,147,197	($79,634)	$1,067,563
23	**Income From Operations**	$43,072	$148,830	$191,902
	Taxes			
24	Federal Income Tax	($3,111)	48,654	$45,543
25	State & Local Income Tax	2,350	9,738	12,088
26	**Net Operating Income** (Line 23-24-25)	$43,833	$90,438	$134,271
		(a)	**(b)**	

FOOTNOTES:

(a) SOURCE: Adjusted Test Year per USWC Exhibit GAR-S5 (corrected per response to UTI 56-2).
(b) ACC Staff Schedule C, Page 3 of 3.

Witness: S. Carver
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
SUMMARY OF ACC STAFF NOI ADJUSTMENTS
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	ADJUSTMENT NUMBER / SCHEDULE REFERENCE C-1	C-2	C-3	C-4	C-5	C-6	C-7	C-8	C-9	SUBTOTAL
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)
	Revenues										
1	Local Service Revenues	$8,887							$7,960		$16,846
2	Network Access Service Revenues			(1,824)							(1,824)
3	Long Distance Network Service Rev.		360								360
4	Miscellaneous				(1,473)	41,340	3,657				43,524
5	Total Operating Revenue	$8,887	$360	($1,824)	($1,473)	$41,340	$3,657	$0	$7,960	$0	$58,907
	Expenses										
6	Maintenance						2,068				$2,068
7	Engineering Expense										0
8	Network Operations										0
9	Network Administration										0
10	Access Expense										0
11	Other										0
12	Total Cost of Svcs & Products	$0	$0	$0	$0	$0	$2,068	$0	$0	$0	$2,068
13	Customer Operations										0
14	Corporate Operations								(1,651)	1,087	(564)
15	Property and Other Taxes										0
16	Uncollectibles							(101)			(101)
17	Tot Selling, General & Administrative	$0	$0	$0	$0	$0	$0	($101)	($1,651)	$1,087	($665)
18	Other Operating Income & Expense										0
19	Depreciation Expense										0
20	Universal Service Fund										0
21	Link Up America										0
22	Total Operating Expense	$0	$0	$0	$0	$0	$2,068	($101)	($1,651)	$1,087	$1,402
23	**Income From Operations**	$8,887	$360	($1,824)	($1,473)	$41,340	$1,589	$101	$9,611	($1,087)	$57,505
	Taxes										
24	Federal Income Tax	$2,862	$116	($587)	($474)	$13,312	$512	$33	$3,095	($350)	$18,517
25	State & Local Income Tax	711	29	(146)	(118)	3,307	127	8	769	(87)	4,600
26	**Net Operating Income** (Line 23-24-25)	$5,314	$215	($1,091)	($881)	$24,722	$950	$61	$5,747	($650)	$34,388

ADJUSTMENTS:

- C-1 REVENUE ANNUALIZATION - RECURRING LOCAL SERVICE
- C-2 ANNUALIZATION OF INTRASTATE TOLL REVENUES
- C-3 REVERSAL OF ACCESS ANNUALIZATION
- C-4 MISCELLANEOUS REVENUE NORMALIZATION
- C-5 DIRECTORY IMPUTATION PER AGREEMENT
- C-6 BROADBAND CABLE TRANSACTIONS
- C-7 UNCOLLECTIBLES ANNUALIZATION
- C-8 SERVICE QUALITY PROGRAM COST ELIMINATION
- C-9 AFFILIATE TRANSACTION TRUE-UP NORMALIZATION

Witness: S. Carver
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
SUMMARY OF ACC STAFF NOI ADJUSTMENTS
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	PRIOR PAGE SUBTOTAL	ADJUSTMENT NUMBER / SCHEDULE REFERENCE C-10	C-11	C-12	C-13	C-14	C-15	C-16	C-17	SUBTOTAL
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)
	Revenues										
1	Local Service Revenues	$16,846									$16,846
2	Network Access Service Revenues	(1,824)									(1,824)
3	Long Distance Network Service Rev.	360									360
4	Miscellaneous	43,524								3,562	47,086
5	Total Operating Revenue	$58,907	$0	$0	$0	$0	$0	$0	$0	$3,562	$62,469
	Expenses										
6	Maintenance	$2,068	9,259	(6,660)	(155)		(6,527)			0	(2,015)
7	Engineering Expense	0	(453)	(171)	32		(143)			0	(734)
8	Network Operations	0	(1,996)	(1,265)	(202)		(1,099)			0	(4,561)
9	Network Administration	0	(192)	(58)	(20)		(50)			0	(319)
10	Access Expense	0	17,752	0	0		(41)			0	17,711
11	Other	0	(248)	(26)	0					0	(274)
12	Total Cost of Svcs & Products	$2,068	$24,122	($8,180)	($345)	$0	($7,858)	$0	$0	$0	$9,807
13	Customer Operations	0	(18,600)	(4,194)	(2,056)		(3,984)			0	(28,834)
14	Corporate Operations	(564)	(14,802)	(1,256)	(3,039)	(42,246)	(1,266)			0	(63,173)
15	Property and Other Taxes	0	0		0					4	4
16	Uncollectibles	(101)	0		0					0	(101)
17	Tot Selling, General & Administrative	($665)	($33,402)	($5,450)	($5,095)	($42,246)	($5,251)	$0	$0	$4	($92,105)
18	Other Operating Income & Expense	0	(366)							0	(366)
19	Depreciation Expense	0	0			9,933		(2,948)		0	6,984
20	Universal Service Fund	0	n/a							0	0
21	Link Up America	0	29							0	29
22	Total Operating Expense	$1,402	($9,617)	($13,630)	($5,440)	($32,313)	($13,109)	($2,948)	$0	$4	($75,651)
23	**Income From Operations**	$57,505	$9,617	$13,630	$5,440	$32,313	$13,109	$2,948	$0	$3,558	$138,120
	Taxes										
24	Federal Income Tax	$18,517	$3,097	$4,389	$1,752	$10,405	$4,221	$949	($37)	$1,146	$44,437
25	State & Local Income Tax	4,600	769	1,090	435	2,585	1,049	236	(9)	$285	11,040
26	**Net Operating Income** (Line 23-24-25)	$34,388	$5,751	$8,151	$3,253	$19,323	$7,839	$1,763	$46	$2,128	$82,642

ADJUSTMENTS:

- **C-10** EOP NONLABOR REVERSAL
- **C-11** YEAR-END WAGE & SALARY ANNUALIZATION
- **C-12** INCENTIVE COMPENSATION
- **C-13** SOP 98-1 (INTERNAL-USE SOFTWARE)
- **C-14** USWC PAYROLL ADJUSTMENT REVERSAL
- **C-15** PROFORMA DEPRECIATION ANNUALIZATION
- **C-16** INTEREST SYNCHRONIZATION ADJUSTMENT
- **C-17** FCC DEREGULATED SERVICES REVENUE IMPUTATION

Witness: S. Carver
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
SUMMARY OF ACC STAFF NOI ADJUSTMENTS
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	PRIOR PAGE SUBTOTAL	ADJUSTMENT NUMBER / SCHEDULE REFERENCE C-18	C-19	C-20	C-21	C-22	C-23	C-24	C-25	SUBTOTAL
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)
	Revenues										
1	Local Service Revenues	$16,846	$-0								$16,846
2	Network Access Service Revenues	(1,824)	0								(1,824)
3	Long Distance Network Service Rev.	360	0								360
4	Miscellaneous	47,086	0								47,086
5	Total Operating Revenue	$62,469	$0	$0	$0	$0	$0	$0	$0	$0	$62,469
	Expenses										
6	Maintenance	(2,015)	822								(1,193)
7	Engineering Expense	(734)	71								(663)
8	Network Operations	(4,561)	(479)								(5,041)
9	Network Administration	(319)	1								(318)
10	Access Expense	17,711	0								17,711
11	Other	(274)	(38)								(311)
12	Total Cost of Svcs & Products	$9,807	$377	$0	$0	$0	$0	$0	$0	$0	$10,184
13	Customer Operations	(28,834)	(16)								(28,851)
14	Corporate Operations	(63,173)	4,969	(756)	(1,142)	(471)					(60,573)
15	Property and Other Taxes	4	45						(1,238)	2,061	873
16	Uncollectibles	(101)	0								(101)
17	Tot Selling, General & Administrative	($92,105)	$4,998	($756)	($1,142)	($471)	$0	$0	($1,238)	$2,061	($88,652)
18	Other Operating Income & Expense	(366)	0								(366)
19	Depreciation Expense	6,984	(1,755)				(2,877)	0			2,352
20	Universal Service Fund	0	0								0
21	Link Up America	29	0								29
22	Total Operating Expense	($75,651)	$3,621	($756)	($1,142)	($471)	($2,877)	$0	($1,238)	$2,061	($76,453)
23	**Income From Operations**	138,120	($3,621)	$756	$1,142	$471	$2,877	$0	$1,238	($2,061)	$138,922
	Taxes										
24	Federal Income Tax	44,437	($1,166)	$243	$368	$152	$927	$0	$399	($664)	$44,696
25	State & Local Income Tax	11,040	(290)	60	91	38	230	0	99	(165)	11,105
26	**Net Operating Income** (Line 23-24-25)	$82,642	($2,165)	$452	$683	$282	$1,721	$0	$740	($1,233)	$83,122

ADJUSTMENTS:

- **C-18** FCC DEREG -- SEPARATIONS ADJUSTMENT
- **C-19** PUBLIC AFFAIRS/RELATIONS EXPENSE DISALLOW
- **C-20** US WEST INC. DEPARTMENTAL DISALLOWANCES
- **C-21** EMPLOYEE CONCESSION ALLOCATION TO INTERSTATE
- **C-22** DEPRECIATION ON UNRECORDED RETIREMENTS
- **C-23** RESERVED
- **C-24** PROPERTY TAX CORRECTION
- **C-25** OUT OF PERIOD PROPERTY AND OTHER TAXES

