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IFICATE OF SERVICE

I hereby certify that the original and 10 copies of the Direct Testimony of Arleen M. Starr, Lee L. Selwyn and Susan M. Gately on behalf of AT&T Communications of the Mountain States, Inc., regarding Docket No. T-01051B-99-0105, were sent via overnight delivery, this 8th day of August, 2000, to:

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BEFORE THE

ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission
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IN THE MATTER OF THE APPLICATION OF U S WEST COMMUNICATIONS, INC. 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 OF

ARLEEN M. STARR

ON BEHALF OF

AT&T COMMUNICATIONS OF THE

MOUNTAIN STATES, INC.

AUGUST 9, 2000

PUBLIC VERSION

TABLE OF CONTENTS

I. BACKGROUND AND PURPOSE OF TESTIMONY

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Arleen M. Starr. My business address is 1875 Lawrence Street, Denver, Colorado 80202.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by AT&T as a manager in the Local Services and Access Management organization. My responsibilities include analyzing local exchange carriers' intrastate costing and pricing methodologies and studies. As an expert witness, I have submitted testimony on local and access cost and price issues within AT&T's Western Region. I have previously submitted testimony in Colorado, Idaho, Iowa, Minnesota, Montana, Nebraska, New Mexico, North Dakota, Oregon, South Dakota, Utah, Washington and Wyoming.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND.

A. I graduated from DePaul University in 1983 with a Bachelor of Science degree in Commerce, with an emphasis in Accounting. I received a Masters of Business Administration from DePaul University in 1990, with an emphasis in Finance. I have also completed various training seminars offered by AT&T and other educational organizations in marketing, economics, accounting, and costing methods in the telecommunications field.

Q. PLEASE DESCRIBE YOUR WORK EXPERIENCE.

A. I began my career with AT&T in 1984 in the Consumer Marketing Department. I had various responsibilities in this organization, including managing the expense and capital budgets. From 1986 to 1990, I held various positions in the Financial Regulatory Department in Chicago. My responsibilities included intrastate financial analysis and providing reports and data to the regulatory commissions in the Central Region. From 1992 to 1996, I worked in the product equipment business, with financial responsibilities in the product management, sales, and service areas. I assumed my current responsibilities in May of 1996.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. In its rate case application, U S WEST Communications, Inc. ("U S WEST") has proposed changes to several rate elements, including raising local exchange service prices, lowering toll prices and minimally lowering access prices. The overall impact of the changes proposed by U S WEST is a $92 million revenue increase.[1] In addition, U S WEST has proposed to deregulate its high capacity data services and to establish competitive zones which would allow pricing flexibility for all services within the competitive zone, including access services.

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[1] *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,* Arizona Corporation Commission Docket No. T-0105B-99-0105, *("U S WEST Rate Case Application").* The revenue increase requested by U S WEST is the sum of the revenue impact on wholesale services outlined by Scott McIntyre and the revenue impact on retail services outlined by David Teitzel in their respective Supplemental Direct Testimony filed May 19, 2000. The total revenue requirement of $201 million, as calculated by U S WEST, is noted on Exhibit GAR-S1 to George Redding's May 19, 2000 Supplemental Direct Testimony.

I am testifying on behalf of AT&T Communications of the Mountain States, Inc. ("AT&T") to ensure that the wholesale recurring rates for access elements that are ordered in this case are consistent with the rates for unbundled network elements ("UNEs") set in Docket No. U-2428-96-448.[2] Specifically, where UNEs are functionally equivalent to a service (i.e., access) the price for that service should be based on the sum of the UNEs of which it is constructed. I will demonstrate why without setting access rates at forward-looking economic cost, and with the looming entry of U S WEST into the interLATA long distance market, U S WEST will have the ability to price squeeze in the long distance market to the detriment of competition and consumers. U S WEST has also proposed pricing flexibility for wholesale services in the competitive zones. I will demonstrate that without a viable competitive alternative to switched access, and with U S WEST being the monopoly provider of an essential service, safeguards need to be in place to prevent anti-competitive behavior. Lastly, I will comment on U S WEST's proposal for an automatic rider adjustment mechanism related to reciprocal compensation for interconnection. I will demonstrate why this is inappropriate and should be rejected.

Part of U S WEST's proposal attempts to create barriers to competitive market entry and maintain monopoly profits. The purpose of my testimony is to point out the flaws in U S WEST's proposals and to recommend more rational and competitively neutral ways

[2] *In the Matter of the Petition of AT&T Communications of the Mountain States, Inc. for Arbitration with U S WEST Communications, Inc. of Interconnection Rates, Terms and Conditions Pursuant to 47 U.S.C. § 252(b) of the Telecommunications Act et al.,* Arizona Corporation Commission Docket No. U-2428-96-448, *et al.*, Opinion and Order, Decision No. 60635, (Arizona Corp. Comm., January 30, 1998) (dis. op. Commissioner Renz D. Jennings) ("*Permanent Cost Proceeding*").

to establish the cost and price of access to aid in the development of competition in the telecommunications market in Arizona.

Q. PLEASE BRIEFLY OUTLINE YOUR RECOMMENDATIONS.

A. My recommendations are that: (1) access rates be set at forward-looking economic cost; and (2) the Carrier Common Line Charge "(CCLC)" and the Interconnection Charge ("IC") be eliminated.

Q. DO YOU HAVE ANY GENERAL COMMENTS ON PRICING IN THIS RATE CASE?

A. Yes, since the rate design resulting from this proceeding may be structured to meet a Commission determined revenue requirement, prices for all services may not be set at cost, but should nonetheless be based on cost. Rate design in this case should be based on the principles of an efficient and competitive market. Therefore, the resulting policy-based rate design should come as close to cost-based pricing as possible.

Q. HOW CAN THAT BE DONE?

A. By application of a consistent cost and pricing methodology. First, all wholesale services, including access, should be set at forward-looking economic cost, including a reasonable allocation of forward-looking joint and common costs. Second, all prices set in this case must exceed the sum of costs of UNEs needed to provide the service or the forward-looking economic cost of the service if UNE prices are not available. Third, retail prices must be based on cost with a reasonable allocation of joint and common costs.[3] Finally, this Commission must be very careful to avoid setting end user rates that will translate into barriers to competitive entry. Each rate, recurring and nonrecurring, must be examined to identify its impact on the developing market for competitive local exchange service.

Q. LOOKING AT U S WEST'S SPECIFIC PRICING PROPOSALS IN THIS CASE, DO YOU SEE ANY MAJOR PROBLEMS?

A. Yes. There are problems with virtually every part of the U S WEST proposal in this case. From a big picture perspective, really it is just one problem -- anti-competitive imbalance. U S WEST is attempting to achieve competitive classification for certain geographic areas and services, while still wanting to maintain its guaranteed rate of return. It wants to have the advantage of pricing flexibility without accepting the risk that goes along with it. In essence, U S WEST's proposal is an attempt to increase monopoly revenues while maintaining the very barriers to competitive market entry that will sustain the monopoly.

II. ACCESS REFORM

Q. WHAT IS SWITCHED ACCESS?

A. Switched access is a service purchased by interexchange carriers ("IXCs") and is comprised of wholesale network elements that collectively are used to provide access to toll services. Typically, the retail services provided by interexchange carriers that utilize

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[3] Retail rates for a monopoly service provider should be based on cost including a reasonable allocation of forward-looking joint and economic costs. Retail services provided in a fully competitive market are based on competitive market forces.

switched access are intraLATA and interLATA toll.

Q. WHY IS THE AVAILABILITY AND PRICING OF SWITCHED ACCESS CRITICAL?

A. Switched access is necessary for IXCs to provide toll services to its end users. The availability and pricing is critical because, in the majority of markets, Incumbent Local Exchange Carriers ("ILECs") have a monopoly control over switched access and, ultimately, access to end users. Without the availability of competitive alternatives to switched access, IXCs are dependent upon ILECs to provide toll services, leaving them in an unenviable and vulnerable position. The Commission must ensure that ILECs do not use their monopoly control to engage in anti-competitive or discriminatory behavior in the access to, and pricing of, switched access services.

Q. PLEASE EXPLAIN WHAT IS MEANT BY ACCESS REFORM.

A. Today, access is priced substantially above its cost. The difference between the forward-looking economic cost to provide access and the price charged to IXCs is, at best, a significant and historical means of implicit contribution and, at worst, a pure subsidy. The elimination of this subsidy is commonly referred to as access reform.

Q. WHAT WAS THE HISTORICAL ROLE OF THIS SUBSIDY?

A. Historically, the subsidy contained in access services was acknowledged as a way to keep basic local exchange service rates low to promote universal service, while assuring that the incumbent met its traditional revenue requirement. This implicit subsidy may have been workable in a monopoly environment; however, the Telecommunications Act of

1996 ("Act") requires that all subsidies be explicit and that the prices for telecommunications services be just, reasonable and cost-based.[4] This means that access must be priced at forward-looking economic cost and the existing subsidy removed from access and explicitly identified.

Q. WHAT IMPACT WILL PRICING ACCESS AT FORWARD-LOOKING ECONOMIC COST HAVE ON CONSUMERS IN ARIZONA?

A. Consumers will benefit from the resulting competition triggered by access reductions, i.e., additional toll competition, and access reductions will also limit U S WEST's ability to engage in anti-competitive pricing strategies in the toll market, which would impede competition.

Q. DOES U S WEST ADMIT A RELATIONSHIP BETWEEN ACCESS AND UNIVERSAL SERVICE?

A. Yes. Several U S WEST representatives have made statements to that effect. U S WEST witnesses have repeatedly identified access revenues that exceed cost as a source of revenues used to keep local exchange service rates low. U S WEST's Director of Public Policy, Mr. Glenn Brown, noted at the Regional Oversight Meeting in Santa Fe, New Mexico (April 21, 1997) and again in a presentation in Washington, D.C. to the Fifth Annual Conference on Access Charges (June 17, 1997) that Universal Service Fund ("USF") reform and access are closely tied and because U S WEST typically does not

[4] 47 U.S.C., Section 254(e).

receive federal USF, it tends to look at access as its USF. He went so far as to say that "access charges are equal to universal service." One interesting note is that in Arizona U S WEST has received federal USF in the past. For Arizona in 1998, U S WEST received $1,911,794 from the federal universal service fund.[5] So not only has U S WEST received the significant subsidy from access, it is also being subsidized via the federal USF, to the tune of two million dollars annually.

III. ACCESS RATES PRICED AT ECONOMIC COST

Q. ARE THERE NETWORK ELEMENTS THAT ARE EQUIVALENTS TO THE NETWORK ELEMENTS USED TO PROVISION SWITCHED ACCESS FOR TOLL SERVICES?

A. Yes. Local switching, transport, and tandem switching are combined to create access services. Switched access is functionally equivalent to the call termination activity performed in the local arena. I have used the prices of those UNEs, based on the rates established in the *Permanent Cost Proceeding*, to arrive at my access pricing recommendation.[6] I will expand on my recommendation later in my testimony.

Q. ARE THE UNE RATES ESTABLISHED BY THE ARIZONA CORPORATION

[5] National Exchange Carriers Association, Inc., Universal Service Fund, Study Area Detail For All Exchange Carriers, October 1, 1998 for Year End 12/97, Page 2.

[6] The local switching and tandem switching rates are based on the UNE rates previously determined by the Commission in the *Permanent Cost Proceeding*. The transport rates are based on U S WEST's proposed rate structure in this docket and U S WEST's current interstate rates for these elements. This is for consistency in rate structure for the transport elements within the interstate and intrastate jurisdictions. The per minute rates are based on the volumes provided by U S WEST in response to data request WDA-22-011 Attachment F.

COMMISSION IN THE *PERMANENT COST PROCEEDING* BASED ON A PROPERLY CONDUCTED FORWARD-LOOKING ECONOMIC COST STUDY?

A. Generally, no. There are numerous concerns with the UNE rates in Arizona, many of which have to do with the fact that they are neither cost-based, nor in compliance with the FCC's pricing rules or the Act. For instance, although the Commission used the HAI Model (formerly the Hatfield Model) as a starting point to determine the cost of unbundled network elements, the Commission made numerous unsupported revisions to the HAI Model. This resulted in increases to the costs that exceed even U S WEST's excessive and non-compliant forward-looking economic costs for providing those elements. Although the UNE rates established by the Commission in the *Permanent Cost Proceeding* may not be the most accurate reflection of U S WEST's forward-looking economic cost of providing these elements, setting the access elements equal to the UNE rates previously established by the Commission is an expedient step in the right direction.[7]

Q. WHAT ARE THE APPROPRIATE RATE ELEMENTS AND PRICES?

A. AT&T's pricing recommendation for wholesale recurring access rate elements is as

[7] *In the Matter of Investigation into U S WEST's Communications, Inc.'s Compliance with Certain Wholesale Pricing Requirements for Unbundled Network Elements and Resale Discounts,* Arizona Corporation Commission Docket No. T-00000A-00-0194. The Commission has initiated a new cost docket to review many of the UNE rates previously established. One of the purposes of the docket is to review rates to determine compliance with the FCC pricing rules.

follows:

Rate Element	**Price**
Local Switching Usage	$ .0028 per MOU
Tandem Switching Usage	$ .0014 per MOU
Transport	$ .0019 per MOU
Weighted Average Unit Cost[8]	**$0.006 per AMOU**

Q. WHY IS IT CRITICAL FOR ACCESS RATES TO BE SET AT FORWARD-LOOKING ECONOMIC COST?

A. Allowing U S WEST to continue to charge access rates well in excess of forward-looking economic cost, while it retains its monopoly on access services, would create an anti-competitive and discriminatory situation in Arizona. Access rates must be set at forward-looking economic cost without delay, but certainly before U S WEST is permitted to provide in-region long distance service in Arizona.[9] Otherwise, due to U S WEST's excessive access charges, U S WEST will be in a position to engage in discriminatory pricing within the long distance market.

Q. HAS THE COMMISSION TAKEN A POSITION ON THE IMPORTANCE OF SETTING ACCESS RATES AT ECONOMIC COST?

A. Yes. In 1998, the Commission dismissed an access complaint brought by MCI Telecommunications Corporation against U S WEST. The Commission's Order confirmed

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[8] See footnote 6.

[9] *In the Matter of U S WEST Communications, Inc.'s Compliance with §271 of the Telecommunications Act of 1996,* Arizona Corporation Commission Docket No. T-00000B-97-0238, ("*U S WEST Arizona Section 271Application*"). There is a current docket pending before the Commission requesting Section 271 approval for U S WEST to provide in-region long distance service.

"that access charges are not set at their economic cost levels."[10] Although the Commission dismissed the complaint, the Commission confirmed the need to review and price access charges at economic cost, specifically in the context of a U S WEST rate case. The Commission's Order stated:

> While the Commission agrees there is a need to review the level at which access charges are set, we cannot change those cost levels without consideration of the overall impact of any rate change upon the rate of return on the fair value rate base of U S WEST. Consequently, the access charges which were determined to be just and reasonable as part of Decision No. 58927 will need to be reviewed as part of a U S WEST rate case.[11]

Additionally, the Commission saw the need to set access charges at economic cost prior to U S WEST's entry into the interLATA long distance market.

> The enactment of the Act established a policy to move competition into monopoly markets. In a competitive environment, prices of services such as access charges would need to be set at economic cost levels. . . .
>
> . . .
>
> We find that the pricing of access charges should be taken into consideration as part of any request by U S WEST to enter into Arizona's interLATA toll market. . . .[12]

Therefore, this is the appropriate time and proceeding to set access rates at forward-looking economic cost.

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10 *MCI Telecommunications Corporation Against U S WEST Communications, Inc. Regarding Intrastate Access Charges or, In the Alternative, Request that the Commission Investigate U S WEST's Intrastate Access Charges,* Arizona Corporation Commission Docket No. T-01051B-97-200, Opinion and Order, Decision No. 60596, (Jan. 14, 1998), at 3 ("*MCI Access Complaint*").

11 *Id.*

12 *Id.*

Q. WHAT ARE THE CURRENT U S WEST INTRASTATE ACCESS RATE LEVELS IN ARIZONA?

A. It is well known and generally accepted that intrastate switched access rates in Arizona are priced significantly in excess of the forward-looking economic cost of actually providing the service. In fact, U S WEST itself acknowledges that access rates are well above cost. U S WEST witness Scott McIntyre stated, "switched access continues to be priced at relatively high contribution levels."[13] Using the unbundled network element costs for local and tandem switching identified by the Commission in the *Permanent Cost Proceeding* and U S WEST's proposed transport rate structure and interstate transport rates, U S WEST's cost to provide switched access is $.006 (.6 cents) per minute at each end, or $.012 (1.2 cents) per minute for both originating and terminating access combined.[14] This compares to U S WEST's currently tariffed access charges which totals $0.09 (9 cents)[15] for both originating and terminating access, or a difference of over $.078 (7.8 cents) per minute. Even with U S WEST's current access reduction proposal, the new rate would be $0.078 (7.8 cents), resulting in a margin of $.066 (6.6 cents) per conversation minute, barely a noticeable difference.[16]

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[13] *U S WEST Rate Case Application,* Testimony of Barbara M. Wilcox at 10. This testimony was adopted by Scott McIntyre.

[14] *Permanent Cost Proceeding*, Opinion and Order, Decision No. 60635 at Appendix A. The identified UNEs that, when combined, constitute the provision of switched access are: (1) end-office local switching (.28 cents); (2) tandem switching (.14 cents). The associated UNE prices are those that the Commission set in the *Permanent Cost Proceeding*. The transport rate element is based on U S WEST's proposed rate structure and U S WEST's interstate rates. All prices in this analysis are per-minute using the volumes provided by U S WEST in response to data request WDA-22-011 Attachment F.

[15] *U S WEST Rate Case Application*, Testimony of Barbara M. Wilcox (adopted by Scott McIntyre) at 5. 4.5 cents is the switched access averaged weighted rate per minute.

[16] U S WEST response to data request WDA-22-011 Attachment F. 3.8806 cents is the switched access average weighted rate per minute proposed by U S WEST.

Q. PLEASE SUMMARIZE U S WEST'S PROPOSED ACCESS REDUCTIONS AND COMMENT ON THE PROPOSED ACCESS REDUCTIONS.

A. U S WEST has proposed a token reduction in access rates. U S WEST is proposing a minor reduction in the terminating CCL rate, a reduction in the IC rate, and to restructure local transport to reflect the FCC interstate local transport rate design. According to U S WEST, the reduction amounts to approximately 5 million dollars, or about 7 percent for the entire industry.[17] As demonstrated in Exhibit AS-3, this is an insignificant reduction when the existing access rates are compared to their forward-looking economic cost. For U S WEST's rates to be based on forward-looking economic cost, they would have to be reduced by over 85 percent.[18] A minimal reduction of seven percent, when access rates are priced significantly above cost, certainly does not eliminate the anti-competitive advantage U S WEST has over IXCs, and does very little to even reduce it.

A. Switched Access Rate Elements

Q. WHAT ARE THE RATE ELEMENTS WHICH COMPRISE SWITCHED ACCESS?

A. Switched access is comprised of local switching, tandem switching and transport.

Q. WHAT IS LOCAL SWITCHING?

A. Local switching is a minute of use charge paid by IXCs to the local telephone company for switching a call through the central office of the local telephone company.

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[17] *U S WEST Rate Case Application*, Testimony of Scott McIntyre, May 19, 2000, at 5.

[18] 85% percent reduction in access rates is based on the reduction of the current U S WEST tariffed rate for originating and terminating access of 9 cents and the forward-looking economic cost of 1.2 cents per minute of use.