Witness: S. Carver
Prefiled Direct Testimony

ACC Staff
Schedule C
Page 5 of 5

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
SUMMARY OF ACC STAFF NOI ADJUSTMENTS
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	PRIOR PAGE SUBTOTAL	ADJUSTMENT NUMBER / SCHEDULE REFERENCE C-26	C-27	C-28	C-29	C-30	C-31	C-32	C-33	TOTAL
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)
	Revenues										
1	Local Service Revenues	$16,846									$16,846
2	Network Access Service Revenues	(1,824)									(1,824)
3	Long Distance Network Service Rev.	360									360
4	Miscellaneous	47,086			165		6,561				53,812
5	Total Operating Revenue	$62,469	$0	$0	$165	$0	$6,561	$0	$0	$0	$69,195
	Expenses										
6	Maintenance	(1,193)									(1,193)
7	Engineering Expense	(663)		(2)							(666)
8	Network Operations	(5,041)									(5,041)
9	Network Administration	(318)									(318)
10	Access Expense	17,711					17,982				35,693
11	Other	(311)									(311)
12	Total Cost of Svcs & Products	$10,184	$0	($2)	$0	$0	$17,982	$0	$0	$0	$28,164
13	Customer Operations	(28,851)		(9)		(3,038)					(31,898)
14	Corporate Operations	(60,573)		(9,919)		(2,354)					(72,847)
15	Property and Other Taxes	873									873
16	Uncollectibles	(101)									(101)
17	Tot Selling, General & Administrative	($88,652)	$0	($9,928)	$0	($5,393)	$0	$0	$0	$0	($103,973)
18	Other Operating Income & Expense	(366)									(366)
19	Depreciation Expense	2,352				(5,840)					(3,488)
20	Universal Service Fund	0									0
21	Link Up America	29									29
22	Total Operating Expense	($76,453)	$0	($9,931)	$0	($11,233)	$17,982	$0	$0	$0	($79,634)
23	**Income From Operations**	138,922	$0	$9,931	$165	$11,233	($11,421)	$0	$0	$0	$148,830
	Taxes										
24	Federal Income Tax	44,696	$768	$3,198	$53	$3,617	($3,678)	$0	$0	$0	$48,654
25	State & Local Income Tax	11,105	(2,159)	794	13	899	(914)	0	0	0	9,738
26	**Net Operating Income** (Line 23-24-25)	$83,122	$1,392	$5,939	$99	$6,717	($6,830)	$0	$0	$0	$90,438

ADJUSTMENTS:

- **C-26** OUT OF PERIOD INCOME TAXES
- **C-27** IMAGE ADVERTISING, OLYMPIC/SPORTS SPONSORSHIP
- **C-28** RENT COMPENSATION
- **C-29** EXCHANGE SALE ALLOCATION ADJUSTMENTS
- **C-30** RECIPROCAL COMPENSATION
- **C-31** RESERVED
- **C-32** RESERVED
- **C-33** RESERVED

Witness: M. Brosch
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
REVENUE ANNUALIZATION - RECURRING LOCAL SERVICE
TEST YEAR ENDING DECEMBER 31, 1999

CONFIDENTIAL

LINE NO.	DESCRIPTION	ACCOUNT #	Per Books December 99 Revenues Note (a)	Adjustment to Normalize Recorded Amount Note (b)	Annualized Revenues Normal Dec. * 12 Cols (C-D) * 12	Per Books Test Period Revenues Note (c)	Annualization Adjustment $000 Col E - Col F
	(A)	(B)	(C)	(D)	(E)	(F)	(G)
	Local Service Recurring Revenue Accounts:						
1		5001.1100	$31,015,994	($1,225,067)	$357,491,124	$340,519,473	$16,971,651
2		5001.2100	26,556,726		318,680,712	312,074,014	6,606,698
3		5001.5100	861,065		10,332,780	9,232,500	1,100,280
4		5001.7100	15,056		180,672	190,627	(9,955)
5		5001.8100	45,913		550,956	694,473	(143,517)
6		5060.1110	4,974,328		59,691,936	66,892,894	(7,200,958)
7		5060.1210	10,205,934		122,471,208	113,565,200	8,906,008
8		5060.1310	17,581		210,972	208,744	2,228
9		5060.1510	5,271		63,252	1,070,790	(1,007,538)
10		5060.1610	(22,375)		(268,500)	(21,565)	(246,935)
11		5060.2100	1,132		13,584	13,674	(90)
12		5060.4100	58,879		706,548	67,475	639,073
13		5001.4110	87,649		1,051,788	1,230,661	(178,873)
14		5001.4210	166,684		2,000,208	1,538,567	461,641
15	Total Local Service Accounts Annualized by Staff		$73,989,837	($1,225,067)	$873,177,240	$847,277,527	$25,899,713
16	Add: Annualized Impact of Rate Changes Not Included Above:						
17	Directory Assistance Reduction	per UTI 44-04					[redacted]
18	Digital Services Non-recurring Charges	"					
19	Super Savings Plan Non-recurring Charges	"					
20	**Total Staff Annualized Local Service Revenues Per Above**						$21,331,345
21	Less: USWC's Proposed Local Service Annualization Adjustment (P-01 WP's)						12,444,486
22	Staff Adjustment to Restate Local Service Revenue Annualization						$8,886,859
23	STAFF ADJUSTMENT RESTATING LOCAL SERVICE REVENUE ANNUALIZATION - ROUNDED $000						$8,887

Footnotes :

(a) All amounts per Company Workpapers and MR4 Reports

(b) Elimination of Centrex Overbilling (UTI 42-09A), CRIS Posting Accruals (UTI 49-06) and Year-end Accrual Normalization (UTI 49-06). Same as Company-proposed normalizations to these accounts.

(c) All amounts per Company Workpapers and MR4 Reports

(d) USWC's proposed annualization of local revenues is included in adjustment P-01. The Company annualized many more revenue accounts, including non-recurring local revenues, directory assistance, message charges and resale revenue accounts.

Witness: M. Brosch
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
ANNUALIZATION OF INTRASTATE TOLL REVENUES
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

ACC Staff
Schedule C-2
Page 1 of 1

LINE NO.	DESCRIPTION	Per Books December 1999 Revenues Note (a)	Adjustment to Normalize Recorded Amount Note (b)	Annualized Revenues December * 12 Cols (C-D) * 12	Per Books Test Period Revenues Note (c)	Annualization Adjustment $000 Col E - Col F
	(A)	(B)	(C)	(D)	(E)	(F)
1	**Intrastate Toll Revenue Total:**					
2	December 1999 Total Toll Revenues	$2,282,937	0			
3	Total Fourth Quarter Toll Revenues	$2,282,937	$0	$27,395,244		
4	Staff Proposed Annualized Intrastate Toll Revenues				$30,341,703	
5	Staff Adjustment to Annualize Intrastate Toll Revenues (Note d)					($2,946,459)
6	Less: USWC's Proposed Adjustment to Annualize Intrastate Toll Revenues (Note e)					($3,306,458)
7	Staff Adjustment to Restate Intrastate Toll Revenue Annualization					$359,999
8	STAFF ADJUSTMENT TO RESTATE INTRASTATE TOLL REVENUE ANNUALIZATION - ROUNDED $000					$360

Footnotes :

(a) All amounts per Company Workpapers and MR4 Reports

(b) No adjustments to recorded values are required, since linear regression of toll revenues indicates December 1999 recorded values are consistent with revenue trends (see UTI 47-18)

(c) Staff methodology same as USWC, adjustment due to Company input data error.

(d) The annualized percentage reduction in toll revenues per Staff's adjustment 21.5%

(e) The annualized percentage reduction in toll revenues per USWC's adjustme 24.1%

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
REVERSAL OF ACCESS ANNUALIZATION
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	SOURCE	INTRASTATE Arizona Amount
	(A)	(B)	(C)
1	USWC Proposed Access Revenue Annualization Adjustment	dj. P-01 Workpaper	$1,983,000
2	Normalization of Out of Period Access Revenues	UTI 43-20, Att. B	(159,421)
3	Staff Adjustment to Reverse USWC's Proposed Annualization		($1,823,579)
4	STAFF ADJUSTMENT TO REVERSE USWC's ACCESS REVENUE ANNUALIZATION - ROUNDED		($1,824)

Footnotes:

(a) The Company's adjustment is reversed due to the absence of any notable trend in state access revenues.

(b) Upon elimination of the annualization based upon December 1999, it is necessary to normalize out of period portionS of correcting entries for Percent Local Usage (UTI 47-16)

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
MISCELLANEOUS REVENUE NORMALIZATION
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	SOURCE	AMOUNT
	(A)	(B)	(C)
1	USWC Proposed Adjustment to Annualize Miscellaneous Revenues	Company WP's	($5,100)
2	Less: *Elimination of Reciprocal Compensation Embedded in USWC Adjustment*	Company WP's	(9,881)
3	Annualization of Broadband Revenues Embedded in USWC Adjustment	Note (a)	7,946
4	Annualization of Rent Compensation Embedded in USWC Adjustment	Note (b)	462
5	Sub-total of Embedded Adjustments Within USWC's Proposed Miscellaneous Reven	Lines 2+3+4	(6,573)
6	Net Adjustment Proposed by USWC to Annualize Growth in Miscellaneous Revenues	Line 1 - Line 5	1,473
7	STAFF ADJUSTMENT TO REVERSE USWC's MISCELLANEOUS REVENUE ANNUALIZATION		($1,473)

Footnotes:

(a) USWC Annualization of Broadband Revenues Appears per Workpapers:

	Reverse Booked	Monthly ProForma	December 99 Net Adjustment	Annualized Net Adjustment
Other Rent Revenue	18,162	1,593	(16,569)	(198,828)
Corporate Operations Revenues	2,398	208	(2,190)	(26,280)
Misc. Other Acct. 5260	(19,481)	108	19,589	235,068
Total Adjustment for Broadband in USWC Filing			$830	$9,960
Times Intrastate Factor				79.78%
Broadband Revenue Annualization Embedded in USWC Miscellaneous Revenue Adjustment				$7,946

(b)

December 1999 Rent Compensation in Account 5240	3,762.7	
Times 12 to Annualize	12	months
	45,152	booked as negative revenues
Less: Per Books Rent Compensation	45,614	booked as negative revenues
Embedded Rent Compensation Adjustment (Redundant)	(462)	
(See also Schedule C-28 Rent Compensation)		

Witness: M. Brosch
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
DIRECTORY IMPUTATION PER AGREEMENT
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	SOURCE	AMOUNT
	(A)	(B)	(C)
1	Directory Imputation Amount Per Stipulation in Docket No. E-1051-86-252		
2	Approved in ACC Decision No. 56020 dated June 13, 1988	Decision No. 56020	$43,000
3	Less: Value of Fees and Services Received from Dex in Test Period	Note (a)	(1,660)
4	STAFF ADJUSTMENT TO IMPUTE DIRECTORY REVENUES PER 1988 SETTLEMENT AGREEMENT		$41,340

Footnotes :

(a)	Consists of Publisher Products (per UTI 62-02B)	$855,753
	Administrative Services (per UTI 62-01A)	356,291
	Billing & Collection Service (per UTI 42-10)	447,584
		$1,659,628

Witness: M. Brosch
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
BROADBAND CABLE TRANSACTIONS
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

ACC Staff
Schedule C-6
Page 1 of 1

LINE NO.	DESCRIPTION	SOURCE	TEST PERIOD RECORDED $	INTRASTATE ADJUSTMENT PER STAFF
	(A)	(B)	(C)	(D)
1	**Recorded Test Period Revenues - Services Provided to BSI Inc.**	UTI 62-15A	$22,918	
2	Factor To Annualize 12 months / 10 Months	Ratio 12/10	1.200	
3	Annualized BSI Affiliate Revenues	Line 1 * Line 2	27,502	
4	Difference - Total State Revenue Adjustment	Line 3 - Line 1	4,584	
5	Intrastate Factor - Miscellaneous Revenues	Co WP's	79.78%	
6	Staff Revenue Annualization - BSI Affiliate Services	Line 4 * Line 5		3,657
7	**Recorded Test Period Negative Expenses - Services to BSI, Inc.**	UTI 62-16A	(5,724)	
8	Factor To Annualize 12 months / 10 Months	Ratio 12/10	1.200	
9	Annualized BSI Affiliate Negative Expenses	Line 1 * Line 2	(6,869)	
10	Difference - Total State Expense Adjustment	Line 3 - Line 1	(1,145)	
11	Intrastate Factor - Total Expenses	Sch. F, Total SG&A	71.84%	
12	Staff Expense Annualization - BSI Affiliate Services	Line 4 * Line 5		(822)
13	**Removal - Part 64 Broadband Expense Effects that Duplicate Affiliate Billings**	UTI 43-20A		2,890
14	STAFF ADJUSTMENT TO OPERATING INCOME TO ANNUALIZE BSI AFFILIATE TRANSACTIONS			$1,589

Witness: M. Brosch
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
UNCOLLECTIBLES ANNUALIZATION
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	SOURCE	TEST YEAR INTRASTATE AMOUNT
	(A)	(B)	(F)
1	Staff Proposed Adjusted Local Service Revenues	Schedule C-1	$937,608
2	Staff Proposed Adjusted Intrastate Access Revenues	"	113,428
3	Staff Proposed Adjusted Intrastate Toll Revenues	"	22,773
4	Total Revenues Subject to Uncollectibles	Lines 1+2+3	$1,073,810
5	Times USWC Proposed Normalized Uncollectibles Factor	UTI 48-13, Att. A	1.490%
6	Staff Annualized Uncollectibles Expense	Line 4 * Line 5	$16,000
7	Less: USWC's Annualized Uncollectible Expense	Schedule C-1	16,101
8	STAFF ADJUSTMENT TO ANNUALIZE TEST PERIOD INTRASTATE UNCOLLECTIBLE REVENUES		($101)

Witness: M. Brosch
Prefiled Direct Testimony

CONFIDENTIAL

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
SERVICE QUALITY PROGRAM COST ELIMINATION
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	SOURCE	Test Period Revenue Amount	Test Period Expense Amount	Total Service Program Costs
	(A)	(B)	(C)	(D)	(E)
1	Recorded Arizona Service Quality Plan Financial Impact	UTI 42-11A	[redacted]		
2	Separation Factor for Account 6728	Co. Workpapers			
3	Total Intrastate Service Quality Impact	Line 1 * Line 2			
4	Less: Estimated Percentage Applicable to Citizens Exchange S	Note (a)			
5	Estimated Service Program Costs - Exchanges Being Sold	Line 3 * Line 4			
6	Program Costs Remaining in USWC Revenue Requirements	Line 3 - Line 5			
7	STAFF ADJUSTMENT TO EXCLUDE SERVICE QUALITY PLA	Note (b)	[redacted]		$9,611

Footnotes :

(a) Estimated Percentage for Citizens Exchange Sale based upon confidential information in UTI 51-02

(b) Revenues that are foregone must be imputed, while expense incurred are disallowed.

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
AFFILIATE TRANSACTION TRUE-UP NORMALIZATION
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	ARIZONA RECORDED AMOUNT	INTRASTATE FACTOR	INTRASTATE AMOUNT	OUT OF PERIOD PROPOSED NORMALIZATION
	(A)	(B)	(C)	(D)	(E)
1	**OUT OF PERIOD AFFILIATE TRUE UP ENTRIES IMPACTING TEST PERIOD:**				
2	U S West Interprise America Inc. (for 1/98 through 12/98)	$54	71.80%	$39	($39)
3	U S West Business Resources Inc. (for 1/98 through 12/98)	(75)	70.48%	(53)	53
4	U S West Communications Services, Inc. (for 1/98 through 12/98)	235	71.80%	169	(169)
5	U S West Communications Services, Inc. (for 12/99 booked 2/00)	(713)	71.80%	(512)	(512)
6	USWC to Dex (for 2/98 through 12/98)	7	79.22%	6	(6)
7	U S West Dex, Inc. (for 7/98 through 12/98)	(18)	79.22%	(14)	14
8	U S West, Inc. (for 11/98, 12/98)	156	70.48%	110	(110)
9	U S West, Inc. (for 6/98, 12/98)	229	70.48%	161	(161)
10	U S West, Inc. (for 12/99 booked 2/00)	629	70.48%	443	443
11	U S West Information Technologies Inc. (for 1/98 through 12/98)	(2,430)	70.48%	(1,713)	1,713
12	U S West Information Techologies Inc. (for 1999 booked 4/00)	33	70.48%	23	23
13	U S West Long Distance, Inc. (for 1998)	(11)	70.48%	(8)	8
14	U S West Long Distance, Inc. (for 1999, booked 5/00))	(93)	70.48%	(66)	(66)
15	U S West Wireless, LLC (for 1998)	149	70.48%	105	(105)
16	TOTAL STAFF ADJUSTMENT TO NORMALIZE OUT OF PERIOD AFFILIATE ENTRIES				$1,087

Footnotes :

(a) All amounts derived from USWC's response to UTI 43-20, Attachment F.

(b) Separations Factors per Staff Schedule F.

Witness: S. Carver
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
EOP NONLABOR REVERSAL
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

ACC Staff
Schedule C-10
Page 1 of 1

LINE NO.	DESCRIPTION	SOURCE	USWC PROPOSED ADJUSTMENT	STAFF REVERSA ADJUSTMENT
	(A)	(B)	(C)	(D)
1	Maintenance	(a)	($9,259)	$9,259
2	Engineering Expense	(a)	453	(453)
3	Network Operations	(a)	1,996	(1,996)
4	Network Administration	(a)	192	(192)
5	Access Expense	(a)	(17,752)	17,752
6	Other	(a)	248	(248)
7	Total Cost of Svcs & Products		($24,122)	$24,122
8	Customer Operations	(a)	18,600	(18,600)
9	Corporate Operations	(a)	14,802	(14,802)
10	Property and Other Taxes	(a)		0
11	Uncollectibles	(a)		0
12	Tot Selling, General & Administrative		$33,402	($33,402)
13	Other Operating Income & Expense	(a)	366	(366)
14	Depreciation Expense	(a)		0
15	Universal Service Fund	(b)	1,370	n/a
16	Link Up America	(a)	(29)	29
17	Total Operating Expense		$10,987	
18	ACC STAFF ADJUSTMENT TO REVERSE USWC'S PROPOSED ANNUALIZATION OF NONLABOR EXPENSES USING THE DECEMBER 1999 TIMES 12 METHODOLOGY			($9,617)

FOOTNOTE:

(a) Source: USWC updated Adjustment P-01, End-of-Period Non-Labor.

(b) Source: Per USWC response to UTI 50-3, proforma USF and high cost fund amount should be "zero By not reversing this adjustment component, TY level is "zero".

Witness: S. Carver
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
YEAR-END WAGE & SALARY ANNUALIZATION
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE

LINE NO.	DESCRIPTION		Salaries & Wages: Management Regular Payroll Expense (a)	Management Equivalent Employees (c)	Management Regular Pay Per Employee	Occupational Regular Payroll Expense (b)	Occupational Equivalent Employees (c)	Occupational Regular Pay Per Employee	Total
	(A)		(B)	(C)	(D)				
1	**Regular Pay Annualization**								
2	Oct-99								
3	Nov-99								
4	Dec-99								
5	Average Regular Pay								
6	Dec-99 Employee Level								
7	Times: Annualization Multiplier								
8	Annualization Adjustment - Regular Pay								
9	Add: Annualized Overtime/Premium Pay	(e)							
10	Add: TY Incentive Compensation	(d)							
11	Add: TY Termination Pay	(d)							
12	Add: TY Other Pay (not assignable)	(d), (h)							
13	ACC Staff Salary/Wage Annualization				$123,866,976			$246,450,544	370,317,520
14	Add: Benefits Loading (excluding Pensions &	(g)						20.737%	76,792,967
15	Add: Test Year Pension Expense	(j)							(18,034,372)
16	Add: Test Year Net PRB/OPEB Expense	(j), (k)							42,899,481
17	Total Benefits Expense								101,658,076
18	**ACC Staff Proposed Payroll & Benefits Expense**								471,975,595
							Salaries/Wages	Benefits	
19	Less: Test Year Expense	(f)					($365,705,291)	($99,673,981)	(465,379,272)
20	Less: USWC EOP Labor Annualization Adjustment (P-01)	(f)					(21,355,261)	(3,202,942)	(24,558,203)
21	Less: USWC Wage/Salary Increase Adjustment (P-02)	(i)					n/a	n/a	0
22	**ACC Staff Proposed Annualization Adjustment**						($387,060,552)	($102,876,923)	($17,961,880)