Q. WHAT IS THE CURRENT LOCAL SWITCHING RATE?

A. Currently, the local switching rate charged by U S WEST in Arizona is $0.0173 per minute of use.

Q. WHAT CHANGE IS U S WEST PROPOSING TO THE LOCAL SWITCHING RATE?

A. Although U S WEST is not proposing an actual change to the local switching rate, U S WEST is proposing to bifurcate the switching rate into originating and terminating elements. U S WEST states this is to enhance U S WEST's pricing flexibility when competition develops and carriers can substitute other services for switched access service.[19]

Q. WHAT IS AT&T'S POSITION ON THE RATES FOR LOCAL SWITCHING?

A. Local switching, along with all access rate elements, must be based on forward-looking economic cost. Using properly calculated forward-looking economic cost, U S WEST will be fully compensated for its economic costs, reasonable joint and common costs, plus an equitable profit. The primary rate elements that make up switched access service are nothing more than unbundled network elements, and they must, therefore, be based on forward-looking economic cost. Consistent with the rate established by the Commission for local switching in the *Permanent Cost Proceeding*, the local switching rate for access should be set at $0.0028 per minute of use. If U S WEST is allowed to continue to charge the current local switching rate of $0.0173 per minute of use, it will earn a margin

[19] *U S WEST Rate Case Application*, Testimony of Barbara M. Wilcox (adopted by Scott McIntyre) at 9.

significantly above its economic cost on each minute and put competitors at an economic disadvantage in the marketplace.

Q. WHAT IS AT&T'S POSITION ON U S WEST'S PROPOSAL TO BIFURCATE ORIGINATING AND TERMINATING LOCAL SWITCHING TRAFFIC?

A. AT&T is not opposed to U S WEST having separate rate elements for originating and terminating local switching traffic, as long as the prices are set equal to each other. The prices established for originating and terminating traffic should be consistent, since they are providing the same function and have the same economic cost. There is no cost justification to set different originating and terminating rates for local switching; therefore, it appears the only reason U S WEST would desire bifurcating originating and terminating local switching rates would be to discriminate in the marketplace. Allowing U S WEST to charge different rates for originating and terminating access while competition is developing, will permit U S WEST to discriminate by charging higher rates for terminating access. As competition develops, initially it is more likely there will be alternatives for originating access, while IXCs will still be required to pay terminating access at whatever rate the terminating carrier charges. As demonstrated by U S WEST's CCLC rates, it is clear U S WEST has the ability to price terminating access at a higher rate, simply because IXCs have no other choice.[20] While U S WEST retains its monopoly power, this should not be allowed.

[20] *U S WEST Rate Case Application*, Testimony of Scott McIntyre at SAM-1. U S WEST originating CCLC rate is $0.01 and the terminating CCLC rate is currently $0.0242 with a proposed change to $.022668.

Q. WHAT CHANGE IS U S WEST PROPOSING TO THE TRANSPORT RATE ELEMENTS REQUIRED IN THE PROVISION OF SWITCHED ACCESS SERVICES?

A. U S WEST is proposing to add four new elements to more closely align the transport structure in Arizona with the interstate switched access rates filed by U S WEST with the FCC. The four new elements are tandem trunk port, common transport multiplexing, end office shared port associated with tandem-switched transport and end office dedicated trunk port associated with direct trunked transport between serving a wire center and an end office. U S WEST is also eliminating the option to pay for transport between the access tandem and the serving wire center via tandem-switched transport rates and is requiring a carrier to purchase direct trunked transport. U S WEST states that it is restructuring transport to align with its interstate rate structure, but not necessarily with its current interstate rates.

Additionally, U S WEST is only offering direct trunked transport at the DS0, or voice grade level in its switched access tariff. This is not what an efficient provider with any significant amount of traffic would require. U S WEST should be required to offer direct trunked transport at the DS1 and DS3 levels in its access tariff, in addition to the DS0 level.

As part of its rate case application, U S WEST has filed for deregulation of its high capacity services, including DS1 and DS3 transport services. This would allow U S WEST to withdraw its filed tariffs for these services. What this means is that IXCs that must buy DS1 and DS3 transport services from U S WEST do not know what U S WEST intends to charge for these services, or even if it is willing to provide them. U S WEST claims it is attempting to align its Arizona tariff with the FCC tariff and U S WEST provides DS1 and DS3 direct trunked transport in its interstate tariff. Additionally, U S WEST has provided cost studies for direct trunked transport at the DS1 and DS3 levels.[21] Therefore, U S WEST should provide all the options available in its interstate tariff in its intrastate tariff.

Q. WHAT IS THE OVERALL IMPACT OF U S WEST'S LOCAL TRANSPORT RATE RESTRUCTURE?

A. Although U S WEST does not clearly present the impact of its transition to the FCC transport rate structure, the overall impact of U S WEST's transport restructure is an increase of over *[XXX] [Proprietary]* million dollars.[22] This includes the changes U S WEST is proposing to its DS1 and DS3 transport services, services that U S WEST has proposed to deregulate. U S WEST's basis for its proposed deregulation of these services is that competition is eroding it market share for these services. Logic would suggest that in a highly competitive market, as U S WEST claims the market is for these high capacity services, U S WEST would want to lower, not raise, prices. U S WEST

[21] U S WEST Switched Access Service, DS1 Transport Service, Recurring Cost Study and U S WEST Switched Access Service, DS3 Transport Service, Recurring Cost Study

[22] U S WEST Proprietary Response to Data Request WDA 22-0111 Attachment f. Overall industry reduction is *[XXXXXXXX] [Proprietary]*, reduction to the IC is *[XXXXXXXX] [Proprietary]*, no changes to the local switching rate, CCL decrease is *[XXXXXXXXX] [Proprietary]* and the local transport rate increase is *[XXXXXXXXX] [Proprietary]*.

also asserts it believes it can make up the difference between the $92 million and the $201 million revenue deficiency it has calculated through the pricing flexibility it is requesting.[23] This would indicate U S WEST is intending, at least in for some services in certain areas, to raise prices. If U S WEST is able to raise prices and increase revenues of this magnitude, it would indicate the market is not competitive. It is clear from reviewing the detail of U S WEST's access rate proposal, including those services for which U S WEST has requested deregulation, it is attempting to retain its monopoly profits for its bottleneck facilities and lower rates where it has a competitive threat. If this is any indication of what U S WEST intends to do if these services are deregulated, the Commission must deny U S WEST's request for deregulation.

Q. WHAT IS AT&T'S POSITION ON THE RESTRUCTURE OF TRANSPORT RATES?

A. AT&T is not opposed to the new rate structure for the transport rate elements, as long as the rates set are based on forward-looking economic cost. U S WEST's testimony indicates it is restructuring transport to align it more closely with the FCC structure, but it does not clearly indicate that the proposed rates in Arizona in many cases are significantly higher than the FCC interstate rates. Exhibit AS-1 provides a comparison of the U S WEST proposed transport rates for Arizona to the U S WEST interstate rates filed in its Access Service Tariff No. 5 filed with the FCC. What this exhibit shows is

[23] *U S WEST Rate Case Application*, U S WEST response to data request UTI 01-032.

that for some rate elements U S WEST is attempting to price its transport services in Arizona at rates almost four times the rates established by the FCC. As an example, the common transport multiplexing rate proposed by U S WEST in Arizona is $0.000137 per minute, while the same common transport multiplexing rate contained in U S WEST's interstate tariff is $0.0000303 per minute. The rate proposed by U S WEST in Arizona is 352% higher than the interstate rate. These are the same, functionally equivalent elements, and there is no cost justification for such a significant price difference. If U S WEST wants to align its intrastate transport with its interstate transport, the rates must be the same.

This is also seen in the local switching rate in Arizona. The current local switching rate is $.0173 per minute, while the same local switching rate contained in U S WEST's interstate tariff is $.002342 per minute. The rate proposed by U S WEST in Arizona is 639% higher than the interstate rate. These are functionally equivalent elements, and there is no cost justification for such a significant price difference.

Q. WHAT IS THE CARRIER COMMON LINE CHARGE?

A. U S WEST imposes charges on long-distance carriers such as AT&T, in return for those carriers being able to originate and terminate calls to U S WEST's local service customers. The total "access charges" AT&T and other access customers pay U S WEST are comprised of several components, one of which is the CCLC. Some components of access charges are assessed based on the use of the network or, stated another way, the amount of interexchange traffic exchanged between the interexchange carrier and

U S WEST. The CCLC is not based on the amount of interexchange traffic passed between the interexchange and local carrier. That is, the CCLC is not intended to compensate U S WEST for costs that are related to the amount of access traffic that U S WEST actually carries for interexchange carriers. Its purpose is to provide U S WEST with additional revenues from the IXCs. U S WEST's tariff requires interexchange carriers to pay the CCLC on a per minute-of-use (MOU) basis.

Since the CCLC has no cost basis and does not compensate U S WEST for any exchange of traffic, it should be eliminated. The CCLC is a pure subsidy rate element with absolutely no cost basis. With the advent of USF and the 1996 Act's requirements that prices be cost-based and that all subsidies be explicit, there is no justification for the CCLC. The CCLC is an access rate element designed to recover significant revenues from purchasers of access in an attempt to keep residential rates low. This subsidy cannot be maintained in a competitive environment. Furthermore, there is no evidence that the CCLC was and is used to keep residential rates low.

Q. WHAT ARE THE CCLC RATES CHARGED BY U S WEST IN ARIZONA?

A. The CCLC is one of the most significant access rate elements charged by U S WEST in Arizona. The current CCLC rate in Arizona is $0.0100 per originating minute of use and $0.0242 per terminating minute of use.[24] The CCLC generates a significant amount of revenue to U S WEST, almost *[XXXXXXXXX] [Proprietary]* dollars annually, at the

[24] U S WEST Communications Arizona Access Service Tariff, Section 3.8, Page 11, Release 11.

expense of IXCs and, ultimately, consumers of long distance services.[25] U S WEST admits there are no direct costs associated with this element.[26] U S WEST stated that the CCLC "is generally related with the ubiquitous provision of basic telephone service."[27] U S WEST is proposing a minor reduction in the terminating CCLC rate to $.022668 in its rate case application.

Q. WHAT ADDITIONAL SIGNIFICANT ACCESS ELEMENT IS CHARGED BY U S WEST IN ARIZONA?

A. An additional, equally significant, access element in Arizona is the Interconnection Charge ("IC"). The current Interconnection Charge in Arizona is $0.006212 per minute.[28] U S WEST has proposed a reduction in the IC rate, reducing it to $0.002450. This is a step in the right direction, but there is still not any justification for a rate element that does not have a cost basis. The IC also provides a significant contribution to U S WEST's revenue stream, currently over *[XXXXXXXXXXXXXX] [Proprietary]*, at the expense of IXCs.[29] As stated by U S WEST, "The IC provides contribution to common, shared, and embedded costs and support of basic telephone service."[30] This is nothing more than a subsidy paid by IXCs and thus, long distance customers, to U S WEST. Subsidies can not be maintained in a competitive environment.

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[25] U S WEST response to data request WDA 22-011 Attachment F.
[26] *U S WEST Rate Case Application*, Testimony of Barbara M. Wilcox (adopted by Scott McIntyre) at 6.
[27] *Id.*
[28] U S WEST Communications Arizona Access Service Tariff, Section 6.8.4, Page 124, Release 2.
[29] U S WEST response to data request WDA 22-011 Attachment F.
[30] *U S WEST Rate Case Application*, Testimony of Barbara M. Wilcox (adopted by Scott McIntyre) at 7.

B. U S WEST Cost Studies for Switched Access

Q. DO YOU HAVE ANY CONCERNS WITH THE COST STUDIES FILED BY U S WEST FOR ITS SWITCHED ACCESS SERVICES?

A. Yes. As with most cost studies filed by U S WEST, there are many significant flaws and deficiencies in the studies. The main flaw is the studies are not well documented and do not provide the level of detail required to conduct a proper cost analysis. Even without detailed information, there a few major areas of concern I would like to point out. The first is that the studies do not appear to be based on efficient, forward-looking mechanized systems. This is something that has been identified in many previous proceedings and has been found to significantly overstate costs.[31] Additionally, the cost studies contain outdated information from as far back as 1996, hardly forward-looking.[32] Another concern is the cost of money used by U S WEST in the cost studies. The *[XXXXX] [Proprietary]* rate used by U S WEST is significantly above the 9.75% composite return authorized by the Commission in Decision No. 58927. In addition to its direct costs, U S WEST applies up to 15 different factors to account for administrative type costs. These factors are expressed in terms of a percentage and are applied to the investment level. This significantly increases the amount U S WEST is attempting to recover. Another issue, which is more fully addressed in the testimony of Ms. Gately, is the exchanges which U S WEST is in the process of selling to Citizens Utilities. Of the

[31] *In the Matter of the Investigation into Compliance Tariffs filed by U S WEST Communications Inc.,* Advice Nos. 1661, 1685, and 1690. et al., Oregon Public Utilities Docket No. UT 138,139, Order No. 98-444, November 13, 1998 at 69 ("*Oregon Order*").

[32] U S WEST Cost Studies, Arizona Switched Access Service, 2000 Cost Study Prescribed Life, Study ID #2887, 1996 USWC Non Chargeable Intercept Investments and Expenses at Page 10-3.

136 end offices included in the U S WEST cost studies for access services, 38 or almost 25%, have been identified as exchanges being sold.[33] Most, if not all, are higher cost, rural exchanges. Unless these exchanges are removed from the cost analysis, U S WEST will be allowed to recover cost and expenses based on high-cost investment that it no longer owns. There is no justification for this.

Q. WHAT DO THE RESULTS OF THE COST STUDIES INDICATE?

A. This is the most disconcerting issue I have with the U S WEST switched access cost studies. Aside from the many deficiencies and potential overstatement of costs, the difference between the U S WEST derived "cost" of the access elements and the proposed price is astronomical. I have prepared a proprietary exhibit which provides a comparison of the U S WEST "cost" to the U S WEST proposed price for each of the access elements *[Proprietary Exhibit AS-2]*. In some cases the price is over 1,000% above cost. U S WEST's cost studies already include a cost of capital component which is applied to investments, thus allowing U S WEST the opportunity to recover its costs, plus a reasonable profit. Any additional mark-up above a properly calculated forward-looking economic cost, which includes a reasonable profit, should not be allowed. Additionally, in comparing U S WEST's cost studies filed in its original filing in January, 1999 to those studies filed in U S WEST's updated filing in May, 2000, there are significant increases from the 1998 costs to the 2000 costs. There is no reason why U S WEST's costs for providing switched access should have increased so dramatically.

[33] U S WEST response to APA 04-001, U S WEST Cost Studies, 2000 Switched Access, #20 SA-Recurring, End Offices included in this study.

This is extremely disconcerting, considering access elements are necessary to provide toll services, and U S WEST is essentially the only provider of these elements for many segments of the market.

Q. WHAT IMPACT DO THESE SIGNIFICANT ACCESS RATES CHARGED BY U S WEST HAVE ON IXCS PROVIDING LONG DISTANCE SERVICES IN ARIZONA?

A. The unreasonably high access charges that U S WEST is authorized to collect from IXCs will provide U S WEST with an unwarranted and anti-competitive advantage in the market for long distance services. This is even more alarming if U S WEST is allowed to offer in-region interLATA long distance service. This is because the actual economic cost of access, 1.2 cents, is the effective price U S WEST will pay, while IXCs will pay the much higher proposed tariffed price of U S WEST's unreasonably high access rates of 7.8 cents. This difference amounts to over 6.6 cents per minute (See Exhibit AS-3). Another consideration is that U S WEST maintains a virtual monopoly on access services, leaving IXCs with no other alternative but to purchase access at rates well in excess of cost. If this is allowed to continue, it will permit, if not encourage, anti-competitive behavior by U S WEST. This would have a detrimental effect on the level of competition within the long distance market in Arizona.

Q. WHAT ADDITIONAL CONCERNS ARISE RELATED TO UNECONOMIC

ACCESS RATES, IF U S WEST IS GRANTED SECTION 271 RELIEF ALLOWING THEM TO PROVIDE IN-REGION LONG DISTANCE SERVICE?

A. Allowing U S WEST to enter the interLATA long-distance market and to continue to charge access rates well in excess of forward-looking economic cost, while it retains its monopoly on access services, would create an unwarranted anti-competitive advantage for U S WEST over IXCs and Competitive Local Exchange Carriers ("CLECs"). Access rates must be set at forward-looking economic cost before U S WEST is permitted to provide in-region long distance service in Arizona. Otherwise, due to U S WEST's excessive access charges, U S WEST will be in a position to engage in discriminatory pricing in the long distance market, and it will be the consumers of Arizona who ultimately pay the consequences. With U S WEST's Section 271 application currently pending before the Commission, the time is now for U S WEST's access rates to be set at forward-looking economic cost.

Q. ARE THERE OTHER, NON PRICE RELATED, CONCERNS WITH U S WEST'S PROVISIONING OF ACCESS SERVICES?

A. Yes. An additional concern is the potential quality discrimination U S WEST may exhibit in its provisioning of exchange access to long distance carriers. If U S WEST is granted authority to provide in-region interLATA service without appropriate controls to prevent quality discrimination by U S WEST or its affiliates, it will have added reasons to neglect the exchange access needs of its long distance competitors.[34] What IXCs are receiving from U S WEST is poor quality service at rates that are significantly above cost. With U S WEST's merger with Qwest, there is even more potential for price and quality discrimination to long distance carriers in the fourteen state U S WEST region.

IV. POTENTIAL PRICE SQUEEZE IN THE LONG DISTANCE MARKET

Q. WHAT IMPACT DOES U S WEST'S ACCESS RATES HAVE ON THE LONG DISTANCE MARKET?

A. Without setting access rates at forward-looking economic cost and with the potential entry of U S WEST into the long distance market, the result will be a detrimental effect on competition. Additionally, if U S WEST is allowed entry into the long distance market either through Section 271 relief granted by the FCC, the provision of intrastate long distance service in Arizona via the elimination of LATA boundaries, or its merger with Qwest, it will have little, if any, incentive to release its monopoly hold on the local exchange market.

Q. WHAT IMPACT DO ACCESS CHARGES HAVE ON THE ABILITY OF AN IXC OR CLEC TO COMPETE WITH U S WEST IN THE LONG DISTANCE MARKET?

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[34] *In the Matter of the Complaint of AT&T Communications of the Mountain States, Inc. Against U S WEST Communications, Inc. Regarding Access Service*, Arizona Corporation Commission Docket No. T-02428A-99-0476, Complaint, (August 18, 1999). On August 18, 1999, AT&T filed a complaint with the Arizona Corporation Commission detailing the specific service quality issues AT&T is encountering with U S WEST. The complaint identifies U S WEST's failures including (1) an unwillingness to provide facilities necessary for access services; (2) an unwillingness to timely provision those facilities it does provide; (3) practices that favor itself, its affiliates and its own customers; and (4) maintaining unreasonable differences as to access services between localities and classes of services when deciding where to provision facilities.

A. Exhibit AS-3 illustrates the anti-competitive effect U S WEST's entry into the long distance market will have, without reducing access rates to forward-looking economic cost.

<u>Example #1 -- Margin Analysis</u> provides proof of U S WEST's ability to earn 11.8 cents on each minute of long distance, compared to 5.2 cents for an IXC. The difference is directly related to the level of access charges U S WEST charges an IXC. As described earlier, the proposed tariffed rate U S WEST would charge AT&T and other IXCs is 7.8 cents for an originating and terminating minute, while the economic cost to U S WEST of providing that minute is 1.2 cents. If U S WEST is allowed to continue charging access rates well in excess of forward-looking economic cost, it will be impossible for IXCs to compete with U S WEST in the long distance market. This contravenes the intent of the Telecommunications Act.

<u>Example #2 -- Price Squeeze</u> illustrates how with access at rates above forward-looking economic cost, U S WEST will have the ability to eliminate the margin entirely from an IXC. Assuming U S WEST will be required to price its long distance service above cost plus the imputed price of essential services as required by ACC Rule R-14-2-1310, the rate must cover the tariffed access rate plus any internal costs U S WEST would incur. In this example, the minimum price U S WEST would be allowed to charge would be 9.8 cents (7.8 cents access plus 2.0 cents Intra-company costs). In order to compete, IXCs would then be forced to lower their retail rates to match the 9.8 cents per minute charged by U S WEST, eliminating any margin. With a gross margin of zero, IXCs will have little incentive to market their services in Arizona, while U S WEST retains its margin of \$6.6 cents per minute. This is directly related to the difference between the price and the forward-looking economic cost of access. Therefore, it is possible U S WEST's monopoly in the local market will be extended to the long distance market. This is not the intent of the Act, or the direction that will lead to the development of a competitive environment for communication services in Arizona.