(000's)	Salaries & Wages		Benefits				
ACC ADJUSTMENT DISTRIBUTION	TY Distribution	Adjustment Distrib.	TY Distribution	Adjustment Distrib.	Total Arizona	%Intrastate	AZ Intrastate
Maintenance	50.35%	($8,431)	42.85%	($522)	($8,953)	74.39%	($6,660)
Engineering	1.24%	(208)	1.38%	(17)	(225)	76.16%	(171)
Network Operations	8.87%	(1,485)	16.34%	(199)	(1,685)	75.08%	(1,265)
Network Administration	0.44%	(73)	0.53%	(6)	(80)	72.38%	(58)
Access	0.00%	0	0.00%	0	0	n/a	0
Other	0.21%	(34)	0.15%	(2)	(36)	70.88%	(26)
Customer Operations	29.89%	(5,005)	32.23%	(393)	(5,398)	77.70%	(4,194)
Corporate Operations	9.00%	(1,506)	6.51%	(79)	(1,586)	79.22%	(1,256)
Total Operating Expense	100.00%	($16,743)	100.00%	($1,219)	($17,962)		($13,630)
	(f)		(f)			(f)	

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
YEAR-END WAGE & SALARY ANNUALIZATION
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE

FOOTNOTES:

(a) **Management Regular Pay Components**

	Oct-99	Nov-99	Dec-99
Basic Wages	[redacted]		
Paid Absence			
Short Period Sick			
Total			

Source: USWC Confidential response to UTI 42-5.

(b) **Occupational Regular Pay Components**

	Apr-98	May-98	Jun-98
Basic Wages	[redacted]		
Paid Absence			
Short Period Sick			
Total			

Source: USWC Confidential response to UTI 42-5.

(c) Source: USWC Confidential response to UTI 63-2.

(d) Source: USWC Confidential response to UTI 42-5.

(e) **Overtime Annualization**

	As Recorded	Multiplier	Annualized
Management Overtime	[redacted]		
1/99 -- 2/99			
3/99 -- 12/99			
Total Manag			
Occupational Over			
1/1/99 -- 8/14/			
8/15/99 -- 12/3			
Total Occup			
Totals			

Source: USWC Confidential response to UTI 42-5.

(f) Source: USWC Adjustment P-01 workpapers.

(g) **Benefits Loading**

	Benefits excl PRB	Salary/Wage	Benefits Factor
12ME December	[redacted]		
12ME December			
12ME December			

Source: USWC Confidential response to UTI 20-3, UTI 42-4, UTI 18-25 & UTI 42-5.

(h) TY Other Pay (not assigned) attributed to Occupational for presentational purposes.

(i) USWC Adjustment P-02 is reversed through a separate ACC Staff Adjustment.

(j) Source: USWC Confidential response to UTI 42-4.

(k) **Test Year Net PRB/OPEB Expense**

MR Basis Expense -- Test Year	[redacted]
OBK 172 -- Test Year	
Total	$42,899,481

Sources: USWC Confidential response to UTI 42-4 & USWC P-02 Workpapers.

Witness: S. Carver
Prefiled Direct Testimony

CONFIDENTIAL

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
INCENTIVE COMPENSATION
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	SHORT-TERM INCENTIVE PLAN	LONG-TERM INCENTIVE PLAN	ANNUAL BONUS PLAN	IT-CAREER STRUCTURE BONUS	OCCUPATIONAL TEAM AWARDS	TOTAL ARIZONA AMOUNT	USWC %INTRASTATE (c)	INTRASTATE INCENTIVE COMPENSATION	STAFF ADJUSTMENT
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1	**Test Year Incentive Compensation Expense**									
2	Maintenance A/C 61xx	[redacted]					$209	0.7439	$155	($155)
3	Engineering Expense A/C 6535						(43)	0.7616	(32)	32
4	Network Operations A/C 6534						269	0.7508	202	(202)
5	Network Administration A/C 6532						28	0.7238	20	(20)
6	Access Expense						0	0.6065	0	0
7	Other						0	0.7088	0	0
8	Total Cost of Svcs & Products						463		345	(345)
9	Customer Operations A/C 66xx						2,646	0.7770	2,056	(2,056)
10	Corporate Operations A/C 67xx						3,836	0.7922	3,039	(3,039)
11	Property and Other Taxes						0	0.7249	0	0
12	Uncollectibles						0	0.9197	0	0
13	Tot Selling, General & Administrative						6,482		5,095	(5,095)
14	Total Expense						$6,945		$5,440	
		(a)	(a)	(a)	(a)	(b)				
15	ACC STAFF ADJUSTMENT TO DISALLOW THE TEST YEAR COST OF CERTAIN INCENTIVE COMPENSATION PLANS									($5,440)

FOOTNOTES:

(a) Source: USWC confidential response to RUCO 29-14S1, Attachment A.
(b) Source: USWC response to UTI 43-20, Attachment J.
(c) Source: ACC Staff Schedule F.

Witness: S. Carver
Prefiled Direct Testimony

CONFIDENTIAL

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
SOP 98-1 (INTERNAL-USE SOFTWARE)
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	REFERENCE	CALCULATION AMOUNT	ACC STAFF TEST YEAR ADJUSTMENT
	(A)	(B)	(C)	(D)
1	**EXPENSE REDUCTION**			
2	1999 Software Costs Eligible for Capitalization -- Total USWC	(a)	[redacted]	
3	Arizona Prorate Factor	(a)		
4	Total State Expense, Account 6724	Line 2 * Line 3		
5	%Intrastate	(b)		
6	Proforma Intrastate Operating Expense Reduction, Account 6724	Line 4 * Line 5		
7	**AMORTIZATION**			
8	Proforma Intrastate Amount Eligible for Capitalization	Per Line 6		
9	Amortization Period	(a)		
10	Annual Intrastate Amortization, Account 6564	Line 8 / Line 9		
11	**CORRECTION ADJUSTMENT**			
12	USWC Adjustment to Correct Test Year Accounting for SOP 98-1, Account 6724	(b)		
13	ACC STAFF ADJUSTMENT TO CAPITALIZE, AMORTIZE AND CORRECT TEST YEAR INTERNAL-USE SOFTWARE COST	Line 6 + Line 10 + Line 12		($32,313)

FOOTNOTES:
(a) Source: USWC confidential response to UTI 67-4.
(b) Source: USWC response to UTI 43-20, Attachment G.

Witness: S. Carver
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
USWC PAYROLL ADJUSTMENT REVERSAL
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	USWC'S PROFORMA WAGE, SALARY & BENEFIT EXPENSE ANNUALIZATION ADJUSTMENT: MANAGEMENT [3/1/00 Increase]	OCCUPATIONAL [8/15/00 Increase]	TOTAL	ACC Staff ADJUSTMENT
	(A)	(B)	(C)	(D)	(E)
1	Operating Expenses:				
2	Maintenance	$1,597	$4,930	$6,527	($6,527)
3	Engineering	145	(2)	143	(143)
4	Network Operations	644	454	1,099	(1,099)
5	Network Administration	14	36	50	(50)
6	Other Property, Plant & Equipment	3	38	41	(41)
7	Customer Operations	1,381	2,604	3,984	(3,984)
8	Executive, Planning & Legal	192	1	192	(192)
9	Accounting & Finance	198	39	238	(238)
10	External Relations	170	8	177	(177)
11	Human Resources	144	13	157	(157)
12	Information Management	354	12	365	(365)
13	Other Corporate	107	29	136	(136)
14	Total	$4,948	$8,161	$13,109	
		(a)	(a), (b)		
15	ACC STAFF ADJUSTMENT TO REVERSE USWC'S PROPOSED POST-TEST YEAR PAYROLL ADJUSTMENT				($13,109)

FOOTNOTE:

(a) USWC Adjustment P-02, Revised 5/3/00.

(b) Correct Occupational Annualization

	USWC Intrastate Annual. Wages	8/15/00 Increase 3.50%	FICA Impact 7.65%	Savings Plan 2.84%	Group Life 0.1812%	Revised USWC Adustment	Less: Amounts Per USWC Update	Informational Correction Adjustment
Maintenance	$110,453	$3,866	$296	$110	$7	$4,278	($4,930)	($652)
Engineering	(53)	(2)	(0)	(0)	(0)	(2)	2	0
Network Operations	10,174	356	27	10	1	394	(454)	(60)
Network Administrati	801	28	2	1	0	31	(36)	(5)
Other Prop, Plant &	844	30	2	1	0	33	(38)	(5)
Customer Operation	58,333	2,042	156	58	4	2,260	(2,604)	(344)
Exec, Planning & Le	21	1	0	0	0	1	(1)	(0)
Accounting & Financ	882	31	2	1	0	34	(39)	(5)
External Relations	170	6	0	0	0	7	(8)	(1)
Human Resources	290	10	1	0	0	11	(13)	(2)
Info Management	260	9	1	0	0	10	(12)	(2)
Other Corporate	656	23	2	1	0	25	(29)	(4)
Total	$182,831	$6,399	$490	$182	$12	$7,082	($8,161)	($1,079)

(Informational Only – correction to USWC filing if ACC does not adopt Staff's proposed adjustment reversal.)

Witness: S. Carver
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
PROFORMA DEPRECIATION ANNUALIZATION
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	ACCOUNT	TOTAL STATE 12/31/99 INVESTMENT	TOTAL STATE EXCHANGE SALE	%INTRASTATE	INTRASTATE 12/31/99 INVESTMENT	INTRASTATE EXCHANGE SALE	STAFF UPDATED TY ACCRUAL DEPR RATES	ACC STAFF PROFORMA DEPR. 12/31/99 INVESTMENT	ACC STAFF PROFORMA DEPR. EXCHANGE SALE
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
1	Motor Vehicles	2112	$67,008	$2,204	0.7089	$47,502	$1,562	2.8%	1,330	44
2	Spec Purpose Vehicles	2114	25	0	0.7089	18	0	13.7%	2	0
3	Garage Work Equipment	2115	1,356	0	0.7089	961	0	18.1%	174	0
4	Other Work Equipment	2116	22,416	423	0.7089	15,891	300	13.8%	2,193	41
5	Buildings	2121	162,763	14,155	0.7089	115,383	10,034	2.8%	3,231	281
6	Furniture	2122	1,704	7	0.7089	1,208	5	21.2%	256	1
7	Office Equipment	2123.1	5,478	18	0.7089	3,883	13	19.2%	746	2
8	Company Communication Equip (a), (d)	2123.2	1,467	83	0.7089	1,040	59	0.0%	0	0
9	General Purpose Computers	2124	112,017	772	0.7089	79,409	547	4.5%	3,573	25
10	Analog Switching Equip	2211	138,599	49	0.7996	110,824	39	16.2%	17,953	6
11	Digital Switching Equip	2212	819,226	51,289	0.7996	655,053	41,011	10.7%	70,091	4,388
12	Operator Systems	2220	7,080	0	0.9178	6,498	0	7.4%	481	0
13	Radio Systems	2231	35,323	14,698	0.6673	23,571	9,808	3.3%	778	324
14	Circuit Equip									
15	Circuit DDS	2232	8,492	418	0.6673	5,667	279	0.0%	0	0
16	Circuit Digital	2232	1,128,055	62,285	0.6673	752,751	41,563	8.9%	66,995	3,699
17	Circuit Analog	2232	48,900	5,422	0.6673	32,631	3,618	1.5%	489	54
18	Other Terminal Equip	2362	48,461	1,304	0.8273	40,092	1,079	7.1%	2,847	77
19	Public Tel Terminal Equip	2351	17,969	0	1.0000	17,969	0	0.0%	0	0
20	Pole Lines	2411	46,617	9,703	0.7380	34,403	7,161	6.3%	2,167	451
21	Aerial Cable Met	2421	164,522	32,219	0.7380	121,417	23,778	9.6%	11,656	2,283
22	Aerial Cable Non-Met	2421	6,183	1,651	0.7380	4,563	1,218	9.3%	424	113
23	Underground Cable Met	2422	348,312	11,073	0.7380	257,054	8,172	7.8%	20,050	637
24	Underground Cable Non-Met	2422	86,984	2,944	0.7380	64,194	2,173	11.2%	7,190	243
25	Buried Cable Met	2423	1,256,424	132,260	0.7380	927,241	97,608	11.1%	102,924	10,834
26	Buried Cable Non-Met	2423	17,245	3,913	0.7380	12,727	2,888	6.7%	853	193
27	Sub Cable Met	2424	3	3	0.7380	2	2	85.1%	2	2
28	Sub Cable Non-Met	2424	0	0	0.7380	0	0	5.0%	0	0
29	Intra Building Cable Met	2426	41,023	2,718	0.7380	30,275	2,006	3.2%	969	64
30	Intra Building Cable Non-Met	2426	581	6	0.7380	429	4	9.5%	41	0
31	Aerial Wire	2431	8,799	4,368	0.7380	6,494	3,224	17.4%	1,130	561
32	Conduit Systems	2441	305,068	17,670	0.7380	225,140	13,040	2.3%	5,178	300
33	Total		$4,908,100	$371,655		$3,594,290	$271,191	119.4%	$323,723	$24,625
			(a)	(a)	(a)		(a)	(b)		

34	ACC Staff Proforma Intrastate Depreciation		323,723
35	Add: Offbook Depreciation Annualization	(e)	4,178
36	Less: USWC's Proforma Depreciation Adjustment [P-03]		(107,968)
37	Less: Intrastate Per Book Depreciation [A/C 6561]	(c)	(222,881)
38	ACC STAFF ADJUSTMENT TO RECOGNIZE THE TEST YEAR UPDATE TO THE DEPRECIATION ACCRUAL RATES		($2,948)

FOOTNOTES:

(a) Source: USWC response to UTI 52-14.
(b) Source: ACC Staff witness Dunkel.
(c) Source: USWC response to UTI 46-06 for A/C 6561.
(d) Source: USWC response to UTI 55-2.

(e) Offbook Depreciation Annualization

12/99 ST AFUDC/ CRADS	$153
12/99 AFUDC	195
Subtotal	$348
Annualization Factor	12
Annualized OBK Amount	$4,178

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
INTEREST SYNCHRONIZATION ADJUSTMENT
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION		SOURCE	WEIGHTED COST OF DEBT	INTRASTATE AMOUNT
	(A)		(B)	(C)	(D)
1	ACC Staff's Adjusted Rate Base (original cost)		Sched. B		$1,435,287
2	ACC Staff's Weighted Cost of Long Term Debt		Sched. D	3.52%	
3	ACC Staff's Weighted Cost of Short Term Debt		Sched. D	n/a	
4	Total Cost of Debt		[line 2 + 3]		3.52%
5	Synchronized Interest Deduction per ACC Staff		[line 1 x 4]		50,522
6	Less: Annualized Deductible Interest per U S WEST		(a)		(50,407)
7	Interest Deduction Difference (ACC Staff - Company)		[line 5 - 6]		115
8	Income Tax Increase/(Decrease):				
9	Federal Income Tax	32.2000%	[line 7*Rate]		($37)
10	State Income Tax	8.0000%	[line 7*Rate]		(9)
11	ACC STAFF INCOME TAX ADJUSTMENT FOR INTEREST SYNCHRONIZATION		[line 9 + 10]		($46)

FOOTNOTE:

(a)

USWC Deductible Interest	Amount
Adjusted Intrastate Per Book	$45,442
USWC Adjustment to Synchronize Interest	4,965
Total USWC Adjusted Interest Expense	$50,407

Source: USWC workpapers (regulated intrastate) and Adjustment C-06.

Witness: S. Carver
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
FCC DEREGULATED SERVICES REVENUE IMPUTATION
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	1990 Financials Total Part X	Remove Wireless, Payphone & Video	FCC Dereg Included ATL By USWC Direct Filing	**ACC Revenue Imputation Adjustment (c)**	ADJUSTED INTRASTATE RESULTS
	(A)	(B)	(C)	(D)	(E)	(F)
	Revenues					
1	Miscellaneous	$102,104	($16,626)	$85,479	**$3,562**	$89,041
2	Total Operating Revenue	102,104	(16,626)	85,479	**$3,562**	$89,041
	Expenses					
3	Maintenance	43,975	(5,977)	37,998		$37,998
4	Engineering Expense	831	258	1,089		1,089
5	Network Operations	6,897	(442)	6,454		6,454
6	Network Administration	12	0	12		12
7	Access Expense	0	0	0		0
8	Other	64	(31)	34		34
9	Total Cost of Svcs & Products	51,779	(6,192)	45,586	**$0**	$45,586
10	Customer Operations	26,493	(12,056)	14,436		14,436
11	Corporate Operations	26,416	(5,848)	20,568		20,568
12	Property and Other Taxes	2,813	(1,958)	855	**4**	859
13	Uncollectibles	411	(2)	408		408
14	Tot Selling, General & Administrative	56,133	(19,865)	36,267	**$4**	$36,271
15	Other Operating Income & Expense	510	(125)	385		385
16	Depreciation Expense	8,644	(4,134)	4,510		4,510
17	Universal Service Fund	0	0	0		0
18	Link Up America	0	0	0		0
19	Total Operating Expense	117,065	(30,317)	86,748	**$4**	$86,752
20	**Income From Operations**	(14,961)	13,692	(1,269)	**$3,558**	$2,289
	Taxes					
21	Federal Income Tax	(5,979)	4,904	(1,075)	**$1,146**	71
22	State & Local Income Tax	(1,370)	1,441	71	**285**	356
23	**Net Operating Income** (Line 22-24-25)	($7,612)	$7,347	($265)	**$2,128**	$1,863
		(a)	(a)		(b)	

FOOTNOTES:

(a) Source: USWC workpapers -- Regulated Intrastate results (Interface-1990 Financials).

(b) REVENUE IMPUTATION ADJUSTMENT

Telephone Plant In Service	$103,903	($59,435)	$44,468
Short-Term Plant Under Construction	0	0	0
Materials and Supplies	1,189	(624)	565
Accumulated Depr & Amort Reserve	(39,385)	16,514	(22,870)
Accumulated Deferred Income Tax	(7,461)	4,417	(3,044)
Customer Deposits	(205)		(205)
End-of-Period Rate Base	$58,042	($39,128)	$18,914
Times: ACC Staff Proposed Rate of Return (ACC Schedule D)			9.68%
NOI Required			$1,831
NOI Available			($265)
NOI Deficiency			$2,096
Revenue Conversion Factor			1.6995
Revenue Deficiency Imputation			$3,562