A. ACC Pricing Rules

Q. U S WEST'S MTS SERVICE HAS ALREADY RECEIVED COMPETITIVE CLASSIFICATION FROM THE COMMISSION. DOES THIS CAUSE ADDITIONAL PROBLEMS WITH THE ABILITY FOR IXCS TO COMPETE IN THE TOLL MARKET?[35]

A. Yes. When a service is deemed competitive by the Commission, U S WEST may argue it is no longer required to continue to comply with ACC Rule R14-2-1310, which requires the imputation of the price of essential services (access). ACC R14-2-1109 only requires that the price be above the company's total service long run incremental cost of providing the service. If ACC Rule R14-2-1310 no longer applies, this essentially gives U S WEST the ability to price its competitors out of the toll market because the underlying component of toll, access, is not competitive. The only way to prevent price discrimination by U S WEST is to price access at forward-looking economic cost.

[35] *In the Matter of U S WEST Communication, Inc. Petition to Have Certain IntraLATA Toll Services Competitive and to Change Certain message Telecommunications Rates*, Arizona Corporation Commission Docket No. E-1051-96-160, Decision No. 59637 (April 24, 1996).

Q. CAN YOU PLEASE PROVIDE THE REQUIREMENTS OF THE PRICING RULES FOR BASIC COMMUNICATION SERVICES AND COMPETITIVE TELECOMMUNICATION SERVICES?

A. Yes. The relevant sections of R14-2-1310 and R14-2-1109 are:

R14-2-1310 Pricing

A. Pricing of Basic Communication Services

1. The incumbent local exchange carrier shall provide the Commission with price floor calculations for local exchange and long distance services to ensure the avoidance of anti-competitive practices. A NELEC can price below an incumbent LEC's TSLRIC price.

2. Whenever the incumbent local exchange carrier introduces a new local exchange service or long distance service, or proposes to change the rate for an existing local exchange service or long distance service, the local exchange carrier shall provide to the Commission information that demonstrates that the proposed rate equals or exceeds a price floor calculation for that service using an imputation test described in subsection (C).

* * *

C. Imputation

1. An incumbent local exchange carrier shall recover in the retail price of each telecommunications service offered by the company the TSLRIC of all non-essential, and the imputed prices of all essential services, facilities, components functions, or capabilities that are utilized to provision such telecommunications service, whether such service is offered pursuant to tariff or private contract.

R14-2-1109 Pricing of Competitive Telecommunications Services

A. Pricing of Competitive Services. A telecommunications company governed by this Article may price a competitive telecommunications service at any level at or below the maximum rate stated in the company's tariff on file with the

Commission, provided that the price for the service is not less than the company's total service long-run incremental cost of providing the service.

* * *

C. No Cross-subsidization. A competitive telecommunications service shall not be subsidized by any rate or charge for any noncompetitive telecommunications services. To insure that no cross subsidization exists, each competitive telecommunications service must provide revenues that equal or exceed the company's total service long-run incremental cost of providing the service.

Q. DOES REQUIRING U S WEST TO IMPUTE THE PRICE OF ACCESS IN ITS TOLL PRICES ELIMINATE THE ANTICOMPETITIVE ADVANTAGE IT HAS OVER ITS COMPETITORS IN THE TOLL MARKET?

A. No. If U S WEST were required to impute the same access price for a toll minute that it charges others – 7.8 cents – the initial reaction is to say the playing field has been leveled. A competitor has the opportunity to earn the same margin as U S WEST, because U S WEST is imputing the price of access in its toll rates.

A closer look, however, shows that such an interpretation is not quite true. The cost for a competitor truly is 9.8 cents (7.8 cents in access cost and 2.0 cents in intracompany costs). However, for U S WEST, 9.8 cents is its *imputed price floor* – not its cost. U S WEST's cost is only 3.2 cents (1.2 cents in access costs and 2.0 cents in intracompany costs). While it may be imputing the 7.8-cents switched access *price*, U S WEST's switched access *cost* for that toll minute is only 1.2 cents. Therefore, there is a profit for U S WEST embedded within the 9.8 cents imputed price floor for the difference between the price of access and the cost of access of 6.6 cents for every minute. It is a profit from a monopoly service that can, among other things, be used to fund advertising campaigns, make network improvements that will win customers for its toll services or network upgrades to provision advances services, such as U S WEST's MegaBit product line. This is an enormous economic barrier for competitors to overcome.

Q. DOES THE SITUATION YOU JUST DESCRIBED ALLOW U S WEST TO PRICE SQUEEZE ITS TOLL COMPETITORS?

A. Yes. As long as access is priced above cost, U S WEST is always in a position to price squeeze its toll competitors out of the market. Suppose, in the example above, that competition continues to drive the price down from 15 cents. When the price reaches 9.8 cents, it is no longer profitable for U S WEST's competitors to enter or remain in the market over the long run, because that is the point at which the competitor's price equals its cost. On the other hand, at a price of 9.8 cents, U S WEST still makes a profit of 6.6 cents. At 9.8 cents, price does *not* equal cost for U S WEST. This is an economic barrier, which may preclude more efficient providers from offering substitutable services at comparable prices.

Q. DOES THE PRICE OF SWITCHED ACCESS AFFECT THE AVAILABILITY OF FUNCTIONALLY EQUIVALENT SERVICES AT COMPARABLE RATES, TERMS AND CONDITIONS IN THE INTRALATA TOLL MARKET?

A. Yes. As long as access is priced above its forward-looking economic cost, U S WEST's competitors will be subject to a pricing disadvantage that may negatively impact the sustainability of a competitive toll market. A competitor may decide to offer its services at a rate below its cost in the short term to gain market share. However, it is unlikely that these toll providers will be able to sustain losses in the long-term.

U S WEST's competitors may decide to cut their losses by raising prices, limiting the availability of optional calling plans, or discontinuing their provision of intraLATA toll service in U S WEST's serving area. Arizona customers will suffer in the long run because U S WEST will have the ability to raise its prices once competitive pressure on its toll services is reduced or eliminated.

Q. WHAT MUST THIS COMMISSION DO REGARDING ACCESS RATES NOW AS PART THIS RATE CASE AND PRIOR TO U S WEST'S ENTRY INTO THE LONG DISTANCE MARKET?

A. This Commission must address U S WEST's anti-competitive access charges in this proceeding, *before* U S WEST receives approval to provide in-region interLATA services in Arizona. Access priced above its forward-looking economic cost creates an unwarranted advantage for an incumbent such as U S WEST, since it maintains complete control over the vast majority of the network required to provide ubiquitous toll service to all customers in its Arizona serving area. The forward-looking economic cost for U S WEST to provide access to itself for intrastate long distance calls is substantially less than the price that U S WEST charges IXCs for the same, identical access. As illustrated in the above example, U S WEST's competitors will be disadvantaged by a dramatic price squeeze the moment U S WEST receives in-region approval. Consequently, it is vital to remove barriers to competition now, before U S WEST enters its in-region long distance market.

V. SWITCHED ACCESS PRICING PROPOSAL

Q. ARE THERE ANY GENERAL COMMENTS YOU WOULD LIKE TO MAKE WITH RESPECT TO AT&T'S PRICING PROPOSAL?

A. Yes. AT&T's pricing recommendations for access services are consistent with cost-based pricing in an efficient and competitive market.

Q. ARE YOU PROPOSING SPECIFIC PRICES FOR SWITCHED ACCESS RATE ELEMENTS?

A. Yes. Access should be priced at forward-looking economic cost. That would mean the total elimination of the Carrier Common Line Charge and the Interconnection Charge. U S WEST has proposed only a minimal reduction in the CCLC and the IC. Switched access, composed of the switching and transport elements I mentioned earlier, should be set at a composite rate of $0.006 per minute. Additionally, nonrecurring charges ("NRCs") related the provisioning of access services, where necessary from an efficient provider of access elements, should be set at forward-looking economic cost.

AT&T's pricing proposal for the specific switched access rate elements and prices are as follows:

Rate Element	**Price**
Local Switching Usage	$ .0028 per MOU
Tandem Switching Usage	$ .0014 per MOU
Transport	$ .0019 per MOU
Weighted Average	**$.006 per MOU**

VI. ACCESS REDUCTIONS – CONSUMER BENEFIT

Q. IS AT&T WILLING TO FLOW THROUGH ACCESS REDUCTIONS TO CUSTOMERS OF ITS TOLL SERVICES?

A. Yes. If access rates are reduced to forward-looking economic cost, AT&T will comply with the ACAM in its tariff and will make the necessary revisions to its toll rates, based on market conditions, in order for customers of its long distance services in Arizona to experience the benefits of these access savings.

Q. IS THE ACCESS COST ADJUSTOR MECHANISM ("ACAM") PART OF AT&T'S CURRENT LOCAL CHANNEL SERVICES TARIFF IN ARIZONA?

A. Yes. Section 2.6.1 of AT&T's Local Channel Services Tariff 11 states:

> Access Cost Adjustor Mechanism – An ACAM will be used by AT&T to adjust rates for services to reflect changes in local exchange costs as directed by the Arizona Corporation Commission in Docket No. U-2428-86-268, Decision No. 55953, dated April 21, 1988.

Since the ACAM was established over ten years ago, the telecommunications industry was operating in a very different environment. It appears the intent of the ACAM was to alleviate earnings volatility for AT&T and to provide a method for simple and expeditious rate adjustments for costs that AT&T could not control, U S WEST's access rates. The Commission did acknowledge that any change in U S WEST's access rates would be in the context of a rate case and, therefore, the Commission would have an opportunity for review.

VII. COMPETITIVE ZONES FOR WHOLESALE ACCESS SERVICES

Q. IS U S WEST REQUESTING PRICING FLEXIBILITY FOR ITS WHOLESALE SERVICES, AS IT IS FOR ITS RETAIL SERVICES, IN ITS PROPOSED COMPETITIVE ZONES?

A. Yes. U S WEST is asking for pricing flexibility for wholesale services in the competitive zones. The wholesale services include private line, switched access and public access lines. U S WEST is proposing to establish price floors and price ceilings, with the flexibility to change prices within the floor and ceiling. The issue of competitive zones and pricing flexibility is more thoroughly addressed in the testimony of Dr. Lee Selwyn on behalf of AT&T.

Q. WHAT IS ONE OF THE REASONS U S WEST HAS STATED FOR THE NEED OF PRICING FLEXIBILITY FOR ITS WHOLESALE SERVICES?

A. One of the reasons U S WEST has stated for the need for pricing flexibility of its wholesale access services is that U S WEST will loose switched access revenue as local competition develops and U S WEST loses customers to CLECs.

Q. IS THIS ANY JUSTIFICATION FOR U S WEST TO BE ALLOWED PRICING FLEXIBILITY FOR THESE SERVICES?

A. No. U S WEST does not appear to truly understand the concept of competition. There is risk U S WEST will lose some switched access revenue as competition in the local exchange market develops, but there is risk and reward in a competitive market. U S WEST appears to be unwilling to except the risk, but wants the reward of pricing flexibility. The important point to consider is that U S WEST is the monopoly provider of switched access service. Without a viable competitive alternative to switched access, and with U S WEST being the monopoly provider of an essential service, safeguards need to be in place to prevent anti-competitive behavior.

Q. DOES U S WEST STILL MAINTAIN A MONOPOLY IN THE PROVISION OF SWITCHED ACCESS SERVICE IN ARIZONA?

A. Yes. Although, U S WEST claims "the alternatives to U S WEST switched access services are continuously *increasing*," what is relevant is the current alternatives to switched access service.[36] The answer to this is the options are very limited. The alternatives, as suggested by U S WEST, include direct connection between the long distance carrier and its customer, with this direct connection being provided via U S WEST's private line service. This may be an alternative to switched access, but it is still a service for which long distance carriers are dependent upon U S WEST, unless there is a competitive access provider offering private line services to the specific

[36] *U S WEST Rate Case Application*, Testimony of Barbara M. Wilcox (adopted by Scott McIntyre) at 4 (emphasis added).

location. It is also revenue still being provided to U S WEST from long distance carriers and is only a viable alternative for business customers. It is certainly not an alternative for residential customers, a market in which U S WEST continues to have almost 100% of the customers. Additionally, U S WEST states that wireless services, internet telephony and e-mail are substitutes for traditional long distance services. There are potential substitutes, but all of these technologies are in their infancy and are not being used in any significant quantity. The bottom line is that IXCs are still heavily dependent on U S WEST's switched access services in order to provide long distance services to their customers, most significantly residential and small business customers.

VIII. RECIPROCAL COMPENSATION – AUTOMATIC RIDER

Q. WHAT NEW ISSUES HAS U S WEST RAISED IN ITS SUPPLEMENTAL TESTIMONY?

A. One of the new issues raised by U S WEST is an automatic adjustment rider for reciprocal compensation. Specifically, U S WEST is requesting an automatic rider that adjusts up and down based on the net payments for reciprocal compensation.[37] U S WEST states this is necessary because reciprocal compensation is growing very rapidly and is very volatile.[38] The amount currently calculated by U S WEST would increase its revenue requirement by $13,253 million.[39]

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[37] *U S WEST Rate Case Application*, Supplemental Testimony of George Redding at 14.
[38] *Id.*
[39] *U S WEST Rate Case Application*, Supplemental Testimony of George Redding at GAR-S9.

Q. IS AN AUTOMATIC RIDER APPROPRIATE FOR THE RECOVERY OF COST RELATED TO RECIPROCAL COMPENSATION?

A. No. Reciprocal compensation is intended to compensate carriers for cost of exchanging traffic between a CLEC's network and U S WEST's network. Depending on the terms of a CLEC's interconnection agreement, the compensation may be bill and keep or reciprocal compensation rates. U S WEST is compensated or required to make payments based on the terms of the Commission approved interconnection agreements. This is the appropriate mechanism for cost recovery related to reciprocal compensation. The Commission should reject the automatic adjustment mechanism proposed by U S WEST.

IX. CONCLUSION

Q. WHAT DO YOU RECOMMEND THAT THE ARIZONA COMMISSION ORDER IN THIS PROCEEDING?

A. There are several things this Commission needs to order. These include:

- Set access rates at forward-looking economic cost equivalent to the UNE rates established by the Commission in the cost proceeding in Arizona for local and tandem switching and equal to U S WEST's interstate rates for transport;
- Eliminate the Carrier Common Line Charge and the Interconnection Charge, which have no cost basis and are merely subsidies being provided to U S WEST by IXCs at the ultimate expense of end users; and
- Reject U S WEST's proposed Automatic Adjustment Mechanism for reciprocal compensation.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

Exhibit AS-1

COMPARISON OF U S WEST ACCESS RATES PROPOSED ARIZONA INTRASTATE RATES TO FCC INTERSTATE RATES

		PROPOSED INTRASTATE RATES		FCC INTERSTATE RATES		DIFFERENCES	
Direct Trunked Transport		**Fixed per Month**	**Per Mile per Month**	**Fixed per Month**	**Per Mile per Month**	**Fixed per Month**	**Per Mile per Month**
VG	Over 0 - 8 Miles	$25.96	$0.17	$19.52	$0.25	33.0%	-32.0%
	Over 8 - 25 Miles	$25.96	$0.17	$19.91	$0.14	30.4%	21.4%
	Over 25 - 50 Miles	$25.96	$0.17	$19.05	$0.12	36.3%	41.7%
	Over 50 Miles	$32.45	$0.45	$24.67	$0.29	31.5%	55.2%
DS1	Over 0 - 8 Miles	$86.50	$13.55	$53.90	$8.16	60.5%	66.1%
	Over 8 - 25 Miles	$109.85	$14.19	$68.70	$8.61	59.9%	64.8%
	Over 25 - 50 Miles	$116.35	$14.63	$74.65	$9.06	55.9%	61.5%
	Over 50 Miles	$127.99	$15.11	$82.20	$9.48	55.7%	59.4%
DS3	Over 0 - 8 Miles	$714.84	$78.90	$477.65	$78.90	49.7%	0.0%
	Over 8 - 25 Miles	$714.84	$78.90	$457.88	$50.88	56.1%	55.1%
	Over 25 - 50 Miles	$714.84	$80.73	$459.50	$51.91	55.6%	55.5%
	Over 50 Miles	$805.44	$91.74	$520.36	$58.94	54.8%	55.6%
Tandem Switched Transport		**Per Minute**	**Per Minute per Mile**	**Per Minute**	**Per Minute per Mile**	**Per Minute**	**Per Minute per Mile**
Tandem Transmission							
	Over 0 - 8 Miles	$0.000199	$0.000020	$0.000199	$0.000020	0.0%	0.0%
	Over 8 - 25 Miles	$0.000255	$0.000023	$0.000255	$0.000022	0.0%	2.9%
	Over 25 - 50 Miles	$0.000263	$0.000023	$0.000263	$0.000019	0.0%	18.7%
	Over 50 Miles	$0.000265	$0.000023	$0.000265	$0.000017	0.0%	35.2%
Tandem Switching			**Per Minute per Mile**		**Per Minute per Mile**		**Per Minute per Mile**
	Per Minute per mile		$0.005000		$0.002989		67.3%
Entrance Facilities			**Per Month**		**Per Month**		**Per Month**
	Voice Grade		$64.67		$48.06		34.6%
	DS1		$125.00		$108.44		15.3%
	DS3		$1,500.00		$1,203.92		24.6%
Multiplexer			**Per Month**		**Per Month**		**Per Month**
	DS1/VG Multiplexer		$250.00		$235.27		6.3%
	DS3/DS1 Multiplexer		$300.00		$280.41		7.0%
End Office Shared Port			**Per Minute**		**Per Minute**		**Per Minute**
			$0.001300		$0.000903		44.0%
Common Transport Multiplexing			**Per Minute**		**Per Minute**		**Per Minute**
			$0.000137		$0.0000303		352.0%
Tandem Trunk Port			**Per Month**		**Per Month**		**Per Month**
			$6.59		$5.24		25.7%
End Office Dedicated Trunk Port			**Per Month**		**Per Month**		**Per Month**
			$9.01		$6.50		38.6%
Local Switching			**Per Minute**		**Per Minute**		**Per Minute**
	Originating and Terminating		$0.017300		$ 0.002342		638.6%

SOURCE: Intrastate Arizona - U S WEST Data Response WDA 22-011 Attachment F
Interstate - U S WEST FCC Tariff FCC No. 5, Section 6.8 7/1/2000

AS – 2
PROPRIETARY

Exhibit AS-3

ARIZONA

The Present Market Structure, Without Access Charge Reform Gives ILECs an Anti-Competitive Advantage Over Competitors

For calls originating and terminating in U S WEST's service territory

Example #1-Margin Analysis
Domestic Dial - 1 Long Distance Call, In-Region, Per Minute

U S WEST		Any IXC	
Retail Price	15.0 ¢	**Retail Price**	15.0 ¢
Costs :		**Costs :**	
Access at forward-looking economic cost	1.2 ¢	U S WEST proposed tariffed access rates	7.8 ¢
Intra-company costs, including billing & collection**	2.0 ¢	Intra-company costs, including billing & collection**	2.0 ¢
Network Cost of Goods Sold	3.2 ¢	**Network Cost of Goods Sold**	9.8 ¢
Gross Margin	11.8 ¢	**Gross Margin**	5.2 ¢

Example #2-Price Squeeze*
Domestic Dial - 1 Long Distance Call, In-Region, Per Minute

U S WEST		Any IXC	
Retail Price	9.8 ¢	**Retail Price**	9.8 ¢
Costs :		**Costs :**	
Access at forward-looking economic cost	1.2 ¢	U S WEST proposed tariffed access rates	7.8 ¢
Intra-company costs, including billing & collection**	2.0 ¢	Intra-company costs, including billing & collection**	2.0 ¢
Network Cost of Goods Sold	3.2 ¢	**Network Cost of Goods Sold**	9.8 ¢
Gross Margin	6.6 ¢	**Gross Margin**	0.0 ¢

* Assumes U S WEST follows an imputed cost rule, as required by AAC Rule R-14-2-1310, where price could not be less than the average access rate charged to other firm plus U S WEST's cost of goods sold.