Witness: S. Carver
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
FCC DEREG -- SEPARATIONS ADJUSTMENT
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	Intrastate Adjustments			Composite Separation Factors			Ratio	ACC Staff Adjustment
		USWC Proposed	Staff Proposed	Total	USWC Proposed (incl. FCC Dereg)	Staff Proposed (excl. FCC Dereg)	Net Change	(H=G/E)	(I=H*D)
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)
	Revenues								
1	Local Service	($34,172)	$16,846	($17,326)	n/a	n/a	n/a	n/a	$-0
2	Network Access Service	(5,827)	(1,824)	(7,651)	n/a	n/a	n/a	n/a	0
3	Long Distance Network Service	(7,905)	360	(7,545)	n/a	n/a	n/a	n/a	0
4	Miscellaneous	(10,594)	47,086	36,492	n/a	n/a	n/a	n/a	0
5	Total Operating Revenues	(58,498)	62,469	3,971					0
	Expenses								
6	Maintenance	(3,741)	(2,015)	(5,756)	0.7439	0.6377	-0.1062	-14.28%	822
7	Engineering Expense	35	(734)	(699)	0.7616	0.6842	-0.0774	-10.16%	71
8	Network Operations	7,650	(4,561)	3,089	0.7508	0.6342	-0.1166	-15.52%	(479)
9	Network Administration	160	(319)	(159)	0.7238	0.7196	-0.0042	-0.58%	1
10	Access Expense	(19,378)	17,711	(1,667)	0.6065	0.6065	0.0000	0.00%	0
11	Other	799	(274)	525	0.7088	0.6579	-0.0509	-7.18%	(38)
12	Total Cost of Svcs & Products	(14,475)	9,807	(4,668)	0.7350	0.6369	-0.0981	-13.34%	377
13	Customer Operations	29,048	(28,834)	214	0.7770	0.7180	-0.0590	-7.59%	(16)
14	Corporate Operations	20,485	(65,542)	(45,057)	0.7922	0.7048	-0.0874	-11.03%	4,969
15	Property and Other Taxes	(3,568)	828	(2,740)	0.7249	0.7129	-0.0120	-1.66%	45
16	Uncollectibles	0	0	0	0.9197	0.8995	-0.0201	-2.19%	0
17	Total Selling, General & Administrative	45,965	(93,549)	(47,584)	0.7818	0.7184	-0.0634	-8.11%	4,998
18	Other Operating Income & Expense	829	(366)	463	n/a	n/a	n/a	n/a	0
19	Depreciation Expense	89,170	4,107	93,277	0.7008	0.6876	-0.0132	-1.88%	(1,755)
20	Universal Service Fund	1,370	0	1,370	0.0000	0.0000	0.0000	n/a	0
21	Link Up America	(29)	29	0	0.0000	0.0000	0.0000	n/a	0
22	Total Operating Expense	122,830	(79,972)	42,858	0.7449	0.6819	-0.0629	-8.45%	3,621
23	**Income From Operations**	($181,328)	$142,441	($38,887)	0.5702	0.5735	0.0033	0.57%	($3,621)
		(a)	(b)		(c)	(c)			

FOONOTES:
(a) Source: Company Test Year adjustments per USWC Exhibit GAR-S5 (corrected per response to UTI 56-2).
(b) Source: ACC Staff Schedule C (excluding C-18).
(c) Source: ACC Staff Schedule F.

Witness: M. Brosch
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
PUBLIC AFFAIRS/RELATIONS EXPENSE DISALLOWANCE
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	SOURCE	Above the Line Arizona Charges	Below the Line Arizona Charges	Total Arizona Charges	TEST YEAR INTRASTATE AMOUNT
	(A)	(B)	(C)	(D)	(E)	(F)
1	Arizona Charges for Public Policy / Public Affairs Activities	UTI 61-06	$2,348	$203	$2,551	
2	Recorded Below-the-line Percentage	Col. D / Col. E		8%		
3	Restate Charges for 50 Percent Below-the-line Reclassification	Col. E * 50/50%	1,276	1,276	2,551	
4	Adjustment to Reclassify Public Policy / Public Affairs Costs	Line 3 - Line 1	(1,073)	1,073	0	
5	Intrastate Factor	Schedule F	70.48%			
6	Intrastate Adjustment Amount	Line 4 * Line 5	(756)			(756)
7	STAFF ADJUSTMENT TO PARTIALLY DISALLOW PUBLIC/COMMUNITY AFFAIRS					($756)

Witness: M. Brosch
Prefiled Direct Testimony

CONFIDENTIAL

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
US WEST INC. DEPARTMENTAL DISALLOWANCES
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION		SOURCE	ARIZONA INTRASTATE AMOUNT
	(A)		(B)	(C)
1	U S West, Inc. Parent Company Charges by Responsibility Center:			
2	President and CEO	RC 0210000	UTI 46-20A	[redacted]
3	Executive Vice President and CFO	RC 0100000	"	
4	Strategic Planning	RC 0220000	"	
5	Corporate Development	RC 0230000	"	
6	Retired Officer Support	RC 0304000	"	
7	Vice President - Public Relations	RC 0500000	"	
8	Foundation Operations	RC 0530000	"	
9	Cash Management	RC 0731000	"	
10	Delaware Legislative	RC 0811000	"	
11	Total USWI Departmental Charges for Partial Disallowance		Sum Lines 2 - 10	2,284
12	Staff's Disallowance Factor Applied to USWI Costs		Note (a)	50%
13	ACC STAFF ADJUSTMENT TO PARTIALLY DISALLOW USWI ALLOCATED COS		Line 11 * 12	($1,142)

Footnotes:

(a) In Decision No. 58927 at pages 25 through 31, the Commission disallowed either 50% or 100% of the costs in most of these RC's. Staff has applied the lower 50% disallowance factor, recognizing changes in the makeup of USWI since 1994.

Witness: M. Brosch
Prefiled Direct Testimony

CONFIDENTIAL

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
EMPLOYEE CONCESSION ALLOCATION TO INTERSTATE
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	SOURCE	INTRASTATE AMOUNT
	(A)	(B)	(C)
1	Test Period Employee Telephone Concession Benefits - Negative Revenues	UTI 52-13	[redacted]
2	Allocation Factor to Attribute Employee Benefits to the Interstate Jurisdiction	Note (a)	
3	ACC STAFF ADJUSTMENT TO ALLOCATE EMPLOYEE CONCESSIONS	Line 1 * Line 2	($471)

Footnotes:

(a) [redacted]

Witness: M. Brosch
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
DEPRECIATION ON UNRECORDED RETIREMENTS
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION			PROPERTY VINTAGE	VINTAGE INVESTMENT AMOUNT	STAFF UPDATED TY ACCRUAL DEPR RATES	DEPRECIATION ON VINTAGE INVESTMENT	%INTRASTATE	INTRASTATE AMOUNT
	(A)			(B)	(C)	(D)	(E)	(F)	(G)
1	General Purpose Computers	361C	Account 2124	1989	$24,060	4.50%	$1,083	0.7089	$768
2	Digital Switching Equipment	DEZ	Account 2212	1955	397	10.70%	42	0.7996	34
3	Digital Circuit Equipment	CRD	Account 2232	1955	737	8.90%	66	0.6673	44
4	Underground Metallic Cable	UGM	Account 2422	1925	10,104	7.80%	788	0.7380	582
5	Buried Metallic Cable	BCM	Account 2423	1925	16,781	11.10%	1,863	0.7380	1,375
6	Intra-Building Metallic Cable	IBM	Account 2426	1925	3,211	3.20%	103	0.7380	76
7	Total				$55,290		$3,944		$2,877
					(a)	(b)		(c)	
8	ACC STAFF ADJUSTMENT TO REVERSE DEPRECIATION ON UNRECORDED RETIREMENTS								($2,877)

Footnotes:

(a) Source: USWC's RCND study, Exh. NHH-1, pages 26, 29, 34, 45, 48 and 53.

(b) Source: ACC Staff Schedule C-15.

(c) Staff Schedule F

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
RESERVED
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION
	(A)
1	RESERVED FOR FUTURE USE

Witness: S. Carver
Prefiled Direct Testimony

CONFIDENTIAL

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
PROPERTY TAX CORRECTION
TEST YEAR ENDING DECEMBER 31, 1999
(000's)

LINE NO.	DESCRIPTION	SOURCE	INTRASTATE AMOUNT
	(A)	(B)	(C)
1	Final Full Combined Cash Value	(a), (b)	[redacted]
2	Revised Statutory Assessment Ratio	(b)	
3	Assessed Value		
4	Average Tax Rate	(b)	
5	Total Arizona Annualized Property Tax		
6	%Intrastate	(c)	
7	Arizona Intrastate Annualized Property Tax		$49,661
8	Less: Intrastate Property Tax Included in USWC Updated Filing	(d), (e)	(50,465)
9	Less: OOP Property Tax Adjustment	(f)	(433)
10	ACC STAFF ADJUSTMENT TO CORRECT USWC'S YEAR-END ANNUALIZATION OF PROPERTY TAX EXPENSE		($1,238)

FOONOTES:

(a) Source: USWC workpapers supporting updated Adjustment P-01.
(b) Source: USWC response to UTI 45-11.
(c) Source: ACC Staff Schedule F.
(d) Arizona Intrastate Annualized Property Tax

AZ Property Tax Expense (MR5)		$69,394
USWC %Intrastate	(c)	0.7249
MR Basis Per Book		50,302
Add: USWC P-01 Property Tax Adjustme		163
USWC AZ Intrastate Annualized Property		$50,465

(e) Property tax effect of access line sale is handled through separate adjustment. This effect is intentionally excluded from the annualization adjustment calculation.
(f) Source: ACC Staff Schedule C-25.

Witness: S. Carver
Prefiled Direct Testimony

CONFIDENTIAL

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
OUT OF PERIOD PROPERTY AND OTHER TAXES
TEST YEAR ENDING DECEMBER 31, 1999
(000's)

LINE NO.	DESCRIPTION		REFERENCE	MONTH BOOKED	ACCRUAL ORIGINATING PERIOD	RECORDED TRANSACTION (whole dollars)	%INTRASTATE	TEST YEAR ADJUSTMENT (000's)
	(A)		(B)	(C)	(D)	(E)	(F)	(G)
1	Property Tax	7240.19	(a)	Sep-99	1994	[redacted]		
2		7240.19	(a)	Sep-99	1996			
3		7240.19	(a)	Sep-99	1997			
4	Subtotal		(c)					
5	Flat Rate License Tax	7240.30	(a), (b)	Jan-00	1999			
6	Use Tax	7240.91	(a)	Jun-99	1996			
7		7240.91	(a), (b)	Jan-00	1999			
8	Sales Tax Assumed	7240.93	(a), (b)	Jan-00	1999			
9	Total							
10	ACC STAFF ADJUSTMENT TO RECOGNIZE OUT-OF-PERIOD ADJUSTMENTS TO OTHER TAX EXPENSE							$2,061

FOOTNOTE:
(a) Source: USWC response to UTI 59-16.
(b) "Sign" intentionally not reversed on accruals recorded in 2000 that relate to test year operations.
(c) Adjustment for OOP property tax effects are considered in quantification of ACC Scheduled C-24 annualization adjustment.