** Intra-company costs for both U S WEST and IXCs are illustrative and not intended to indicate the level of actual costs incurred

Access rates based on :
IXC Rate - U S WEST proposed tariffed rate of 7.8 cents for terminating and originating minutes (3.8806 * 2 = 7.8 cents), including the CCLC.
Rate is based on U S WEST's average rate of 3.8806 cents per minute filed in Arizona Rate Case Application, U S WEST response to data request WDA 22 -011 Attachment F.

U S WEST Forward-Looking Economic Cost (FLEC) based on UNE rates in Docket No. U-3021-96-448 et al., Opinion and Order, Decision No. 60635
Rate of 1.0 for both originating and terminating minutes based on local switching rate of $.0028, tandem switching rate of $.0014 per mintue of use and U S WEST interstate transport rate of $.0019. (.0061 *2 = 1.22 cents)

Local switching	0.0028	2	0.0056
Tandem switching	0.0014	2	0.0028
Transport	0.0019	2	0.0038
Access unit cost	0.0061		0.0122

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ARIZONA CORPORATION COMMISSION

In the Matter of the Application of US West Communications, Inc., a Colorado Corporation, for a Hearing to Determine the Earnings of the Company, the Fair Value of the Company for Ratemaking Purposes, to Fix a Just and Reasonable Rate of Return thereon and to Approve Rate Schedules Designed to Develop Such Return	**Docket No. T-1051B-99-0105**

Direct Testimony

of

LEE L. SELWYN

on behalf of

AT&T COMMUNICATIONS
OF THE MOUNTAIN STATES, INC.

August 8, 2000

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TABLE OF CONTENTS

ALLEGEDLY PROPRIETARY DATA
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ALLEGEDLY PROPRIETARY DATA
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Tables

Figures

Attachment 1: Statement of Qualifications

INTRODUCTION

Qualifications

Q. Please state your name, position, and business address.

A. My name is Lee L. Selwyn. I am president of Economics and Technology, Inc., One Washington Mall, Boston, Massachusetts 02108. Economics and Technology, Inc. (ETI) is a research and consulting firm specializing in telecommunications economics, regulation, management, and public policy.

Q. Please summarize your educational background and previous experience in the field of telecommunications regulation and public policy.

A. I have prepared a Statement of Qualifications, which is attached hereto as Attachment 1.

Q. Have you previously testified before the Arizona Corporation Commission?

A. Yes, I have appeared before this Commission on a number of occasions dating back to the 1970s. I have testified in several Mountain Bell general rate cases (1975, 1980, 1981, 1985 and 1988) as well as on several other occasions in proceedings dealing with local measured service. My testimony has been on behalf of various parties, including business user organizations, RUCO, and the Commission's Staff. My most recent appearance was in Docket No. E-1051-91-298 dealing with Caller ID and "CLASS" services, on behalf of RUCO.

Assignment

Q. What was your assignment in this proceeding?

A. Economics and Technology, Inc. has been engaged by AT&T Communications of the Mountain States, Inc. ("AT&T") to analyze and present recommendations concerning certain aspects of US West's filing in Docket No. T-01051B-99-0105. US West's application combines requests for regulatory relief commonly contained in a traditional rate case (review of the Company's revenue requirement and rate structure) with requests for major changes in the regulatory treatment of a significant segment of the Company's services. In particular, my assignment was to examine and respond to US West's claims regarding the status of competition in Arizona and the Company's proposed responses to that alleged competition, including its pricing flexibility and data services deregulation proposals. I was also asked to prepare testimony regarding US West's proposed treatment of directory revenues and the implications for US West's revenue requirement in Arizona of findings contained in the Federal Communications Commission Staff Audits of the Continuing Property Records (CPRs) maintained by US West.

Summary of testimony

Q. Please summarize the primary aspects of US West's filing that you address in your testimony.

A. US West has chosen to combine a request for major changes in the regulatory regime applied to the ILEC in Arizona with a traditional rate case. In other words, although the proceeding is nominally about seeking an increase in the revenues US West can collect through its regulated services to cover the Company's revenue requirement, US West has also proposed numerous fundamental changes in the way its services are regulated, premised upon the claim that the Company now confronts robust competition for various services, particularly in the state's two largest metropolitan areas.

Specifically, US West is proposing that the Commission (1) pre-classify all "new" services as "competitive;" (2) permit the Company to integrate local directory assistance into its existing National Directory Assistance offering; (3) permit the Company to create an entirely novel form of pricing flexibility that is not service-specific, allowing it complete pricing discretion for all services offered to business and/or residential customers in so-called "competitive zones;"[1] and (3) "deregulate"[2] all data services.

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1. Under the Company's proposal, US West could price below the TSLRIC price floor of a service so long as the total revenues from all of the services purchased by a customer or group of customers (e.g., business customers) in the competitive zone exceeded the aggregate TSLRIC.

2. Usually, when a service provided by a rate-of-return regulated company is "deregulated," both the costs and the revenues associated with the service are placed "below

(continued...)

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My testimony addresses and refutes the Company's claims that it faces substantial competition in Arizona and that US West requires the broad additional pricing flexibility it proposes here in order to respond effectively to the prices and service offerings of new entrants. I also address why pre-classifying as competitive all services filed as "new" offerings by the Company is inconsistent with the Commission's rules and, more importantly, harms customers of noncompetitive services who have paid for (and continue to support) the vast common infrastructure over which US West's existing and "new" services are provided. Finally, I explain why it is inappropriate to deregulate US West's data services at this time.

The problem with US West's proposal is more fundamental, however, than merely the fact that it misrepresents the competitive environment and thus prematurely seeks deregulation/pricing flexibility. In my testimony, I explain why rate of return regulation cannot be applied effectively in the piecemeal fashion that would result from the adoption of US West's proposal. Every time a service or portion of a service is deregulated, there is a need for complex cost allocation decisions to be made, so that the services that remain under regulation are not burdened with investments made in whole or in part to support the deregulated services. Moreover, each time the Company obtains pricing

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2. (...continued)
the line." It is unclear from US West's filing whether this is the treatment it proposes for data services or whether US West is proposing that the Commission cease applying any price or cost regulation to data services while permitting the Company to continue to include the costs and revenues associated with these services for purposes of determining the Company's revenue requirement. In my testimony, I will explain why either approach provides US West the opportunity to misallocate costs and/or revenues between noncompetitive regulated services and the Company's data services.

flexibility before there is effective competition in the entire, properly defined product and geographic market, US West acquires the ability to raise prices selectively to customers who do not, in reality, have competitive alternatives.

A well-specified price regulation plan, which the Corporation Commission has the authority to adopt, would permit the Commission to provide US West with selective pricing flexibility for truly competitive services with far less adverse exposure to customers of noncompetitive services. Under such a plan, US West would have the opportunity to gain from efficiency in its operations undertaken to be competitive with new providers, but customers of noncompetitive services would not have to indemnify the Company's competitive ventures.

My testimony also addresses the results of FCC Staff audits of the Continuing Property Records (CPRs), maintained by the Regional Bell Operating Companies as of June 30, 1997.[3] The audits revealed a pattern of systematic overstatements of capital investments on the RBOCs' books relative to assets physically present in their networks. US West, and its operations in Arizona, were reviewed in that audit process. To the extent that existing US West rate levels (in both the state and federal jurisdictions) are linked directly or indirectly to the net book value of plant in service, an overstatement of such book value would necessarily result in excessive prices for US West services. My testimony discusses the specific implications of the CPR audits for the ongoing ratemaking and other related regulatory activities in Arizona.

3. See footnote 45, *infra*, for full cites to the FCC's audit proceedings.

The Commission should reject USWC's proposal to discontinue the annual $43-million imputation of Yellow Pages contribution, and in fact should increase it. Contrary to the Company's claims, its directory publishing affiliate, DEX, enjoys enormous, fortress-level market power in the Arizona Yellow Pages business as a direct consequence of the telephone company's incumbency in that business prior to its transfer to US West Direct in 1984. Claims by USWC that DEX derives no *current* value from USWC with respect to the Yellow Pages business, even if true, are not relevant to the issue of imputation. What is relevant, and which USWC's own witness readily concedes, is that DEX "capitalized" on USWC's incumbency in the Arizona Yellow Pages business when it acquired the use of the Mountain Bell name and preexisting user and advertiser relationships without specific compensation to Mountain Bell at the time of the transfer. That DEX maintains the same extreme market dominance today is confirmed by examining its financial results, which yield a return on investment for 1999 of *at least* 90.5% and perhaps even several times that conservative figure. If imputation is to be discontinued, then USWC must be compensated for the transfer of the Yellow Pages business to its affiliate by means of a one-time payment by the affiliate to USWC of the current fair market value of the Arizona Yellow Pages business, which I estimate conservatively to be worth at least PROP<<[redacted]>>ENDPROP and may well be as much as PROP<<[redacted]>>ENDPROP. The Washington Utilities and Transportation Commission (WUTC) on July 27, 2000 issued an order in a US West yellow pages imputation case where the issues were substantially identical to those before this Commission. In that order, the WUTC rejected in their entirety the very same arguments that US West is advancing in this case in support of its proposal to eliminating yellow pages imputation, and concluded that "USWC retains the [yellow pages directory] asset, both by the factual history of the transaction [in which then-Pacific Northwest Bell transferred its yellow pages business to the US West directory affiliate] and as a matter of law."[4]

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4. Washington Utilities and Transportation Commission, *In Re the Petition of US West Communications, Inc. for an Accounting Order*, Docket No. UT-980948, Fourteenth Supplemental Order; Order Denying Petition, issued July 27, 2000 ("WUTC Yellow Pages Order"), at para. 169, p. 44.

US WEST'S PRICING FLEXIBILITY PROPOSAL

Competition for local exchange and intrastate exchange access services falls far short of what is required to constrain US West's market power.

Q. What is the status of competition for local exchange service in Arizona today?

A. The evidence shows that while limited, preliminary competitive inroads are being made, specifically in portions of the state's major urban centers, US West still exercises market power with respect to local exchange service provided to residence and business customers in Arizona. Put differently, what limited competition exists at this time is insufficient to ensure that business and residential customers in Arizona can obtain high-quality telecommunications services at just and reasonable rates.

Q. What indicators of local competition statewide are available for Arizona?

A. A primary public source of this information is the competition data submitted by ILECs to the FCC's Common Carrier Bureau on a voluntary basis. The most recent such data was reported as of June 30, 1999. The information reported to the FCC by US West for Arizona shows that 0.5 percent — that is, one-half of one percent — of the Company's switched lines were being provided to CLECs for "total service resale."[5] UNE loops

5. Federal Communications Commission, Common Carrier Bureau, Industry Analysis Branch, *Trends in Telephone Service*, March 2000, Table 9.3, "Lines Provided by Large ILECs to CLECs for Resale" (as of June 30, 1999).

leased by CLECs from US West in Arizona accounted for another 0.1 percent of US West's switched access lines,[6] for a grand total of six-tenths of one percent.[7]

Q. Is this data also consistent with what US West has reported in the proprietary exhibits to Mr. Teitzel's supplemental direct testimony?

A. According to Mr. Teitzel, as of March 2000, US West was providing PROP<<>>ENDPROP UNE loops.[8] It is encouraging to see that there has been some small amount of growth in UNEs over the nine months since US West's last reported federal data. However, even so, a full year after US West so boldly proclaimed that it faced vigorous competition in Arizona, UNE loops only account for barely PROP<<>>ENDPROP percent of US West's total switched access lines in the state.[9] The growth in resale lines in the past year appears to be even slower, PROP<<>>ENDPROP

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6. *Id.*, at Table 9.4, "Lines Provided by Large ILECs to CLECs under UNE Arrangements" (UNE Loops as a percentage of total switched lines, as of June 30, 1999).

7. US West has supplied similar information in its response to the questions raised by the Commission as set forth in Attachment A in Order 60218. In this response, submitted with US West's Section 271 filing with the Commission (Docket No. T-0000B-97-0238), the Company identified 19,734 resale lines and 1,460 UNE loops as of March 1999 and 2,738,417 access lines in service as of February 28, 1999. Att. A, pp. 7, 14.

8. Exhibit DLT-40.

9. Calculated by dividing March 2000 UNE loops, as per DLT-40, by total switched lines, in thousands, as of June 1999, per March 2000 *Trends* report.

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Q. ILECs sometimes point to "growth" in competition as a significant indicator. Are these numbers increasing at a fairly rapid rate?

A. Not really. Let's compare the TSR numbers reported by US West to the FCC as of December 31, 1997 and June 30, 1999. Over that time, the percentage of US West's lines provided to CLECs for TSR increased from 0.2 percent to 0.5 percent. However, even if this rate of increase continued, it would take another four years before the CLEC market share through TSR topped 5 percent.[10]

Q. What is the significance of CLEC co-location arrangements with regard to demonstrating effective competition?

A. While certainly the existence of co-location arrangements can be seen as a positive development, it proves very little about the extent of local competition. From a pragmatic viewpoint, the very fact that competitors' actual gains are so small for customers served over UNE loops suggests that co-location rights alone are insufficient to permit the CLECs to compete for the vast majority of the customers that they, in theory, are positioned to serve.

10. As US West itself admits, outside of the Phoenix and Tucson SMSAs, there is even less competition. US West reported that, as of July 1999, only 837 local exchange lines (about three thousandths of one percent of the state's access lines) were being provided on a TSR basis (the least investment-intensive form of competition) in these non-urban areas. US West Response to ATT-59.

Q. Mr. Teitzel's testimony contains proprietary exhibits that show the percentage of business access lines in Phoenix and in Tucson that are within 1000 feet of a competitor's fiber facilities. Assuming that the underlying data is correct, what does this information show about competition in these urban areas?

A. This line of evidence was significantly criticized in filings submitted to the FCC in response to US West's petition for forbearance from regulation of its high-capacity services in the Phoenix area.[11] In essence, it has been shown that US West has vastly underestimated both the cost and non-cost barriers that prevent competitors from obtaining customers, even when they have deployed facilities in their general vicinity. I will discuss these criticisms in greater detail later in my testimony where I address the Company's data services deregulation proposal.

Q. Do the Commission's existing rules already permit US West to obtain significant pricing flexibility in Arizona?

11. In its order on pricing flexibility for high-capacity special access and dedicated transport services, the FCC granted price cap ILECs *a more limited form of pricing flexibility* than US West proposed for high-capacity data services in Arizona, based on *a more stringent showing* than US West proposed. *Access Charge Reform* (CC Docket No. 96-262), *Price Cap Performance Review for Local Exchange Carriers* (CC Docket No. 94-1), *Interexchange Carrier Purchases of Switched Access Services Offered by Competitive Local Exchange Carriers* (CCB/CPD File No. 98-63), and *Petition of US West Communications, Inc. for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA* (CC Docket No. 98-157), *Fifth Report and Order and Further Notice of Proposed Rulemaking*, FCC 99-206, released August 27, 1999 (hereinafter, "*Pricing Flexibility Order*") at paras. 77.

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A. Yes. Under R14-2-1108, a telecommunications company may petition the Commission to classify as competitive any service or group of services. US West has already obtained the reclassification of several major services, including intraLATA toll (MTS, WATS) and private line services.

Q. What does the carrier have to show in making application to have a service classified as competitive?

A. The carrier must supply, *at a minimum*, all of the information specified in subsection (B) of R14-2-1108. Under this rule, the company proposing the reclassification "shall have the burden of demonstrating that the service at issue is competitive."[12] US West is ignoring those rules and the procedures that should be used to amend them, if amendment is appropriate. As discussed further below, the attempted circumvention of the Commission's rules regarding classification is compounded by the extraordinary degree of pricing flexibility that US West proposes for "competitive zone" services, through which it appears that the Company could also violate other Commission rules regarding imputation, the TSLRIC price floor and cross-subsidization.

Q. What is your response to US West's claim that it should be given the same regulatory treatment for its services that its competitors receive?

12. R14-2-1108(H).

A. US West is simply misapplying the principle of regulatory "parity." Where the current regulatory regime treats US West differently from competitive local exchange carriers, it is because US West, the incumbent, has market power, whereas new entrants do not. In point of fact, where US West has demonstrated that a service is competitive, the Commission's rules do treat the Company's services similarly to those of other providers.[13]

US West's competitive zone proposal will harm customers without competitive alternatives and facilitate the Company's ability to engage in anticompetitive pricing practices.

Q. What is your understanding of US West's "competitive zone pricing" proposal?

A. The Company proposes that specific wire centers be designated as "competitive zones," once it is established that customers within the zone have access to a "competitive alternative." Under US West's proposal, a "competitive alternative" is deemed to exist if US West can demonstrate that another carrier is "marketing its services within a wire center through facilities based service, resale, or by way of unbundled elements."[14] "Zones would be designated as competitive for either residence customers, business customers, or both."[15]

13. See generally, Article 11 of the Commission's Rules regarding treatment of "Competitive Telecommunications Services."

14. Allcott (USWC), Direct at 9; see also, Teitzel (USWC), Direct at 18.

15. Allcott (USWC), Direct at 9; see also, Teitzel (USWC), Direct at 19.

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Under its proposal, US West would be permitted pricing flexibility for *all services* offered to customers located within the competitive zone. The "cap" for each service offered within the competitive zone would be 200 percent of the rates established in the present rate proceeding, with the exception of residential exchange service, which would be capped at $19.00.[16] Under its plan, US West would also be allowed to "bundle" services and set the prices for those bundles, without prior Commission approval. Significantly, US West proposes that it be permitted to ignore the TSLRIC price floor for individual services offered within the competitive zone, so long as the total charges to the customer or group of customers exceeds TSLRIC.

In its filing, US West specifies 33 wire centers as the initial "competitive zones" for business customers in the Phoenix area and 11 for business customers in the Tucson area, along with 23 residential "competitive zones" in the Phoenix area.[17] To get an additional wire center declared a "competitive" zone, US West would notify the Commission that the competitive criteria were met for that zone. The Commission would have a predetermined time to indicate any objection (the Company proposes 15 days).[18] If the Commission did not object within this time, the wire center would automatically become a competitive zone. If there were an objection or if Commission needed more information to make its determination, US West proposes that the Commission be

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16. Teitzel (USWC), Direct at 20.

17. Teitzel (USWC), Direct at 20-21 identified 3 wire centers as being "competitive" for residential service. In Mr. Teitzel's Supplemental Direct Testimony (at ii, 35), that number grew to 23 wire centers

18. Teitzel (USWC), Direct at 21.

required to issue a formal notice to that effect (within the 15 day period). According to US West, even if such additional review occurs, the application for a competitive zone should be completed within 60 days of the initial notification.[19]

Q. How does what US West has proposed compare with what it is required to show to get a service classified as competitive under the Commission's existing rules?

A. Table 1 contrasts the specific and detailed requirements in R14-2-1108 for demonstrating that a service is competitive with the cursory examination of competition that would suffice, under US West's proposal, to permit the Company to designate a wire center as a "competitive zone."

19. *Id.*, at 22-23.

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Table 1 US West Proposal vs. the Commission's Competition Rules	
Competitive Classification Information required under R14-2-1108	**Showing required under US West competitive zone pricing proposal**
Comprehensive evaluation of the relevant market for the service, including:	Single competitor
Description of the general economic conditions that exist which make the relevant market for the service one that is competitive	Marketing or offering services either by: a) resale; OR b) leased UNEs; OR c) own facilities
Number of alternative providers of the service	
Estimated market share held by each alternative provider of the service	
Names and addresses of any alternative providers that are US West affiliates	
Evaluation of ability of alternate providers to make functionally equivalent or substitute services readily available at competitive rates, terms, and conditions; and	
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	

Q. Should the Commission accept US West's proposal?

A. No, and for several reasons. First, the criteria that US West has proposed for designating a wire center as "competitive" simply do not ensure that all or even a substantial majority of customers served out of that wire center are being offered competitive alternatives to US West's services. For example, in its response to WDA 04-009, US West states that "[r]esale of any residential access-line based service under the Commission's purview could trigger a request for establishment of a competitive zone." Resale alone certainly does not create price-constraining competition, since the CLEC's costs (and thus its rate) are directly linked to US West's own retail price; if there is insufficient competition to constrain that retail price below monopoly levels, then CLEC entry via resale will not by itself be capable of bringing market prices closer to cost. Simply knowing that a CLEC has a single customer for some service using US West-provided UNEs also does not permit the Commission to determine whether customers in the wire center have generally available competitive alternatives at competitive prices. Even the presence of a facilities-based CLEC is not definitive proof that all services throughout the wire center are subject to effective competition, without additional evidence that US West has generally removed barriers to competitive entry. There is a stark contrast between the flimsy evidence that US West is proposing that it be required to show in order to establish a competitive zone (as little as one resale customer) and what it is required to show under the Commission's rules to have a service declared competitive (comprehensive evidence regarding competition in the relevant market).

Without stronger evidence of competition throughout the zone for all affected customers, the pricing rules that US West has proposed are inadequate to ensure that customers are charged just and reasonable rates and that US West does not cross-subsidize between services (and/or customers) that confront competition and those that do not. The fact that noncompetitive services exist alongside competitive services within the proposed competitive zones may well explain why US West seeks such a high degree of *upward* pricing flexibility when competitive pressures are supposed to force prices downward. There is a clear risk that a large number of customers could be overcharged in order to let the Company drop prices for a select few targeted customers. And the Commission's imputation rules as interpreted by US West will not be sufficient to prevent this outcome.

US West proposes that it be permitted to ignore the TSLRIC price floor for particular services, so long as its revenues overall for services furnished to the customer or group of customers is above TSLRIC.[20] Moreover, Mr. Teitzel also inserts the caveat that "[o]nly regulated costs will be used to make this determination,"[21] suggesting that the Company could bundle other, nonregulated products or services into the offering and also price those below cost — indeed, it would apparently be possible for such bundled packages as a whole to fail imputation even if individual ("regulated") components nominally satisfy the requirement. Such pricing is blatantly anticompetitive and violates the Commission's

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20. *Id.*, at 20. See also, WDA 04-008 [Question: "Would US West be allowed to price Business PBX service below TSLRIC, as long as the total revenues from business services was above the combined TSLRIC of those services?" Response: "Yes, assuming PBX trunks are regulated, US West would be allowed to price PBX trunks below TSLRIC in a competitive zone as long as the total regulated revenues from business services purchased by the customer or group of customers in the competitive zone was above TSLRIC."]

21. *Id.*

rules as well as Section 254(k) of the 1996 *Telecommunications Act*, which expressly prohibits cross-subsidization from noncompetitive to competitive services.[22]

Q. Can you be more specific with regard to how this treatment would violate the Commission's rules?

A. Yes. R14-2-1310 sets forth principles for pricing of ILEC services. This rule requires the ILEC, US West, to provide "price floor calculations for local exchange and long distance services to ensure the avoidance of anticompetitive practices." Additionally, this rule contains an imputation requirement that provides that "[a]n incumbent local exchange carrier shall recover in the retail price of each telecommunications service offered by the company the TSLRIC of all non-essential, and the imputed prices of all essential services, facilities, components, functions, or capabilities that are utilized to provision such telecommunications service, whether such service is offered pursuant to tariff or private contract."

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22. Section 254(k), "SUBSIDY OF COMPETITIVE SERVICES PROHIBITED," states,

> 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.

In the same vein, the Commission's Rule R14-2-1109(C) states that a "competitive telecommunications service shall not be subsidized by any rate or charge for any noncompetitive telecommunications service(s)."

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R14-2-1109 also specifies TSLRIC as the absolute price floor for any competitive telecommunications service and prohibits cross-subsidization. It provides that "[t]o ensure that no cross-subsidization exists, each competitive telecommunications service must provide revenues that equal or exceed the company's total service long-run incremental cost of providing the service."

Q. Does US West request pricing flexibility for wholesale services as well, within so-called competitive zones?

A. Yes. US West asks for pricing flexibility with respect to what it designates as "finished" wholesale service, "such as private line, switched access and public access lines."[23]

Q. Has US West adequately justified its request?

A. No. US West's claim rests primarily upon largely unsubstantiated claims (using proprietary market research that the Company does not adequately disclose) that the ILEC's market share for private lines service has eroded. According to US West, this alleged loss of market share for private lines shows that ILEC is facing competition for both private lines and for switched access services (because some businesses "bypass" switched access using dedicated circuits).

23. Wilcox (USWC), Direct at 27.

US West's spin on the competitive impact of private lines, as presented by Ms. Wilcox, is misleading for several reasons. First, while Ms. Wilcox's testimony refers generically to "private line" competition, Exhibit BMW-13, which she references as the source of her conclusion, deals only with *high-capacity* private lines. Moreover, while there is no back-up for the data presented in this exhibit, it likely derives from the same, discredited Quality Strategies study that US West relies upon at numerous points in its filing.

Ms. Wilcox's conclusions with respect to switched access service competition via private lines are even less well substantiated. Again referring to "market research" of unspecified origin (illustrated with a graph that also has no specified source),[24] Ms. Wilcox concludes that some portion of the traffic that Arizona business users might otherwise originate or terminate using switched access service is now routed over a dedicated line. The use of dedicated access to serve certain high-volume locations is hardly new. Moreover, dedicated access is a substitute for switched access only in certain limited cases, and is certainly not an economical choice for the vast majority of customers. (Dedicated access is almost *never* a substitute for switched access for terminating outbound toll calls or for originating inbound 800-type calls.)

Q. Is the existence of wholesale competition even a prerequisite for the classification of a wire center as a competitive zone, under US West's proposal?

24. Wilcox (USWC) at 28 and Exh. BMW-14.

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A. No. Under US West's proposal, the Company's resale of a single retail line is sufficient to have a wire center classified as "competitive." This would mean that, under the Company's proposal, US West could have a monopoly (or near-monopoly) for one or more of the "finished" wholesale services and still obtain pricing flexibility.

Q. What is the likely competitive result of giving US West pricing flexibility for switched access, special access (private lines) and PAL lines in wire centers that lack effective, facilities-based competition?

A. US West would be in a very good position to implement a price squeeze, by dropping the price of its *retail* services, while not making corresponding adjustments in the rates for wholesale services purchased by its competitors.

Q. Couldn't this possibility be solved by imposing an imputation requirement on US West with respect to its retail price?

A. In theory, that might work, but under a pricing flexibility regime the Commission may lack the machinery to monitor and to enforce any price imputation requirement. Moreover, to be effective, imputation would need to be applied on an element-by-element basis, which would effectively neutralize the very pricing flexibility that US West is seeking here.

Q. Are there any other sources of concern?

A. Yes. In addition to these major, substantive flaws, the framework being proposed by US West is also procedurally inadequate. US West should not be permitted to reclassify a wire center on 15 days' notice and without explicit Commission action. Moreover, if such a framework were to be adopted, there should be minimum filing requirements that support the Company's claim of competition.

Q. In its current filing, US West has identified 44 wire centers for business and 23 for residential service that it proposes to treat as competitive zones. Has US West demonstrated that the business and/or residential customers in these wire centers can obtain all of the telecommunications services that would be affected by the Company's proposed reclassifications from other providers at competitive rates?

A. No. As discussed above, US West has not demonstrated that there is price-constraining competition for all services offered within each of the competitive zones. Moreover, even if there were facilities-based providers present in each of these wire centers, US West has not shown that the level and geographic scope of such competition is sufficient to assure that *all* customers served out of the subject wire center confront *bona fide* competitive choices, and that US West will thus be incapable of discriminatory pricing within the wire center district, effectively using services furnished within noncompetitive regions thereof to cross-subsidize services furnished to locations where actual competitive alternatives exist.

"New" services cannot be assumed, per se, to be competitive.

Q. What is US West's proposed treatment for "new" services?

A. US West proposes that each new service be deemed and classified as "competitive" from the time of its introduction. Under this scheme, US West would be permitted to establish the initial price for the service at whatever level it chose (above TSLRIC). Thereafter, the service would be subject only to the pricing constraint applicable to "competitive" services, which would permit the Company to vary the price of the service at any time between a floor of TSLRIC and the "cap" specified by the Company when it made its initial filing for the new service.[25]

Q. What basis does US West advance for its claim that a blanket pre-classification of "new" services is warranted at this time?

A. US West claims that this treatment is simply in parity with how its competitors can offer new services and that, for such services, US West has no special advantages related to its incumbency.[26] US West protests that it shouldn't be required to wait around for a competitor to offer a same service before getting the opportunity to have its own new service classified as competitive. The Company further seeks to minimize concerns about

25. Of course and as discussed above, if the "new" service is provided within a "competitive zone," it would be possible for its price to be set below TSLRIC so long as the overall mix of services within the zone is priced at or above TSLRIC.

26. According to Mr. Allcott, "US West has no monopoly for a new service at the time the service is introduced. We start out with no customers, no revenues, and no market share."

receiving this regulatory "blank check" for all "new" services from the moment they are introduced by asserting that most such services are "optional" or "discretionary."

Q. Do you agree that "new" services are likely to be "discretionary" in nature?

A. No. There is no way to know *a priori* whether any given "new" service will be considered "discretionary" by customers. For some customers, a service like "call waiting" may be considered "essential" in that it, for example, enables children to get through to their home in an emergency even if the line is in use. ISDN is another example of a relatively new service for which there is often no competitor and whose provision makes use of the same common network infrastructure as is used to provide basic dial tone. When ISDN was introduced, some ILECs argued that, as a new service, this offering should be treated as "competitive." But, at the time ISDN was introduced, there was no competition for this service (and the ILECs' high rates reflected this).

Q. Is it reasonable to assume that all "new" services face competition?

A. No. While, to be sure, some "new" services may well face competition or indeed may even be offered in response to services introduced by rivals, it would be fundamentally incorrect to categorically conclude that *all* "new" services are competitive. US West and its predecessors have been afforded the *unique* ability to acquire a ubiquitous network infrastructure over more than a century with the vast majority of the costs and risks attendant thereto being borne by ratepayers of its monopoly services. No existing competitor comes even remotely close to matching this ubiquity. "New" telecommunications services that derive some or all of their value from their use of this ubiquitous network are no more competitive than existing basic network services, and the date at which the specific service may have first been introduced does not alter that fact.

Q. Does the Company's position fairly represent the effects upon US West's ratepayers and upon the development of competition of giving broad pricing flexibility to a service simply because it is nominally "new"?

A. No. The key point to focus on is that the "new" aspects of most new services comprise a very small portion of what is being offered. Most of these services depend extensively upon a common infrastructure and resource base, the construction and acquisition of which was financed primarily by the ILEC's monopoly customers. Services and features that are incremental to a monopoly service "platform," i.e., that have no independent existence in that they cannot be provided to a customer unless the customer also subscribes to the "platform," are no more "competitive" than the basic platform itself, and thus should take the same regulatory status as the "platform" service. Services that have an independent existence but that are furnished out of the same common infrastructure/ resource base along with monopoly services and which could not as a practical matter be furnished by US West without the use of that common infrastructure should also take the regulatory status of the core "monopoly" services.

Q. What would make a service truly "new," such that US West indeed would have no incumbency advantages?

A. A truly "new" service would have no physical or financial linkage with any of the Company's core monopoly services. Given the extensive, universal scope of operations and preexisting customer relationships enjoyed by US West within the communities it serves, it is difficult to identify specific services that would in fact fully satisfy these criteria.

Q. Why is presumptively classifying all "new" services as competitive not consistent with the Commission's competitive telecommunications rules?

A. Although the rules do provide for the classification of either an individual service or a "group of services" as competitive, "new" services cannot reasonably be considered a "group" under these rules, since it is not possible to make the showing specified in R12-2-1108(B) with respect to a group of services that is not yet defined and that does not, by its very nature, share a set of common market characteristics.

Q. How should "new" services be classified?

A. These should be dealt with on a case-by-case basis, no differently than for existing services that are proposed for reclassification to "competitive." And as with existing services, a "new" service should be presumptively "monopoly" unless it can be shown to satisfy the requirements of R12-2-1108(B).

The effect of the Company's Directory Assistance proposal is to eliminate local directory assistance service in Arizona and, in so doing, impose a substantial rate increase upon local directory assistance services.

Q. Please describe your understanding of US West's proposal with respect to the pricing treatment for Directory Assistance.

A. US West characterizes its proposal as a plan to "restructure and simplify the entire Directory Assistance offering" by effectively "merging" its traditional Directory Assistance, along with the "Complete-A-Call" option, into its "National Directory" service. Although the Company does not portray it as such, the *effect* of this proposal is to *eliminate* local directory assistance service in Arizona and, in so doing, subject local directory assistance charges to a substantial rate increase.

Q. Please explain.

A. Currently, the first local directory assistance call is bundled into the basic residential dial tone line rate; additional DA calls are charged at $0.59 (consisting of a tariffed rate of $0.47, plus a temporary surcharge of $0.12, pursuant to Decision No. 60381). Under the Company's proposal, local DA service would be withdrawn altogether, and requests for local numbers would instead by handled by the "national" directory assistance offering, at 85 cents per request. In addition, the monthly DA allowance would be eliminated. Thus, a residential subscriber currently placing three directory assistance calls per month would experience an increase in his/her total monthly bill of $1.11 [$0.59 for the previously "free" call, plus the $0.26 per call increase on the two additional calls].[27]

Q. What are the implications of this change?

A. US West's attempt to impose such a substantial increase hardly suggests strong competitive pressure on the local DA offering. Moreover, this increase should be considered as an additional increase in rates for basic residential service, over and above the explicit $2.50 increase also being proposed by the Company.

Q. US West claims that its reason for proposing this change is to eliminate customer confusion. Do you believe that customers are being "confused" by the current distinction between "local DA" at 47 (or 59) cents and "national DA" at 85 cents?

A. A number of Bell companies across the country have now introduced "national" DA access using the same '411' dialing protocol as is used for "local" DA, and maintain the pricing distinction between these two services. (In my home state of Massachusetts, for example, residential subscribers receive an allowance of ten free intraLATA DA calls per month, but are charged $0.95 cents for each request for a "national" number, i.e., one outside of their home LATA.) US West has not explained why Arizona consumers

27. Without factoring in the surcharge, which presumably is expected to expire at some point, the effective increase be $1.23 [$0.47 + (2 * $0.38)].

should be more "confused" than consumers in other states; indeed, I know of no reason that this should be the case. In any event, whatever "confusion" may result from the integration of "local" and "national" DA using the same '411' access code was created by US West itself when it introduced the National DA service. The "solution" to the "problem" (if in fact there is a "problem" in the first place) is definitely *not* to increase the charges for local directory assistance by nominally "eliminating" the service altogether.

The basis for whatever "confusion" may exist is the fact that both US West's local and its national directory assistance services are accessed in exactly the same manner, i.e., by dialing '411'. This might well cause confusion, in that some '411' calls are charged at 59 cents or may even be "free" if within the monthly allowance, whereas others are subject to an 85 cent charge. Significantly, this very same "confusion" of which the Company speaks has the effect of affording US West a distinct and unique competitive advantage vis-a-vis other providers of national directory assistance service which are *not* accessed via the familiar '411'.

Q. Please explain.

A. As the Commission recognized in its Decision No. 62129, several other companies are currently offering national directory assistance service.[28] For example, the AT&T

28. *In the Matter of the Application of US West Communications, Inc., for Competitive Classification of Directory Service*, Docket No. T-01051B-99-0362, Decision No. 62129, December 7, 1999.

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national DA service is accessed by dialing '00' if the customer has selected AT&T as his or her presubscribed interexchange carrier (PIC), or 1010-288-0 for non-AT&T customers. MCI's national DA service is accessed by dialing 1010-9000 both for MCI and non-MCI customers. However, the Commission also recognized the substantial advantage possessed by US West with regard to the familiar '411' DA access code. If a US West local service customer dials '411' and requests a long distance DA number, US West, and not the customer's long distance carrier, will provide the DA service and realize the DA revenue.

By utilizing the familiar '411' DA access code, US West is attempting to link ("tie" in the antitrust sense) its local directory assistance service, which is bundled with its basic monopoly dial tone line offering, to its "competitive" national DA service, and in so doing is effectively preempting its customers (particularly those that US West itself concedes may be "confused" by the whole '411' situation) from choosing an alternative long distance DA provider.

US West could easily remedy the "customer confusion" of which it complains by adopting a separate and distinct number for national directory assistance. For example, US West could use its existing Carrier Identification Code (CIC) of 101-5123, plus a '0', just as AT&T and MCI are required to do when offering this service to their customers. This would create a level playing field as between US West and its non-ILEC competitors, and would de-link local and long distance directory assistance by eliminating the use of '411' as the long distance DA access code. If US West elects to continue with a single number, the Commission should not permit the Company to rectify any resulting "confusion" by increasing its customers' local service and local directory assistance rates.

Alternatively, US West could be required, as a condition for being permitted to offer its own '411'-based national DA service, to make the '411' access code available on a presubscription basis to a carrier selected by the subscriber, e.g., the subscriber's interexchange carrier. If US West were to refuse to make the '411' access code available to competitors in this manner, it should not be permitted to offer its own competitive DA service via the '411' access code.

Q. After the Company's initial filing in this proceeding, the Commission granted US West's petition to reclassify basic directory assistance as "competitive."[29] Does this change cause you to change your opinion about the Company's proposal for directory assistance?

A. No. While the Commission's decision finds that customers have competitive alternatives for local DA, it is still not clear that there is sufficient competition to restrain US West from raising the price of local DA to a supracompetitive level. The Commission's decision expressly acknowledges that US West still handles a majority of local DA calls (I suspect a substantial majority) and that US West has some very distinct competitive advantages with respect to offering the "extremely familiar" and "easy to dial" 411

29. *Application of US West Communications, Inc. for competitive classification of directory assistance service*, Docket No. T-01051B-99-0362, Decision No. 62129, December 7, 1999.

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code.[30] In fact, although the Commission granted US West's petition to reclassify the service, it denied US West's request to raise the maximum rate for local DA and consolidated that issue with the ongoing rate case, noting Staff's concerns about the "significant" rate impact of this proposal.[31]

Q. What action should the Commission take with respect to US West's request to combine local and national DA, make call completion a non-severable part of the DA service, and raise the rate ceiling to $1.50?

A. The Commission should reject the proposal. Moreover, the Commission should expressly require that if US West continues to offer national DA service using the '411' access code, it make the '411' access code available on a presubscription basis to competing DA providers.

US West has not offered a satisfactory explanation as to why it needs significant *upward* pricing flexibility for services that are alleged to be competitive.

Q. Given that the Company is asking for pricing flexibility specifically so as to enable it to respond more rapidly to competitive pressures, will the pricing flexibility that is being sought by US West be limited to *downward* price changes only?

30. Arizona Corporation Commission Decision No. 62129 at paras. 14, 17.

31. *Id.*, at para. 23.

A. No, the Company is seeking the discretion to both reduce as well as to increase prices in markets in which, it alleges, competition is present.

Q. What *upward* pricing flexibility has US West requested?

A. For services classified as "competitive," US West gets to vary prices between TSLRIC (Total Service Long Run Incremental Cost) and a "cap" or ceiling established at the time the service is deemed competitive (under the Company's proposal for "new" services, this would occur at the time the service was introduced). For services provided in "competitive zones," US West proposes that the cap be 200% of the price for the service at the time the zone is declared to be "competitive," except for residential exchange service, which would be capped at $19.00 (exclusive of federal Subscriber Line, Universal Service, and Local Number Portability charges). If deregulated, data services (discussed below) would presumably have no cap whatsoever.