Witness: S. Carver
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
OUT OF PERIOD INCOME TAXES
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION		REFERENCE	MONTH BOOKED	ACCRUAL ORIGINATING PERIOD	RECORDED TRANSACTION (whole dollars)	TEST YEAR ADJUSTMENT (000's)
	(A)		(B)	(C)	(D)	(E)	(F)
1	Federal Income Tax						
2	Operating ITC - Net	7210.1	(a)	Nov-99	1998	$75,374	($75)
3	Operating FIT	7220	(a)	Nov-99	1998	1,406,210	(1,406)
4		7220	(a)	Jun-99	1994	(424,348)	424
5	Deferred FIT - Net	7250.1	(a)	Nov-99	1998	(1,824,801)	1,825
6	Total Federal						768
7	State & Local Income Tax						
8	Operating ITC - Net	7210.2				n/a	0
9	Operating SIT/LIT	7230	(a)	Nov-99	1998	602,953	(603)
10		7230	(a)	Jun-99	1994	1,109,584	(1,110)
11	Deferred SIT/LIT - N	7250.2	(a)	Nov-99	1999	446,698	(447)
12	Total State						(2,159)
13	ACC STAFF ADJUSTMENT TO RECOGNIZE OUT-OF-PERIOD ADJUSTMENTS TO INCOME TAX EXPENSE						($1,392)

FOOTNOTE:
(a) Source: USWC response to UTI 43-20, Attachment H.

Witness: S. Carver
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
IMAGE ADVERTISING, OLYMPIC/SPORTS SPONSORSHIP
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

CONFIDENTIAL

LINE NO.	DESCRIPTION	SOURCE	TOTAL ARIZONA	% INTRASTATE	INTRASTATE AMOUNT
	(A)	(B)	(C)	(D)	(E)
1	Corporate Image Advertising, Account 6722 (External Relations	(a), (d)	[redacted]		
2	Olympic Sponosorship				
3	Account 6535 (Engineering Expense)	(b)			
4	Account 6611/12 (Sales Expense)	(b)			
5	Account 6722 (External Relations Expense)	(b)			
6	Account 6724 (Information Management Expense)	(b)			
7	Subtotal				
8	Sports Sponsorships				
9	Diamondbacks, Account 6722	(c), (d)			
10	Phoenix Suns, Acount 6722	(c), (d)			
11	Subtotal				
12	Total Image Advertising and Olympic Sponsorship				$9,931
13	ACC STAFF ADJUSTMENT TO ELIMINATE IMAGE ADVERTISING AND OLYMPIC / SPORTS SPONSORSHIP COSTS				($9,931)

FOOTNOTES:

(a) Source: USWC confidential response to UTI 64-22.
(b) Source: Value-in-Kind and cash payments per USWC response to RUCO 28-14.
(c) Source: USWC confidential response to UTI 65-8.
(d) Source: ACC Staff Schedule F.

Witness: M. Brosch
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
RENT COMPENSATION
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	SOURCE	TOTAL STATE AMOUNT	INTRASTATE AMOUNT 79.06%
	(A)	(B)	(C)	(D)
1	Company Proposed Annualized Arizona Rent Compensation	Company WPs	$48,091	
2	Test Period Recorded Rent Compensation - January through Dec 1999	"	45,614	
3	Company Proposed Annualization Adjustment P01	Line 1 - Line 2	$2,477	$1,958
4	December 1999 Times 12 - Annualized Rent Compensation Amount	Company WPs	45,152	
5	Corrected Annualization Adjustment - Overlap in Company's Adjustments	Line 1 - Line 5	2,939	2,323
6	**Incremental Staff Adjustment to Correct USWC's Overlapping Adjustments**	Line 5 - Line 3	462	365
7	Restated January 2000 Rent Compensation for Staff Rate of Return - Arizona Annual	Staff Workpaper StaffRevRPRG12000	47,420	
8	Less: Company Proposed Annualized Arizona Rent Compensation	Line 1	48,091	
9	**Staff Adjustment for Rent Compensation Rate of Return**	Line 7 - Line 8	(671)	(530)
10	STAFF ADJUSTMENT TO CORRECT AND RESTATE RENT COMPENSATION	Line 6 + Line 9		($165) Note (a)

Footnotes:

(a) Rent Compensation is recorded as Negative Miscellaneous Revenues

(b)

USWC's January 2000 Rent Compensation Study ROR	10.17%
Staff Proposed Overall ROR	9.68%
ROR Spread in Line 9 Adjustment	0.49%
Intrastate Dollars per Basis Point	(10.8)

Witness: M. Brosch
Prefiled Direct Testimony

CONFIDENTIAL

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
EXCHANGE SALE ALLOCATION ADJUSTMENTS
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	SOURCE	INTRASTATE AMOUNT	STAFF ADJUSTMENT AMOUNT
	(A)	(B)	(C)	(D)
1	Arizona Total State Test Period Marketing Expenses	UTI 51-03	[redacted]	
2	Percentage of Arizona Revenues in Exchanges Being Sold	Note (a)		
3	Marketing Expenses Allocated by Staff to Exchanges Being Sold	Line 1 * 2		
4	Less: Marketing Expenses Allocated to Sold Exchanges per USWC	UTI 51-03		
5	Additional Marketing Expense Adjustment Required	Line 3 - Line 4		
6	Arizona Total State Test Period Corporate Operations Expenses	UTI 51-03		
7	Percentage Reduction in Corporate Expenses Assumed by Staff	Note (b)		
8	Corporate Expenses Allocated by Staff to Exchanges Being Sold	Line 6 * 7		
9	Less: Corporate Operations Expenses Allocated to Sold Exchanges per USWC	UTI 51-03		
10	Additional Corporate Operations Expense Adjustment Required	Line 8 - Line 9		
11	Depreciation for Exchange Sale at New Accrual Rates	Note (c)		
12	Allocated Per Books 1999 Depreciation Allocated to Exchange Sales by USWC	Co. W/P p-07		
13	Additional Depreciation Expense Adjustment Required			
14	ACC STAFF ADJUSTMENT TO REVISE EXPENSE ALLOCATIONS TO EXCHANGES SOLD			($11,233)

Footnotes :

(a) [redacted]

(b) See testimony of M. Brosch

(c) Source: ACC Adjustment C-15.

Witness: M. Brosch
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
RECIPROCAL COMPENSATION
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	SOURCE	TEST PERIOD RECORDED REVENUES	TEST PERIOD RECORDED EXPENSES	NET COST OF INTRASTATE RECIPROCAL COMP.
	(A)	(B)	(C)	(D)	(E)
1	Recorded Test Period Reciprocal Compensation - Eliminated by	Co Adj. W/Ps	$6,561	$17,982	$11,421
2	ACC STAFF ADJUSTMENT TO RESTATE RECIPROCAL COMPENSATION AT TEST PERIOD RECORDED LEVELS				($11,421)

Witness: S. Carver
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
CAPITAL STRUCTURE SUMMARY
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	CAPITAL RATIO	COST RATES	WEIGHTED COST
	(A)	(C)	(D)	(E)
	AS FILED BY USW: (a)			
1	Debt	47.60%	7.39%	3.52%
2	Common Equity	52.40%	14.00%	7.34%
3	Total Capital	100.00%		10.86%
	ACC STAFF PROPOSED: (b)			
4	Debt	47.60%	7.39%	3.52%
5	Common Equity	52.40%	11.75%	6.16%
6	Total Capital	100.00%		9.68%

FOOTNOTES:

(a) SOURCE: Capital Structure per USWC Exhibit GAR-2 (Redding Direct Testimony).
(b) ACC Staff Witness Hill Exhibit ___ (SGH-2), Schedule 14.

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
RECONCILIATION OF POSITIONS
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	SCH./ ADJ. NO.	DESCRIPTION	AMOUNT	DIFFERENCE IN PRETAX RETURN	REVENUE REQUIREMENT VALUE
		(A)	(B)	(C)	(D)
1	SCH. A	**USWC'S Revenue Requirement**			$201,221
2	SCH. B	**Return Difference At USWC'S Rate Base**	$1,422,100	-2.05%	(29,159)
3		Subtotal Revenue Requirement			172,062
				PRE-TAX RETURN	
4		**ACC STAFF RATE BASE ADJUSTMENTS**			
5	B-1	UNRECORDED RETIREMENTS	0	13.99%	0
6	B-2	SOP 98-1 (INTERNAL-USE SOFTWARE)	(7,417)	13.99%	(1,038)
7	B-3	FAS87 PENSION ASSET	(42,344)	13.99%	(5,924)
8	B-4	CASH WORKING CAPITAL	(9,469)	13.99%	(1,325)
9	B-5	PROFORMA DEPRECIATION -- RESERVE REVERSAL	64,565	13.99%	9,032
10	B-6	BROADBAND CABLE TRANSACTIONS (ASSET TRANSFER)	6,791	13.99%	950
11	B-7	FCC DEREG -- SEPARATIONS ADJUSTMENT	1,061	13.99%	148
12		Total Value of ACC Staff Rate Base Adustments	13,187		1,845
13		ACC Staff Rate Base Recommendation	$1,435,287		
14	SCH. A	USWC Net Operating Income	$43,833	REVENUE CONVERSION MULTIPLIER	
15		**ACC Staff NET OPERATING INCOME ADJUSTMENTS**			
16	C-1	REVENUE ANNUALIZATION - RECURRING LOCAL SERVICE	5,314	1.6995	(9,032)
17	C-2	ANNUALIZATION OF INTRASTATE TOLL REVENUES	215	1.6995	(366)
18	C-3	REVERSAL OF ACCESS ANNUALIZATION	(1,091)	1.6995	1,853
19	C-4	MISCELLANEOUS REVENUE NORMALIZATION	(881)	1.6995	1,497
20	C-5	DIRECTORY IMPUTATION PER AGREEMENT	24,722	1.6995	(42,014)
21	C-6	BROADBAND CABLE TRANSACTIONS	950	1.6995	(1,615)
22	C-7	UNCOLLECTIBLES ANNUALIZATION	61	1.6995	(103)
23	C-8	SERVICE QUALITY PROGRAM COST ELIMINATION	5,747	1.6995	(9,768)
24	C-9	AFFILIATE TRANSACTION TRUE-UP NORMALIZATION	(650)	1.6995	1,105
25	C-10	EOP NONLABOR REVERSAL	5,751	1.6995	(9,774)
26	C-11	YEAR-END WAGE & SALARY ANNUALIZATION	8,151	1.6995	(13,852)
27	C-12	INCENTIVE COMPENSATION	3,253	1.6995	(5,529)
28	C-13	SOP 98-1 (INTERNAL-USE SOFTWARE)	19,323	1.6995	(32,840)
29	C-14	USWC PAYROLL ADJUSTMENT REVERSAL	7,839	1.6995	(13,322)
30	C-15	PROFORMA DEPRECIATION ANNUALIZATION	1,763	1.6995	(2,996)
31	C-16	INTEREST SYNCHRONIZATION ADJUSTMENT	46	1.6995	n/a
32	C-17	FCC DEREGULATED SERVICES REVENUE IMPUTATION	2,128	1.6995	(3,616)
33	C-18	FCC DEREG -- SEPARATIONS ADJUSTMENT	(2,165)	1.6995	3,680
34	C-19	PUBLIC AFFAIRS/RELATIONS EXPENSE DISALLOWANCE	452	1.6995	(768)
35	C-20	US WEST INC. DEPARTMENTAL DISALLOWANCES	683	1.6995	(1,161)
36	C-21	EMPLOYEE CONCESSION ALLOCATION TO INTERSTATE	282	1.6995	(479)
37	C-22	DEPRECIATION ON UNRECORDED RETIREMENTS	1,721	1.6995	(2,924)
38	C-23	RESERVED	0	1.6995	0
39	C-24	PROPERTY TAX CORRECTION	740	1.6995	(1,258)
40	C-25	OUT OF PERIOD PROPERTY AND OTHER TAXES	(1,233)	1.6995	2,095
41	C-26	OUT OF PERIOD INCOME TAXES	1,392	1.6995	(2,365)
42	C-27	IMAGE ADVERTISING, OLYMPIC/SPORTS SPONSORSHIP	5,939	1.6995	(10,092)
43	C-28	RENT COMPENSATION	99	1.6995	(168)
44	C-29	EXCHANGE SALE ALLOCATION ADJUSTMENTS	6,717	1.6995	(11,416)
45	C-30	RECIPROCAL COMPENSATION	(6,830)	1.6995	11,607
46	C-31	RESERVED	0	1.6995	0
47	C-32	RESERVED	0	1.6995	0
48	C-33	RESERVED	0	1.6995	0
49		Total Value of ACC Staff Net Operating Income Adj.	90,438		(153,620)
50	SCH. A	ACC Staff Net Operating Income Recommendation	$134,271		
51		**OTHER REVENUE REQUIREMENT DIFFERENCES**			
52		Bellcore 3 Year Adjustment			0
53		Automatic Adjustment Revenue Requirement			(13,252)
54		Total Other Differences			(13,252)
55		RECONCILED REVENUE REQUIREMENT			$7,034
56		UNRECONCILED DIFFERENCE			208
57	SCH. A	**ACC STAFF REVENUE REQUIREMENT RECOMMENDATION**			$7,242