Q. What does US West's request for the discretion to *increase* prices in markets that are ostensibly subject to competition suggest as to the actual degree of competition in those markets?

A. Obviously, if US West is feeling pressure from competitors who are, presumably, offering services at lower prices, it is understandable that the Company would want the flexibility to reduce its own prices in response. It is far less obvious, however, that US West would need the ability to *increase* prices in response to competition *other than for the purpose* *of generating increased revenues from relatively noncompetitive services for the purpose of cross-subsidizing its lower prices for services that do confront actual competitive challenge*. The Commission can reasonably conclude that the only situation in which the Company would want the ability to raise prices is where it has the *economic* ability to do so, i.e., where there are no existing competitors in the market. And in such cases, there would be no basis for the Commission to afford US West the pricing flexibility it is seeking. Hence, if and to the extent that the Commission determines that the Company should be given a level of pricing discretion beyond that which it already has, that flexibility should be limited to the downward direction only.

US West has not demonstrated that there is effective competition statewide for high-capacity data services, and it should not be granted deregulation of these services until regulatory safeguards against the misallocation of costs and revenues have been adopted.

Q. What is your understanding of US West's proposal to deregulate data services?

A. The Company requests, pursuant to A.R.S. § 40-281(e), that the Commission deregulate its high-capacity digital services, including DS1 and DS3 facilities, ATM Service, Frame Relay, Transparent LAN, and MEGABIT services.[32] My testimony considers the proposed deregulation of data services in the greater context of US West's various pricing flexibility proposals.

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32. Allcott (USWC), Direct at 11; see also, Stewart (USWC), at 2-4.

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Q. What does A.R.S. § 40-281(e) provide?

A. The section provides as follows:

> "When the commission determines after notice and hearing that any product or service of a telecommunications corporation is neither essential nor integral to the public service rendered by such corporation, it shall declare that such product or service is not subject to regulation by the commission."

Q. Does Ms. Stewart claim that US West's high-capacity digital services throughout Arizona are no longer "essential nor integral" to the Company's public service?

A. Not directly. However, Ms. Stewart does assert that US West no longer possesses market power for these services, so that regulation is no longer necessary.[33]

Q. Has US West substantiated this claim?

A. No. The evidence that US West has produced falls far short of demonstrating a competitive market. In reality, US West clearly continues to possess very significant market power with respect to its provision of high-capacity digital services.

Q. What is the primary evidence filed by US West in support of its proposed deregulation of data services?

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33. Stewart (USWC), Direct at 2.

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A. Ms. Stewart's testimony relies primarily upon reports originally filed by US West in support of a petition it filed with the FCC a year ago.[34] In that petition, US West asked the FCC to forbear from regulating the Company as a dominant carrier for provision of special access and dedicated transport for switched access at DS1 and higher transmission levels. The petition included a report prepared by the consulting firm Quality Strategies and a paper authored by Drs. Alfred Kahn and Timothy Tardiff, which assesses US West's market power in the Phoenix MSA based upon the Quality Strategies and other similar reports.

Q. Does the evidence that US West has submitted demonstrate that there is effective competition for its high-capacity data services in Arizona?

A. No. In fact, the evidence does not even show that there is effective competition for high-capacity services in the Phoenix MSA, no less in Tucson and the less urban areas of the state. The criticisms I discuss further below deal with US West's attempt to show competition for high-capacity services in the Phoenix area. However, since the Company's filing requests deregulation of these services *statewide,* I should point out at the outset that virtually all of the Company's evidence deals with the Phoenix area alone. The only evidence presented regarding the Tucson area consists of naming competitors, primarily based upon marketing information. Ms. Stewart makes no attempt to quantify competition for these services in the Tucson area, and her testimony is even weaker with

34. *Petition of US West Communications, Inc. for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA* ("*Phoenix Forbearance Proceeding*"), CC Docket 98-157, filed August 24, 1998.

respect to areas of the state where there are no competitive facilities (she asserts that resale alone is sufficient to constrain US West's prices).[35]

Q. Assuming for the moment that Phoenix is the only relevant market for this Commission's consideration — which, of course, it is not — what are some of the factors that diminish the relevancy of the Company's FCC petition and any evidence attached thereto to what it proposes here with respect to deregulation of high-capacity data services?

A. First, US West has not presented any evidence that deals with *intrastate* high-capacity services. Although US West is asking this Commission to deregulate its intrastate *end user* (i.e., retail) high-capacity digital services, the majority of the services studied by Quality Strategies are furnished in connection with interstate access, a *wholesale* service furnished primarily to interexchange carriers that is under FCC jurisdiction. As discussed below, there are many flaws in US West's analysis of its market dominance with respect to high-capacity services used for interstate access. However, at least these interstate services represent the bulk of what was actually studied by Quality Strategies. The *intra*state high-capacity services that US West is asking this Commission to deregulate represent only a small portion of the total high-capacity digital services provided to customers in Arizona, and it is likely that US West's intrastate market share is significantly higher than its share of interstate special access.

35. Stewart (USWC), Direct at 3.

Second, the Company's proposal in this proceeding involves services that were not even at issue in the FCC filing, including several that bundle together high-capacity transmission and switching capabilities. The FCC filing dealt with access services, offered primarily to interexchange carriers, whereas the instant filing involves a number of retail services provided to end user customers.

Even if one were to assume that the data presented by US West to the FCC were relevant to intrastate retail end user services offered by US West in Arizona, which they are not, there are still several other flaws in the Company's presentation that work to discredit its attempt to portray data services as highly competitive, including misspecification of the product and geographic markets and faulty analysis of both demand and supply elasticity and of market share. As pointed out in the comments in CC Docket 98-157:

- US West's estimates of competitive "losses" focus upon the retail market, when the relevant market for access services is wholesale. AT&T attested that 90 percent of its DS-1 services in Phoenix were purchased from US West and that, as of September 1, 1998, 80 percent of the dollars AT&T spent on DS-1 circuits went to US West.[36]

36. *Phoenix Forbearance Proceeding*, CC No. Docket 98-157, AT&T Opposition (October 7, 1998) at 7. MCI Worldcom provides similar statistics. See, MCI Worldcom Opposition at footnote 34.

- US West's studies overstate competitors' revenue share of the market by converting DS-3 circuits into DS-1 equivalents. While a DS-3 has the transmission capacity of 28 DS-1s, they sell for much smaller multiples of the DS-1 price.[37]

- US West's analysis vastly underestimates what is required for CLECs to extend services from their fiber backbones to actual end user locations, including negotiating with the landlord for access and use of building facilities (often accompanied by a demand by the landlord for payment), obtaining rights-of-way, and making the initial capital investment to supply fiber and the associated electronics to the building.

- In assessing demand elasticity, US West ignores the substantial impact of termination liability provisions that effectively prevent customers from considering competitive options for high-capacity services they have taken subject to US West's term discount plans.

In fact, large users, the very group that US West suggests are the most likely beneficiaries of competition for high-capacity digital services, also opposed US West's petition, relating from their first-hand experience that US West did not face effective competition for the provision of such services in the Phoenix MSA.[38]

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37. *Phoenix Forbearance Proceeding*, CC No. Docket 98-157, FCC 99-206, footnote 241, citing AT&T Opposition at 7 (DS-3 often priced at only 2 to 3 times the DS-1 rate) and BellSouth Telecommunications, Inc. Tariff F.C.C. No. 1, 4th Revised Page 7-144.1 and 3rd Revised Page 7-145.0.1.2 (effective July 1, 1998).

38. Reply Comments of the Ad Hoc Telecommunications Users Committee, CC Docket No. 98-157, October 28, 1998.

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Q. Did the FCC find merit in these criticisms?

A. Yes. In an order released November 22, 1999, the FCC denied US West's petition.[39] The FCC found multiple problems in the evidence relied on by US West and the other Bell operating company petitioners who claimed they no longer possessed market power in the provision of special access and high capacity dedicated transport in the specified markets (for US West, the Phoenix MSA). Notably, the FCC refused to rely on the Quality Strategies market reports as evidence of the petitioners' diminished market share, because the BOCs' failed to disclose sufficient detail regarding the study methodology and the underlying data, thus depriving the Commission and interested parties of a meaningful opportunity to examine the conclusions in those reports.[40] The FCC also rejected the attempt by US West and others to base their market share analysis on "DS1" equivalents, finding that this measure of market share significantly overstates competitive inroads by placing a disproportionate emphasis on DS3 circuits.[41] The FCC also concluded that US West presented a distorted view of its existing market power by attempting to define competitive losses on a "retail" basis, when IXCs were still purchasing the underlying circuits (at wholesale) from US West.[42]

39. *Phoenix Forbearance Proceeding*, CC Docket 98-157, FCC 99-365, released November 22, 1999. In this order, FCC also acted on petitions by several other Bell operating companies (BOCs) who had (subsequent to US West's petition) requested similar relief in portions of their respective service territories.

40. *Id.*, at para. 25.

41. *Id.*, at para. 27.

42. *Id.*, at para. 29.

Each of the FCC's findings regarding the inadequacy of US West's evidence and the methodology it relied on to show its non-dominance as a provider of high-capacity services in the Phoenix MSA would apply equally to the Company's testimony and exhibits in the current proceeding.

Q. Do you agree with Mr. McIntyre's statement that the FCC denied US West's forbearance petition "because it considered the regulatory relief requested was essentially provided"[43] by the generic rules adopted in the Access Charge Reform docket?

A. No, this is simply incorrect. It is true that the FCC denied US West's petition for forbearance and referred US West and other ILECs to the newly adopted rules governing pricing flexibility for high capacity services. The new generic rules provided some limited, immediate pricing flexibility to ILECs, but nowhere near what US West had requested. Under the rules adopted by the FCC, requests for additional pricing flexibility and forbearance are subject to two competitive threshold tests, which must be satisfied on an MSA-by-MSA basis, based on a very specific evidentiary showing. Mr. McIntyre's testimony fails to acknowledge that US West has yet to meet the FCC's competitive threshold test for even Phase 1 pricing flexibility (no less for regulatory forbearance) for the Phoenix MSA.

43. McIntyre (USWC), Supplemental Direct at 19.

Q. Mr. McIntyre goes on to state that "[d]eregulation of these services at the state level would allow US West to market state and interstate services in much the same way."[44] Is this also misleading?

A. Indeed, yes. FCC forbearance has not occurred, and is in no way guaranteed to US West, unless it can satisfy the specific standards set forth in the FCC's rules. It is thus completely misleading to suggest that this Commission needs to proceed with deregulation of US West's intrastate high-capacity services in order to permit equivalent treatment of inter- and intrastate high-cap services. Indeed, using Mr. McIntyre's own argument, this Commission should expressly *not* deregulate intrastate high-capacity services precisely because they continue to be regulated at the federal level.

Q. From what you can tell, have the problems with the Quality Strategies market share analysis been cured in the "update" referenced by Mr. McIntyre?

A. No. While Mr. McIntyre references an "updated report," his Exhibit SAM-8 consists of a single, summary page with graphics that purport to represent market shares for US West and other carriers as of 2Q99. There is nothing to indicate that the methodology is any different from what was used to calculate the earlier market share projections. In fact, the exhibit states that the market shares are based on "DS-1 Equivalents," an approach specifically repudiated by the FCC.

44. *Id.*

Piecemeal deregulation, under rate-of-return regulation, creates opportunities for cost recovery to be inappropriately shifted to noncompetitive services.

Q. Is the Company proposing to remove both the costs and revenues associated with all data services from the determination of its regulated revenue requirement?

A. That certainly would be the customary treatment of a deregulated service under traditional regulatory principles.[45] However, what US West is proposing is not entirely clear from its filing.

Q. Assuming that US West were able to show that high-capacity data services confronted competition statewide and that deregulation were appropriate, would you have any concerns with the Company's treatment of the costs and revenues for these services?

A. Indeed, yes. The fact that one cannot tell from the filing whether the costs and revenues for these services are included in the revenue requirement calculation is just the tip of the iceberg. Whenever a service (or group of services) is deregulated while the bulk of the Company's investment and expenses remain under rate-of-return regulation, there is a need for complete and accurate cost allocation to ensure that all of the costs for the deregulated service are removed from rates and none of the revenues from services that remain under regulation are improperly attributed to the deregulated services. Obviously, it is important that this be done before the Commission gives up jurisdiction over the

45. *See*, e.g., *Application of Pacific Bell for an increase in intrastate rates*, D.91-11-023, 1991 Cal. PUC LEXIS 737, 41 CPUC 2d 647 (1991).

service proposed to be deregulated. Whatever US West has done, there is no indication that it includes any such cost allocation.

Q. Suppose that the Company is not proposing below-the-line treatment for the "deregulated" services — would that eliminate your concern?

A. No. There would still be a similar problem under rate-of-return regulation, since there is an opportunity to shift costs to noncompetitive services (and misattribute revenues from noncompetitive services to more competitive ones). Later in my testimony, I discuss how the Commission could curtail the opportunities for misallocation of costs and revenues by adopting a well-specified price regulation framework.

US West's pricing flexibility proposal is part of an all-out attempt by the Company to obtain premature deregulation of its intrastate operations.

Q. Dr. Selwyn, you have discussed your concerns with many of the specific elements of US West's pricing flexibility/deregulation proposal. At a broad public policy level, how would you summarize your concerns with what US West is attempting to achieve?

A. Although the present proceeding is nominally a rate case, US West is using it as a vehicle to put regulation on trial. Seeking pricing flexibility for services that do not confront effective competition, and attempting to fashion new, less rigorous tests for treating services as "competitive," are just two ways in which US West is aggressively whittling away the existing regulatory frameworks that are needed to ensure the opportunity for local competition to actually develop.

Q. What would be the overall effect upon competition in the Arizona telecommunications market if US West's proposal is adopted?

A. US West still has extensive market power with respect to local exchange and exchange access services in Arizona. If US West can create opportunities to exercise that market power in the absence of regulatory constraints, it can increase the obstacles to competitive entry. Thus, *premature* dismantling of economic regulation (whether through outright deregulation or some other form of excessive pricing flexibility) directly contravenes the pro-competitive policy initiatives that the Commission and federal regulators, along with state and federal legislators, have worked so diligently to promote.

Q. In addition to the extensive pricing flexibility and service deregulation that US West is pursuing in this rate case, what other actions support this strategy?

A. After making its initial Section 271 filing, US West tried unsuccessfully, to have the Commission's proceeding regarding the Company's Section 271 application put on such a "fast track" as to preclude meaningful review of the Company's compliance. Having failed to circumvent a rigorous review of its Section 271 compliance, US West renewed earlier efforts (which had been decisively rebuked by the FCC) to win the Commission's agreement to eliminate LATA boundaries within Arizona. Also, as discussed earlier, US

West attempted to obtain forbearance from FCC regulation of its high-capacity digital services in the Phoenix MSA, but was turned down because of the insufficiency of its competitive showing. In fact, the Company's FCC petition elicited strong criticism from consumers, including large business customers who presumably would be the first beneficiaries of true competitive pricing for such services.

Q. If the Commission denies US West's pricing flexibility requests, is the ILEC put at a disadvantage relative to new entrants?

A. No. US West's incumbency still provides it with a vast array of incumbency advantages that competitors cannot overcome with the incremental amount of pricing flexibility they may have for certain services. Until the market evolves to the point where those incumbency advantages no longer predominate, the Commission should not be concerned that it is somehow putting US West at a competitive disadvantage.

Even if other problems (e.g., market definition) in US West's competitive zone proposal were overcome, the persistence of US West's incumbency advantages would continue to pose a major roadblock to competition. Regulatory flexibility/forbearance relative to competitive services in any "competitive zone" should be coupled with specific measures that result in the diminution of US West's incumbency advantages, such as full compliance with Section 251 and 252 of the federal Act (including fully compliant OSS) with respect to services affected by the proposed pricing flexibility, balloting to select the customer's intraLATA toll provider, and balloting to select the customer's provider of local services.

Q. What is the more appropriate approach for the Commission to take with respect to a regulatory framework that will give US West reasonable pricing flexibility while ensuring just and reasonable rates for noncompetitive services and lay the foundation for effective telecommunications competition to develop throughout Arizona?

A. First, I would say that the Commission has a strong framework (in R-14-2-1108) for judging whether or not services are competitive and should continue to apply that framework rigorously. Second, the Commission should recognize that equitable treatment of US West does not require and should not consist of treating it the same as new entrants that lack market power. US West has extensive incumbency advantages over new entrants. Finally, as I discuss below, insofar as the Commission is inclined to selectively lift regulatory controls as individual services become competitive, it is important to implement a framework that creates safeguards that work to protect noncompetitive services against improper allocations of costs and revenues.

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REGULATORY REFORM PROPOSAL

"Rate-of-return" regulation is an appropriate method for setting ILEC rates provided that it is applied in a consistent manner to *all* of the services furnished by the regulated company.

Q. What is the objective of rate of return regulation?

A. Rate of return regulation is supposed to ensure just and reasonable rates and allow the ILEC the opportunity to earn a reasonable return on its investment in plant used and useful in the provision of regulated telecommunications services.

Q. In theory, how does rate of return regulation ensure that rates are just and reasonable?

A. Under rate of return regulation, there is a two-step process for setting rates. The first step involves determining the Company's overall "revenue requirement," which depends upon its investments (plant "used and useful" for the provision of a regulated telephone service), its expenses, and the allowed return on the net book value of its investments. The second step involves determining how the revenue requirement should be recovered ("spread") from each of the services offered by the ILEC under regulation.

Q. How does this second step work?

A. Typically, each service is responsible for covering its "direct" costs, plus a share of the joint and common costs associated with its use of common network infrastructure and other investments and overhead expenses that are not susceptible to direct assignment. Since total direct costs of all individual services are typically less than the total revenue requirement of the ILEC, various other considerations, including public policy and public interest objectives, influence the precise manner in which the so-called "common costs" (variously defined, but generally those that cannot be or are not attributed to specific services) are recovered. To the extent that an ILEC maintains an effective monopoly with respect to certain of its services while confronting competition at various levels for others, it has an incentive to shift common cost recovery toward its noncompetitive services and away from those for which competitive pricing pressures exist. Competitors, who do not enjoy this ability (because they do not supply a large core base of noncompetitive services) must necessarily recover all of their "common costs" from the same types of services that, when furnished by an ILEC, can escape this responsibility. Besides burdening customers of the noncompetitive services, this type of cost shifting can often block or otherwise frustrate entry into those service markets in which competition is theoretically possible.

Q. Are these "common costs" fixed in the sense that their aggregate magnitude is the same whether or not the ILEC offers services in competitive markets?

A. No. Even though ILEC cost studies frequently avoid making specific attributions of the so-called "common costs" to individual services, studies conducted by my firm and others have consistently demonstrated a strong relationship between the overall scale of ILEC operations and the magnitude of the so-called "common costs." Hence, when "competitive" services fail to recover a fair share of "common costs," the effect is to force noncompetitive services to cross-subsidize competitive operations.

Q. Are there any specific risks, under rate of return regulation, when the ILEC obtains broad pricing flexibility for some services or customer groups, at the same time that it retains a large customer base that lacks effective competitive options?

A. Yes. Whenever the ILEC sacrifices revenues (in an attempt to beat out the competition) or loses market share, so long as the ILEC is guaranteed full cost recovery and a pre-specified return on its rate base, it can seek to recoup these competitive losses through rate increases to the remaining customers who lack competitive alternatives. Put differently, pricing flexibility and price deregulation within a "rate-of-return" regulation framework permits the ILEC to shift costs from competitive services to noncompetitive services, in effect insulating the company from the business risks that ordinarily confront firms operating under competitive market conditions and, worse, assuring full recovery of all costs *even if the company were to suffer actual competitive losses.*

Q. Is this what is likely to happen under US West's proposal?

A Absolutely. The US West proposal superficially retains ROR regulation, but introduces far more pricing flexibility than is currently authorized under the Commission's Rules. US West would be permitted to increase prices by as much as 100% for "competitive zone" services and possibly by an even greater amount for "deregulated data services" if its plan is adopted. Obviously, the only circumstances where increases of this magnitude could be sustained in the marketplace would be where competition is nonexistent (notwithstanding the nominal "classification" of these services or areas as "competitive"). The Company would thus be able to quickly replace any revenue losses from instances of *actual* competition (due either to market-driven price decreases and/or to losses of market share) simply by raising prices for the actually noncompetitive services that it has succeeded in categorizing as "competitive."

Q. Would it remedy the problem you describe if the services in question, instead of being given pricing flexibility, were simply moved below-the-line?

A. No, and in fact that policy might actually exacerbate the problem. Selective deregulation creates much the same opportunities for cost-shifting that I have described above, because *both* revenues *and* costs would need to be moved below-the-line. Assuming that "competitive" services are correctly identified, it would be a relatively simple matter to flag those revenues for below-the-line treatment. However, the same is distinctly not the case on the *cost* side of the equation. Monopoly and competitive services share vast amounts of common plant and other organizational resources that cannot be easily separated into the two categories, and the Company would have a strong financial incentive, under such an arrangement, to leave as many costs as it possibly can "above-the-line" to assure full recovery under rate-of-return regulation.

But, as we have discussed, it is not even a simple matter to correctly classify services as "competitive." For deregulation to be appropriate, two conditions must be met: First, there must be effective (price-constraining) competition for the service, so that *all* customers thereof are able to purchase the service at market-driven cost-based rates in the absence of regulation. As I have shown, this condition does not in fact exist for the services that US West is proposing to treat as "competitive." Second, when the service is deregulated, all of the costs (and revenues) associated with the service must be correctly allocated to that service and removed from the Company's regulated books. These costs must include the appropriate share of the vast common network infrastructure and expenses that are not directly assignable. This is an extremely difficult undertaking, and it is even harder to do correctly. It would be especially difficult to accomplish this with the ongoing, piecemeal reclassification of services and wire centers that the Company is proposing, since such allocations would need to occur each and every time a service was deregulated.

Price cap regulation, incorporating a well-designed and correctly specified price adjustment mechanism, can overcome at least some of the problems that limit the effectiveness of rate-of-return regulation in a mixed monopoly/competitive, regulated/ nonregulated environment.

Q. Would a change in the form of regulation of US West permit the Commission to retain effective controls to ensure just and reasonable rates for noncompetitive services, while permitting the Company an opportunity to obtain pricing flexibility for truly "competitive" services?

A. Yes. A price cap alternative regulation plan could offer many advantages over rate of return regulation in the current industry environment. Price cap regulation has replaced rate of return regulation in the overwhelming majority of states.

As I have discussed, the nominal continuation of rate-of-return regulation for US West, coupled with the Company's flexibility to reclassify as "competitive" those services that are inextricably linked in production with indisputably noncompetitive services, would enable US West to shift revenues away from competitive services continuing to recover a residue of costs from noncompetitive services customers. A well-designed price cap system (with particular emphasis on "well-designed") can overcome these shortcomings.

Q. Please describe the objective of price cap regulation.

A. The fundamental objective of a well-designed price cap mechanism is to capture for monopoly service ratepayers the efficiency incentives characteristic of competitive markets and to provide protections against excessive prices and cross-subsidization of competitive services where price-constraining competition is not yet present. It is therefore essential that the price cap mechanism include components that provide an appropriate representation of all the attributes of a competitive marketplace, and in particular, the incorporation of an appropriate productivity factor. My testimony below will explain the key features of the plan, and why those features are required in order to achieve the "competitive result" goal for alternative regulation.

A well-designed price cap formula should include an appropriate offset against economy-wide inflation, reflecting the ILEC productivity growth rate, the differential between the growth in ILEC input prices and the growth in input prices for the economy as a whole, and a "consumer dividend" to recognize the effects of incentive regulation upon ILEC efficiency.

Q. What are the key features of a price cap plan?

A. Under price cap regulation, the weighted average prices for the services in a given price cap basket must be less than or equal to the price cap index (PCI). The basic PCI formula consists of an inflation measure, typically the Gross Domestic Product Price Index (GDP-PI), minus a productivity offset or so-called "X-Factor," plus or minus any permitted exogenous cost changes. It is also appropriate to incorporate a service quality factor, to discourage the ILEC from cost-cutting measures that impair the quality and reliability of its services.

The X-Factor is itself comprised of three basic components:

(1) *Productivity growth rate*, to reflect the annual gain in Total Factor Productivity (TFP) that the ILEC can reasonably be expected to achieve;

(2) *Input price differential*, to give effect to and to capture the fact that the prices of the *inputs* to the ILEC's production processes (most significantly, plant and equipment) are rising far more slowly than the overall rate of economy-wide inflation (indeed, these prices have been *declining* both in real and nominal dollars for the past several decades); and

(3) *Consumer productivity dividend*, to specifically reflect and capture the salutary effects upon ILEC efficiency arising from adoption and implementation of incentive-based regulation itself.

The price cap formula would take the form

GDP-PI - X ± Z - Q, where

GDP-PI = the annual percentage change in the Gross Domestic Product Price Index, a measure of economy-wide output price inflation published by the U.S. Department of Commerce;

X = a "productivity offset" to capture the cost-decreasing effects of anticipated annual improvements in USWC's productivity and input price levels. The X factor set most recently by the FCC, based on total company (intra- and interstate) productivity for major ILECs was 6.5%;

Z = potential adjustments to reflect certain external or "exogenous" impacts on USWC's costs; and

Q = an adjustment to reflect substandard service quality performance (when applicable).

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Q. Can you give a simple numerical example showing how this formula is applied?

A. Certainly. The first variable, the GDP-PI, is determined and published by the US Commerce Department, Bureau of Economic Analysis; the change in the GDP-PI for the year ending December 31, 1999 was 1.4 percent.[46] The X-factor that US West has agreed to in Utah, under a settlement with Staff in March 2000, is 6.2 percent.[47] Assuming no service quality adjustment or exogenous cost recovery, the formula would look as follows:

Price cap index = 1.4% - 6.2% - 0 + 0 = -4.8%.

Thus, the level of US West's rates, as a whole, would need to *decrease* by 4.8%.

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46. US Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, June 2000, Table 8.1.

47. Utah Public Service Commission Docket No. 99-049-41, Stipulation, March 8, 2000. The selection of a 6.2% X-factor is consistent with the 6.5 percent X-factor adopted by the Federal Communications Commission the last time it fully adjudicated the productivity factor for price cap LECs. *In the Matter of Access Charge Reform (et al.)*, CC Docket Nos. 96-262/94-1/99-249/96-45, Order on "CALLS" Proposal, FCC 00-193, released May 31, 2000. This decision was remanded to the FCC for further proceedings, and the evidence gathered in that subsequent phase supported an X-factor even higher than the 6.5 percent level. However, no final determination of the X-factor was reached, as the FCC opted instead for a comprehensive settlement of access charge-related issues (the so-called CALLS proposal), under which no explicit X-factor was identified. *Price Cap Performance Review for Local Exchange Carriers*, Fourth Report and Order in CC Docket 94-1 and Second Report and Order in CC Docket No. 96-262, 12 FCC Rcd 16642 (1997), *aff'd in part, rev'd in part, USTA v. FCC*, 188 F.3d 521 (D.C. Cir. 1999).

Q. Does price cap regulation permit the Commission to carry out its obligation to ensure that the ILEC is charging just and reasonable rates?

A. Yes, provided that the price cap mechanism is correctly specified. It is simply an alternative form of regulation that may have some advantages over pure rate of return regulation during the transition to a more competitive environment. As I understand it, the Arizona Constitution gives the Commission the "full power" to set "just and reasonable rates." Art. 15, sec. 3. While rate of return regulation has been the traditional way of regulating monopoly public service providers, this form of regulation is not the exclusive means to ensure just and reasonable rates. The Federal Communications Commission and various state commissions have adopted price cap plans without specific "alternative regulation" legislation, relying only on their general supervisory powers over telecommunications rates, terms and conditions of service.[48]

Q. To what services should the price cap formula (including the X-factor adjustment) be applied?

A. The overall price cap index (PCI) should apply, in the aggregate, to all services that are noncompetitive, whether or not they are considered "discretionary." However, some price

48. *See*, e.g., *Petition of New England Telephone and Telegraph Company, d/b/a NYNEX for an Alternative Regulatory Plan for the Company's Massachusetts intrastate telecommunications services*, Massachusetts DPU 94-50, Interlocutory Order, February 2, 1995 at 61-62, Order, May 12, 1995 at 106, and G.L. c. 159, §§ 14, 19, 20; *In the Matter of Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, 4 FCC Rcd 2873, 2882 (1989) and 47 USC §§ 201, 202.

cap plans provide for separate retail service baskets for basic noncompetitive services and noncompetitive services that are "discretionary" in nature (e.g., vertical features that have moderate-to-low penetration levels). If two baskets of noncompetitive services were established (Category 1 - basic, and Category 2 - discretionary, for the sake of discussion), then increases in the rates for any service in Category 1 should not exceed the annual percentage change in the price cap, while in Category 2, the annual percentage increase in the price cap could serve as a ceiling on rates for the basket as a whole, with pricing flexibility for *individual* services limited to an annual percentage change (e.g., the Consumer Price Index) that might exceed the annual change in the overall price cap index. Also, services sold at wholesale to competitors, such as switched and special access services, should be in a basket separate from the related retail offerings. Otherwise, the ILEC could meet its price cap by raising the price of its competitors' service "inputs" and lowering the price of the corresponding retail service, resulting in a price squeeze. By putting the retail and wholesale offerings in separate baskets subject to the same overall price cap adjustment, the relationship between retail and wholesale rates will be maintained.

Services provided subject to price-constraining competition would be grouped in a "competitive" basket and would not come under the price cap mechanism. It is nonetheless appropriate, in order to prevent cross-subsidization, to require that such services be priced at or above TSLRIC and to satisfy imputation with respect to all noncompetitive services or service elements that are utilized in furnishing the competitive service. It is also necessary to guard against misclassification of services as competitive by prohibiting the Company from raising the rate for any competitive service by more than 10 percent per year, and require re-evaluation of the "competitive" classification of any service for which the Company has raised the rate 25% or more in any three-year period.

Q. Should US West be permitted to reclassify services as competitive when those services confront actual competition?

A. Yes. The Commission's existing rules provide for classification of services as competitive, and these rules could serve as the foundation for "Category 3" classification under the price cap plan. Indeed, the use of "baskets" for competitive and non-competitive services largely addresses the various cost allocation concerns that I discussed earlier. If the Commission decides on a three-basket system, there would also need to be criteria for classifying noncompetitive services to "Category 2" (discretionary).

Adoption of an effective price cap system (one with an adequate X-factor) would ameliorate much of the effect upon the Company's monopoly ratepayers arising from US West's decision to forgo revenues from competitive services. However, for any subsequent reclassification of a service to the "competitive" category, US West should be required to demonstrate that any network or other corporate resources that are utilized jointly by US West to produce its monopoly and the reclassified "competitive" services are available on the same terms and conditions and on an economically and technically equivalent basis to any nonaffiliated competitor. US West should not, for example, be permitted to utilize its Operations Support Systems (OSS) to process and to fulfill service orders or perform other functions in connection with services reclassified as competitive unless it makes these exact same resources available on exactly the same basis to nonaffiliated competitors.

Q. Are you proposing a specific price cap plan in this case?

A. Not in all the details needed to implement such a plan. My purpose is to demonstrate that a well-formulated price cap plan is an appropriate means of achieving some of the pricing flexibility that US West claims to seek, while still retaining a regulatory framework that can ensure just and reasonable rates for noncompetitive services. Specifying values for each of the price cap regulation parameters, however, is beyond the scope of my engagement and, accordingly, ETI has not performed the detailed analysis that would be necessary to support detailed recommendations. I base my general recommendations upon the broad experience that I and my firm have had in state and federal price cap proceedings over the past dozen years.

However, it is certainly appropriate that the current rate case serve as a first step toward price cap regulation, since even price cap regulation depends upon having appropriately set "going-in" rates, based upon the costs developed under a rate of return regulation framework.

ADJUSTMENTS FOR OVERSTATED PLANT ACCOUNTS

The FCC Continuing Property Record Audits reveal substantial overstatement of plant on US West's books that cannot be ignored.

Q. Please describe your understanding of the audits that were conducted by the FCC relative to the Regional Bell Operating Companies' Continuing Property Records, and the principal conclusions that were reached by those audits.

A. On February 24th, 1999, the Federal Communications Commission released the results of audits its staff had conducted of the RBOCs' Continuing Property Records (CPRs) as these existed on June 30, 1997.[49] The audits revealed a pattern of systematic

49. FCC Releases Audit Reports on RBOCs' Property Records, Report No. CC 99-3, Common Carrier Action, February 25, 1999. Also *Audit of The Continuing Property Records of Ameritech Corporation, as of July 30, 1997,* FCC Accounting Safeguards Division, December 22, 1998 ("Ameritech CPR Audit"); *Audit of The Continuing Property Records of NYNEX Telephone Operating Companies also Known as Bell Atlantic North, as of March 31, 1997,* FCC Accounting Safeguards Division, December 22, 1998 ("Bell Atlantic North CPR Audit"); *Audit of The Continuing Property Records of Bell Atlantic Telephone Operating Companies, also Known as Bell Atlantic South, as of March 31, 1997,* FCC Accounting Safeguards Division, December 22, 1998 ("Bell Atlantic South CPR Audit"); *Audit of The Continuing Property Records of BellSouth Telecommunications, Inc., as of July 31, 1997,* FCC Accounting Safeguards Division, December 22, 1998 ("BellSouth CPR Audit"); *Audit of The Continuing Property Records of Pacific Bell and Nevada Bell Telephone Companies, as of June 30, 1997,* FCC Accounting Safeguards Division, December 22, 1998 ("Pacific Bell CPR Audit"); *Audit of The Continuing Property Records of Southwestern Bell Telephone Company As of June 30, 1997,* FCC Accounting Safeguards Division, December 22, 1998 ("SWBT CPR Audit"); *Audit of The Continuing Property Records of US West Telephone Operating Companies, as of June 30, 1997,* FCC Accounting Safeguards Division, December 22, 1998 ("US West CPR Audit"); Sections VI. Collectively, the seven RBOC CPR audits ("The RBOC CPR Audits").

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overstatements of capital investments on the RBOCs' books relative to assets physically present in their networks.

Q. What were the principal findings of the FCC CPR audits?

A. The audits were limited to a review of hard-wired central office equipment (COE), and thus did not address many other categories of capital spending. The sheer magnitude of the missing COE revealed by the audits in just this "hard-wired" category compels further examination by this Commission. As a general matter, the FCC auditors found that one out of every five line items of hard-wired central office equipment (slightly over 20%) that they had attempted to verify could not be located.[50] US West's results were the worst of all the RBOCs, with 24.8% of the total line items sampled being found deficient. The FCC's "Recommended Write-off" relative to the *missing* RBOC COE assets nationwide is approximately $5-billion. US West's share of that $5-Billion is $724-million.[51] Since the FCC's $724-million amount is an *unseparated* total, roughly three-quarters ($543-million) of the unaccounted-for assets is subject to state-level regulation. Accordingly, the questions of what to do about the lion's share of the misreported assets

50. *See*, US West CPR Audit, at 19; SWBT CPR Audit, at 19; Pacific Bell CPR Audit, at 19; Bell South CPR Audit, at 18; Bell Atlantic North CPR Audit, at 19; Bell Atlantic South CPR Audit, at 18; and Ameritech CPR Audit, at 19.

51. *FCC Public Notice*, February 25, 1999 "FCC Releases Audit Reports on RBOC's Property Records," (CC 99-3). Despite concerns that the Bureau's extrapolation of the results of its samples up to the $5-billion level overstate missing equipment, as I discuss more fully below, there are good reasons to believe that the $5-billion figure may in fact be quite conservative.

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and whether additional plant categories suffer from the same types of overstatements fall to this Commission to address.

The present rate investigation offers the Arizona Corporation Commission the opportunity to correct the potentially excessive prices being imposed upon Arizona ratepayers by the inflated capital stock that is presently included on US West's regulatory accounting books. Such corrections will undoubtedly translate into substantial rate reductions.

Q. What are the potential consequences of such overstatements of assets?

A. To the extent that existing BOC rate levels — in both the state and federal jurisdictions — are linked, directly or indirectly, to the net book value of plant in service, an overstatement of such book value would necessarily result in excessive prices for BOC services. The findings of the CPR audits are thus highly relevant for ongoing state PUC ratemaking and regulatory oversight activity in general, both in the context of ongoing proceedings as well as underscoring the need for state regulators to initiate remedial responses. In the instant proceeding in Arizona, elimination of the overstatements of rate base assets would have the effect of reducing US West's revenue requirement.

The Continuing Property Records audited by the FCC are a useful policy tool designed to reflect RBOC inventory and cost documentation at a detailed level.

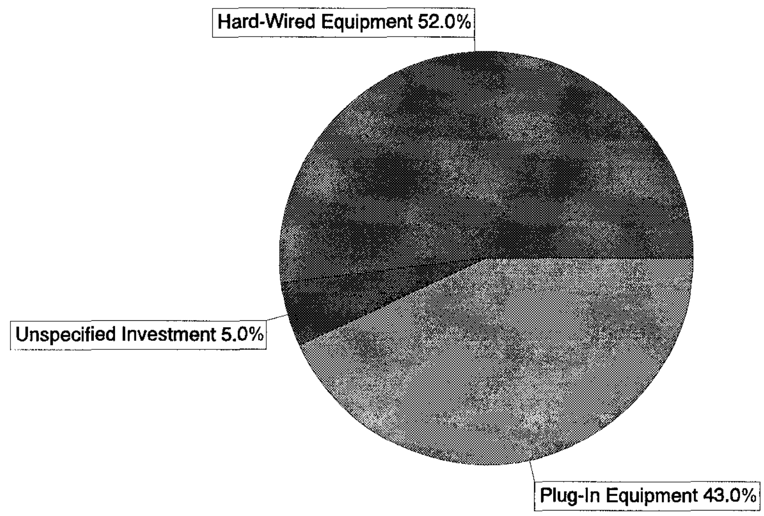
Q. What specific assets were included within the scope of the CPR audits?

A. The FCC audits examined the investment in Central Office Equipment as reported in the RBOC Continuing Property Records. Under Commission Rules, a carrier is required to provide a complete description of its plant-in-service assets including the actual or estimated original acquisition cost, and the "specific location of the property within each accounting area in such a manner that it can be readily spot-checked for proof of physical existence."[52] The CPR is designed to provide a detailed inventory and cost documentation of a carrier's plant assets. The CPR is relied upon as a tool in policymaking, including the setting of initial prices, low-end adjustments, X-factors, and earnings sharing levels for carriers regulated under price caps.

Within the CPR, COE is further broken down into three categories: Hard-wired Equipment, Plug-in Equipment, and Unspecified Items (see Figure 1 below). The Hard-wired Equipment category, representing 52% of total RBOC COE investment, includes permanent equipment that requires a considerable amount of installation effort and cost. Examples of Hard-wired Equipment are circuit equipment, telephone switches, and frames. The Plug-in Equipment Category, representing 43% of total RBOC COE, consists of portable items that are designed to have simple, "plug-in" installation requirements. The Unspecified Investment Category (5% of total RBOC COE) is broken down into four sub-categories: Undetailed Investment, Unallocated Other Costs, Plug-in Other Costs, and Right-to-Use Fees. The Commission's audit of physical assets focuses upon the Hard-wired Equipment category and two sub-categories of Unspecified Items —

52. 47 CFR §32.2000(e)(5).

Undetailed Investment and Unallocated Other Costs — and accounts for *more than* 52% of total RBOC COE investment.