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
CALCULATION OF PRE-TAX RETURN
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

LINE NO.	DESCRIPTION	WEIGHTED COST (SCH. D)	REVENUE CONVERSION MULTIPLIER (SCH. A-1)	PRETAX RETURN
	(A)	(B)	(C)	(D)
	RETURN PER ACC STAFF:			
1	Debt	3.52%	1.0000	3.52%
2	Common Equity	6.16%	1.6995	10.47%
3	ACC Staff Total Pretax Return	9.68%		13.99%
	RETURN PER USWC:			
4	Long Term Debt	3.52%	1.0000	3.52%
5	Common Equity	7.34%	1.7056	12.52%
6	USWC Total Pretax Return	10.86%		16.04%
7	**DIFFERENCE IN PRETAX RETURNS**			-2.05%

Witness: S. Carver
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
SEPARATION FACTOR COMPOSITES
TEST YEAR ENDING DECEMBER 31, 1999

Source: Company Workpapers

LINE NO.	DESCRIPTION	1990 Financials: Total State MR Basis	Total State JD Offbook	Total State JR	Intrastate JR	FCC Dereg PART X	Remove Wireless, Payphone & Video	USWC PROPOSED (Includes FCC Dereg in Intrastate): REGULATED INTRASTATE	% REGULATED INTRASTATE FACTORS	ACC STAFF PROPOSED (Excludes FCC Dereg from Intrastat): REGULATED INTRASTATE	% REGULATED INTRASTATE FACTORS
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)
	Revenues										
1	Local Service	$954,933,510		954,933,510	954,933,510			954,933,510	1.0000	954,933,510	1.0000
2	Network Access Service	603,899,634		603,899,634	121,079,275			121,079,275	0.2005	121,079,275	0.2005
3	Long Distance Network Service	30,371,863		30,371,863	30,318,408			30,318,408	0.9982	30,318,408	0.9982
4	Miscellaneous	178,544,239		178,544,239	56,957,039	102,104,364	(16,625,712)	142,435,691	0.7978	56,957,039	0.3190
5	Total Operating Revenues	1,767,749,246	0	1,767,749,246	1,163,288,232	102,104,364	(16,625,712)	1,248,766,884	0.7064	1,163,288,232	0.6581
	Expenses										
6	Maintenance	357,833,823	(197,627)	357,636,196	228,065,407	43,974,697	(5,977,110)	266,062,994	0.7439	228,065,407	0.6377
7	Engineering Expense	14,061,421		14,061,421	9,621,260	830,744	257,820	10,709,824	0.7616	9,621,260	0.6842
8	Network Operations	55,375,419		55,375,419	35,120,336	6,896,632	(442,366)	41,574,602	0.7508	35,120,336	0.6342
9	Network Administration	2,834,672		2,834,672	2,039,722	11,954	0	2,051,676	0.7238	2,039,722	0.7196
10	Access Expense	34,298,658		34,298,658	20,801,064	0	0	20,801,064	0.6065	20,801,064	0.6065
11	Other	666,121		666,121	438,267	64,473	(30,580)	472,160	0.7088	438,267	0.6579
12	Total Cost of Svcs & Products	465,070,114	(197,627)	464,872,487	296,086,056	51,778,500	(6,192,236)	341,672,320	0.7350	296,086,056	0.6369
13	Customer Operations	244,845,308		244,845,308	175,807,054	26,492,757	(12,056,399)	190,243,412	0.7770	175,807,054	0.7180
14	Corporate Operations	204,386,153	31,036,120	235,422,273	165,922,800	26,416,024	(5,848,360)	186,490,464	0.7922	165,922,800	0.7048
15	Property and Other Taxes	71,165,545		71,165,545	50,730,583	2,813,260	(1,958,238)	51,585,605	0.7249	50,730,583	0.7129
16	Uncollectibles	20,272,457		20,272,457	18,235,984	410,728	(2,480)	18,644,232	0.9197	18,235,984	0.8995
17	Total Selling, General & Administrative	540,669,463	31,036,120	571,705,583	410,696,421	56,132,769	(19,865,477)	446,963,713	0.7818	410,696,421	0.7184
18	Other Operating Income & Expense	13,607		13,607	(366,413)	509,838	(125,328)	18,097	n/a	(366,413)	n/a
19	Depreciation Expense	363,709,774	(21,631,550)	342,078,224	235,204,331	8,644,227	(4,134,396)	239,714,162	0.7008	235,204,331	0.6876
20	Universal Service Fund	0		0	(1,369,596)	0	0	(1,369,596)	0.0000	(1,369,596)	0.0000
21	Link Up America	0		0	(88,374)	0	0	(88,374)	0.0000	(88,374)	0.0000
22	Total Operating Expense	1,369,462,958	9,206,943	1,378,669,901	940,162,425	117,065,334	(30,317,437)	1,026,910,322	0.7449	940,162,425	0.6819
23	**Income From Operations**	398,286,288	(9,206,943)	389,079,345	223,125,807	(14,960,970)	13,691,725	221,856,562	0.5702	223,125,807	0.5735
	Taxes										
24	Federal Income Tax	103,960,088	(1,982,471)	101,977,617	56,978,015	(5,776,537)	4,903,828	56,105,306	0.5502	56,978,015	0.5587
25	State & Local Income Tax	31,769,184	(498,340)	31,270,844	16,940,420	(1,572,232)	1,440,704	16,808,892	0.5375	16,940,420	0.5417
26	**Net Operating Income**	$262,557,016	($6,726,132)	$255,830,884	$149,207,372	($7,612,201)	$7,347,193	$148,942,364	0.5822	$149,207,372	0.5832
	RATE BASE										
27	Telephone Plant In Service	$5,094,841,677	21,201,750	5,116,043,427	3,654,638,781	103,903,288	(59,435,100)	3,699,106,969	0.7230	3,654,638,781	0.7143
28	Short-Term Plant Under Construction	0	0	0	0	0	0	0	0.0000	0	0.0000
29	Materials and Supplies	25,353,734	0	25,353,734	17,820,166	1,189,341	(623,909)	18,385,598	0.7252	17,820,166	0.7029
30	Allowance for Cash Working Capital	0	0	0	(24,398,365)	0	0	(24,398,365)	1.0000	(24,398,365)	1.0000
31	Accumulated Depr & Amort Reserve	(2,578,617,059)	50,166,662	(2,528,450,397)	(1,795,617,425)	(39,384,691)	16,514,403	(1,818,487,713)	0.7192	(1,795,617,425)	0.7102
32	Accumulated Deferred Income Tax	(389,102,118)	(25,611,636)	(414,713,754)	(306,015,636)	(7,460,794)	4,416,554	(309,059,876)	0.7452	(306,015,636)	0.7379
33	Customer Deposits	(7,711,169)	0	(7,711,169)	(5,490,899)	(204,959)	0	(5,695,858)	0.7387	(5,490,899)	0.7121
34	Land Development Agreement Deposits	(24,660,882)	0	(24,660,882)	(18,039,780)	0	0	(18,039,780)	0.7315	(18,039,780)	0.7315
35	Other Assets & Liabilities	0	0	0	0	0	0	0	0.0000	0	0.0000
36	**Net Rate Base**	$2,120,104,183	$45,756,776	$2,165,860,959	$1,522,896,842	$58,042,185	($39,128,052)	$1,541,810,975	0.7119	$1,522,896,842	0.7031

SOURCE: USWC update workpapers WP1-AZFACTOR (AZ1299ft.XLS).