Source: Audits of the Continuing Property Records of: Ameritech, Bell Atlantic North, Bell Atlantic South, Bell South, Pacific Bell/Nevada Bell, Southwestern Bell, US West. As of March 31, 1997. FCC CCB Accounting Safeguards Division. Reported December 22, 1998.

Figure 1. Breakdown of RBOC COE Investment.

Significantly, the Hard-wired Equipment category that the auditors reviewed represents what is probably the least fungible of all RBOC equipment categories, and as such, should be among the categories of RBOC plant most *easily verified.* Although the FCC did not extrapolate the results of the Hard-wired COE audit to other plant categories, it stands to reason that results that are discussed would likely be replicated for other plant categories.

The FCC audit process not only invited the participation of the RBOCs, but also selected items for audit as well as measures for valuing missing assets that were conservative in favor of the RBOCs.

Q. What specific role did the individual RBOCs play in the audit process?

A. The FCC conducted the audits in a manner that encouraged participation and input from the individual RBOCs. The Commission requested overviews from each of the RBOCs describing the various systems used to maintain its CPR, as well as any information about the RBOC's own internal audits or periodic reconciliations.[53] Since the equipment is scattered across a number of central offices, the auditors used a random two-stage stratified sampling procedure[54] to determine which central offices, and which line items

53. *See,* US West CPR Audit, at 16; SWBT CPR Audit, at 16; Pacific Bell CPR Audit, at 16; Bell South CPR Audit, at 15; Bell Atlantic North CPR Audit, at 16; Bell Atlantic South CPR Audit, at 15; and Ameritech CPR Audit, at 16.

54. A stratified sample divides the items to be chosen into groups called strata, within which items will be randomly selected. In this case, the central offices were broken up into strata based on size and location. In this method of selecting central offices, an appropriate number of offices are selected from each strata, rather than all selections being randomly

(continued...)

within each, should be verified. This method assures that the records selected, while random, will provide the most accurate assessment of the RBOCs' maintenance of their continuing property records.

Q. Were all RBOC network assets included within the scope of the Audits?

A. No. In an effort to make the audit process more manageable, the auditors focused solely upon Hard-wired Equipment as well as upon two groups within Unspecified Items: Undetailed Investment and Unallocated Other Costs.[55] The auditors selected Hard-wired Equipment for inspection, since that category of equipment is more permanent in nature, often requiring complex installation. In theory, this attribute should make equipment in this category easier to track and locate. By contrast, Plug-in Equipment, the other major category of COE plant, consists of units that are very portable, making it more difficult to track locations for individual line items. Thus, the audit's focus upon the Hard-wired Equipment category was, if anything, conservative, in that the Hard-wired Equipment should be the most straightforward to locate.

Q. How were the individual inspections conducted?

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54. (...continued) selected from the entire list of central offices. This ensures that offices of various sizes and locations are adequately represented in the overall sample. The second stage of the two-stage sampling is then selecting individual records from each central office chosen.

55. *See,* US West CPR Audit, at 15; SWBT CPR Audit, at 15; Pacific Bell CPR Audit, at 15; Bell South CPR Audit, at 14; Bell Atlantic North CPR Audit, at 15; Bell Atlantic South CPR Audit, at 14; and Ameritech CPR Audit, at 15.

A. The auditors notified each targeted central office prior to the on-site visit and requested the assistance of technical staff who were presumably familiar with the COE. Upon arrival at each central office location, the auditors, assisted by RBOC staff, attempted to find the equipment described in each of the randomly selected Hard-wired Equipment line items. Items were recorded as "Found," "Not Found," "Partially Found," or "Unverifiable."[56] The auditors conservatively labeled line items as "Not Found" only after they themselves and the RBOC technical staff were unable to find the equipment anywhere in the central office building. Items that were found, but not found in the quantity specified in the CPR, were labeled as "Partially Found." "Unverifiable Assets" comprised the remainder of assets that were not easily matched with the CPR description.

Q. Were the individual RBOCs afforded an opportunity to comment or otherwise take exception to the audit's findings?

A. Indeed, yes. Following the physical audit of the Hard-wired Equipment, the RBOCs were provided with the results of the audit and were allowed an opportunity to comment. The Commission then incorporated the RBOC comments into a draft audit report and provided each company with yet another opportunity to respond to the auditors' findings. After the review of the second set of responses, and several months of debate, the Commission released the results of the audits to the public.

56. *See,* US West CPR Audit, at 21; SWBT CPR Audit, at 21; Pacific Bell CPR Audit, at 21; Bell South CPR Audit, at 20; Bell Atlantic North CPR Audit, at 21; Bell Atlantic South CPR Audit, at 20; and Ameritech CPR Audit, at 21.

The results of the audits confirm gross misrepresentations of the BOCs' capital investment as reported in the CPRs.

Q. What types of discrepancies between the individual CPRs and assets physically in place were identified by the auditors?

A. The auditors discovered numerous problems during their attempts to verify the samples. Of the 8,244 individual line items reviewed at the seven RBOCs, 1,789 (21.7%) were found to be seriously deficient, i.e., simply not found in any location within the central office, not found in sufficient quantity, or not easily identifiable. Looking at individual entities, the percentage of deficient line items ranges from 18.5% (for Pacific Bell) to 24.8% (for US West) (see Table 2). Moreover, the level of conformity of these results indicates that the problems with capital reporting and tracking practices are likely to be systemic and consistent throughout the seven audited companies.[57]

Q. What was the overall dollar magnitude of the discrepancies that were identified by the audits?

A. In terms of dollar value, the 8,244 line items sampled in the audit account for $98.7-million. The value associated with the assets found to be seriously deficient is $20.7-million. This represents over 21% of the total assets sampled. Using these numbers, the

57. Additional inconsistencies were found among the line items that were labeled as "Found," including incorrect locations within the central office building and incomplete descriptions as listed in the CPR. The auditors, however, acting conservatively, did not penalize the RBOCs for these flaws in the CPR.

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auditors then applied median statistical inferences to determine an appropriate write-off (see Table 2).

Table 2

Results of Audit, Hard-wired Equipment Category Sample

BOC	Recorded Value of Total Assets Sampled	Value of Partially Found Assets	Value of Assets Not Found	Value of Assets Unverifiable	Partially Found, Not Found or Unverifiable Assets	"Missing" Value Share of Total Value	FCC Recommended Write-off
Ameritech	$11,740,687	$449,831	$536,581	$1,344,864	$2,331,276	19.9%	$566,700,000
Bell Atlantic (North)	$14,711,481	$1,019,908	$574,099	$1,419,653	$3,013,660	20.5%	$758,200,000
Bell Atlantic (South)	$17,219,215	$664,860	$1,306,981	$1,651,454	$3,623,295	21.0%	$805,700,000
Bell South	$15,468,046	$345,077	$257,170	$1,527,928	$2,130,175	13.8%	$430,200,000
Pacific Bell	$14,850,520	$836,218	$1,101,134	$1,537,698	$3,475,050	23.4%	$526,800,000
Southwestern Bell	$11,152,337	$323,583	$329,391	$1,727,554	$2,380,528	21.4%	$1,145,500,000
US West	$13,594,287	$247,596	$1,157,825	$2,320,174	$3,725,595	27.4%	$606,200,000
Total	$98,736,573	$3,887,073	$5,263,181	$11,529,325	$20,679,579	20.9%	$4,839,300,000

Notes: FCC Recommended write-off based on medial statistical inferences drawn from the current audits. See specific BOC audit for details.

Source: See Table 1.

The amount of this recommended write-off, nearly $5-billion, underlies the substantial extent of the RBOCs' failures. The amount of missing assets is equivalent to one out of every five items listed in the CPR, i.e., 20% of the RBOC assets cannot be located.

The auditors also attempted to verify the existence of investment falling in the categories "Undetailed Investment" and "Unallocated Other Costs." Within the scope of each

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RBOC audit, the RBOCs were unable to show the actual existence of cited Undetailed Investment, let alone provide cost support documentation for the line items. On that basis, the Commission recommended that all of the cost related to Undetailed Investment, $1.9-billion for the RBOCs combined, be removed from the respective CPRs. In its review of Unallocated Other Costs, the auditors came to the conservative conclusion that more information and cost documentation was needed from the RBOCs to complete the review with confidence. Therefore, none of the investment associated with Unallocated Other Costs are included in any of the Commission's estimates.

In addition to verifying the existence of the physical equipment referred to in each line item, the auditors also requested cost support documentation from the RBOCs. The FCC's Rules clearly state that "all drawings, computations, and other detailed records which support quantities and costs or estimated costs shall be retained as part of or in support of the continuing property record."[58] The Auditors intended to review the cost support documentation to confirm that the RBOCs are recording accurate costs and quantities in the CPR. The RBOCs had failed to provide adequate documentation for the auditors to make a determination as to the accuracy of the recorded costs. In fact, according to the audit reports, only one of the entities (BellSouth) even appeared to have been able to submit the necessary documentation, and that information had not yet been properly reviewed at the time of the issuance of the reports.

58. 47 CFR § 32.200(f)(2)(iii).

Previous unreleased FCC CPR audits in which issues similar to those raised in the current audits were identified — but to which the RBOCs had failed to meaningfully respond — confirm the long-standing nature of the problems involved.

Q. Is this the first time that the FCC has undertaken CPR audits of this type?

A. No, in fact, the Commission has initiated CPR audits in the past, although the results of such audits have never been released to the public. In the current audit, however, the Commission briefly summarizes the earlier audits (dated 1993 or 1994) and affirms that the problems cited in the current audit (including "Missing" Equipment, Unallocated Investment, improper descriptions, etc.) are long-standing issues that have been previously brought to the attention of the RBOCs in the context of the earlier audits.

Q. Is there any evidence that the RBOCs have undertaken to address and/or remedy the types of deficiencies that have been identified in the CPR audits?

A. No, there is not. Indeed, the RBOCs' failure to remedy such deficiencies over the intervening three to four years demonstrates that it will take more than mere reporting of these results to achieve remedial action. Following the completion of the first set of audits, all seven of the BOCs announced specific plans to address CPR COE inventory requirements and to bring the accounts into line with Commission Rules. For example, after the 1994 CPR Audit, SWBT made numerous announcements that it had addressed the problems outlined in the Audit and made progress in verifying its investment inventory.[59] Despite SWBT's assertions that steps had been taken to correct the problems cited in the CPR audit, an estimated 216,200 records[60] (36.52% of SWBT's *total* CPR COE records) are currently deficient, resulting in the highest write-off recommended by the Commission, amounting to $1.145-billion.[61] In the case of US West, of the 530,200 records included, 169,900 records (32%) were determined to be deficient.[62] Clearly, deficiencies of the level of magnitude manifest in the current CPR audits are not recent in nature, i.e., these deficiencies, and the overstatement of capital investment they reflect, have been festering on the RBOCs' books for a considerable period of time.

Adding to the evidence of the long-standing nature of the RBOCs' capital reporting problems, vintage entries made up a not insignificant portion of RBOCs' deficient records. The earlier round of audits turned up unspecified items dated as early as

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59. In 1995, SWBT initiated an internal review of its CPR for all COE offices which included a physical asset verification process. During the current audit, SWBT declared that they had implemented the Statewide Asset Verification and Retirement ("SAVR") program to verify and monitor investment records at central offices with greater than $10-million in investment, and that physical asset inventories had been completed in only 83 central offices. SWBT CPR Audit, APPENDIX A, at 1, and Joint Response of SBC LECs, January 11, 1999 at 15.

60. SWBT CPR Audit, at ¶ 33.

61. The deficient 216,200 records cited includes Hard-wired Equipment (102,500), Undetailed Investment (46,900) and Unallocated Other Costs (66,800). The $1.145 Billion recommended write-off accounts for only Hard-wired Equipment ($221.6 million) and Undetailed Investment ($923.8 million). Since the capital investment associated with Unallocated Other Costs is not included, the actual recommended write-off is understated.

62. US West CPR Audit, at 33.

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1900.[63] In the current SWBT CPR audit, 99% of the Undetailed Investment records were dated before 1983.[64] In Ameritech's case, $160.8-million, or 61% of total Undetailed Investment, are dated before 1982.[65] The RBOCs argue that the majority of the vintage entries are comprised of equipment installed prior to the implementation of a mechanized system of accounting (in the early 1980s), although this does not dismiss their responsibility to meet basic record keeping requirements. As the District of Columbia Public Service Commission opined in an Order released in 1993 regarding the ILEC in its service territory C&P (now Bell Atlantic) — regardless of reporting requirements, the ILEC had a responsibility to be able to verify the investment underlying depreciation expenses submitted for ratemaking purposes.[66]

The FCC Audit results can fairly be extrapolated down to Arizona rate-making amounts.

Q. Do you know what portion of the unseparated $724-million you discussed previously would appropriately be attributed to US West's intrastate operations in Arizona?

63. *Bell Atlantic South CPR Audit,* Appendix A, at 2.

64. SWBT CPR Audit, at ¶ 30. — Note that actual Undetailed Investment records totalling $923.8-million comprised approximately eighty percent of the overall FCC recommended disallowance for SWBT.

65. Ameritech CPR Audit, at ¶ 30.

66. 148 PUR 4th, at 181.

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A. Working from the top down, it appears that roughly \$78-million in plant on US West's intrastate Arizona books should be removed (with corresponding changes to depreciation expense levels) based upon the FCC's audit findings. According to the ARMIS reports filed by US West with the FCC, operations in Arizona account for approximately 14.3% of US West's Total Telephone Plant in Service (TPIS).[67] Attributing 14.3% of the \$724-million to operations in Arizona results in a total of \$103.6-million, the intrastate portion of that, roughly 75%, is \$78-million.

Q. Wouldn't it be more appropriate to take the disallowance findings that were specific to that portion of the audit conducted in Central Offices in Arizona, and gross those up to a statewide amount, than to work from the US West company-wide results?

A. No. The audit was conducted across a random sample of 33 central offices of various sizes across the fourteen state US West region[68] - of those 33 central offices, PROP<<[redacted]>>ENDPROP were in Arizona.[69] The FCC auditors designed the US West audit sample to be accurate based upon the company in total - and it is those results that should be used as the basis for any disallowances in this proceeding. Basing the analysis on the results flowing from the PROP<<[redacted]>>ENDPROP sampled Arizona offices would necessarily result in a write-off amount that is less accurate than a tops-down apportionment of the region-wide findings.

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67. 14.3% factor was developed from data found in ARMIS Report 43-02, Table I.

68. FCC US West Audit, at 7.

69. US West response to UTI 14-4.

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Q. Does US West concur with the findings of the FCC's audit?

A. No. US West has disputed the FCC's findings all along, and its response to data requests in this proceeding indicate no change in that position. The FCC included US West's written opposition to the findings in its public release of the audit,[70] but in the end was not persuaded by them.

Q. Has US West provided any evidence relative to what it believes the appropriate write-off should be in Arizona?

A. While it has not addressed the question in so many words, in response to request UTI 04-030 from the Corporation Commission Staff, US West maintains that it conducted its own independent review after the FCC audit, and was able to locate all but $11,599.95 of the equipment identified as "not found" by the FCC, and further claims that appropriate retirements have already been made to reflect those findings.[71] By this response, US West seems to be contending that it has somehow taken care of the problem, and that no further adjustments are necessary.

Q. Did US West provide any details on the "independent review" it undertook?

70. US West CPR Audit, at 20.

71. US West Response to UTI-04-030.

A. Limited details were in fact provided, but certainly nothing substantial enough to undermine the results found by the FCC. PROP<<[redacted]>>ENDPROP

The timeline surrounding the audits and US West's "independent review" are interesting: FCC field auditors, accompanied by US West technical staff, first visited the PROP<<[redacted]>>ENDPROP[72] offices in the August to September 1997 time frame.[73] Following those visits on October 31, 1997, the FCC solicited, and on November 15, 1997 received, documentation from US West and the other RBOCs relative to the items of equipment that the RBOCs had claimed to have "found" so that the FCC could "rescore" the audit results where appropriate.[74] The FCC staff reviewed the documentation related to items submitted for rescoring and, where appropriate, adjusted its results. In US West's case, however, the FCC auditors did not

72. US West Response to UTI 14-4.

73. US West, Inc.'s Response to Draft Audit Findings, Audit of Continuing Property Records at 8, appended to FCC CCB ASD December 22, 1998 Audit of the Continuing Property Records of US West Telephone Operating Companies as of June 30, 1997.

74. US West CPR Audit, at footnote 27.

find that the additional documentation submitted by US West warranted re-scoring of any items.[75] The explanatory material provided by US West in response to UTI 14-4 reveals that in many cases the "independent review" that resulted in "verification" of the equipment took place in PROP<< >>ENDPROP. Other "US West found" items bear no time identifier.

Q. Does the "found" designation in the documents provided to the Corporation Commission Staff in response to UTI 14-4 represent the same items, and the same type of verification, that was presented to, and rejected by, the FCC staff in the request for "re-scoring" in November, 1997?

A. I have not seen any documentation relative to the items requested for "rescoring", but it is quite possible that several, if not all, of these "found" items have been reviewed, and not accepted, by the FCC.

Q. What kind of criteria did the FCC use in evaluating items for which "re-scoring" was requested?

A. Put in the most basic of terms, the FCC used common sense. In a Public Notice released in April of 1999, the FCC reports, for example, that in several instances it was presented with physical copies of invoices for equipment, as demonstration that the equipment was

75. *Id.*, at para. 20.

retired between the date of CPR used for the audit (June, 1997), and the time the Audit was conducted some two to three months later (referred to as an *interim retirement*).[76]

If the invoice was accompanied by some accounting record of the retirement, or a document flow (such as a telephone equipment order and confirmation by a technician reflecting removal) indicating retirement during this period, the request for "rescoring" was accepted, and the item was marked found. If the invoice was presented with no further evidence that a retirement had in fact taken place during that two to three month period (i.e., an invoice for a line item listed in the CPR purchased back in 1982 was provided, without additional evidence that it had been removed from the books during this interim period), the "rescoring" request was rejected on the basis that a copy of an invoice for a piece of equipment that couldn't physically be located "is not proof than an interim removal or retirement had occurred."[77]

The public notice goes on to recount claims that "not found" equipment was in fact embedded inside a larger piece of equipment where the auditors would have been unable to view it. During the course of the field audit, the FCC accepted such claims if they were supported by documents such as engineering drawings or manufacturers' schematics that indicated the embedded placement of such items, and the items were scored as

76. Public Notice, *The Accounting Safeguards Division Releases Information Concerning Audit Procedures for Considering Requests by the Regional Bell Operating Companies to Reclassify or "Rescore" Field Audit Findings of Their Continuing Property Records. DA 99-668*

77. *Id.*, at 4.

"found." In cases where such evidence was not proffered but the claim was considered to be credible (i.e., if the other equipment for the frame was found to be in place as listed) the item was scored as "unverified." During the "rescoring" process, the FCC solicited and accepted evidence such as the aforementioned engineering drawings and manufacturers' schematics, for these "unverified" items, and rescored them as "found." The public notice makes quite clear that "in no case where a credible claim was made that an item was embedded was the item scored as 'not found' or included in the evaluation of the cost of 'not found' items."[78]

Q. Is there evidence from which one can infer that the documentation provided by US West suffers from the type of infirmities identified above?

A. Yes. While the FCC's Public Notice does not identify any parties by name, the fact that *none* of US West's requests for rescoring were accepted indicates that they most likely did. Further, the very limited documentation provided by US West in response to UTI 14-4 includes an example of precisely the kind of problem the FCC highlights in its Public Notice. In a discussion of "rescoring" requests related to quantities of units in the CPRs, the FCC indicates that there were cases where it was provided invoices for specific quantities of equipment that purported to demonstrate that the reason the quantities of items identified in the CPR were not found was that the quantities were incorrect (in other words, the CPR says there were four terminal strips, but only three were found, and an invoice indicates that only three were ever purchased). The Public Notice indicates,

78. *Id.*, at 4.

however, that the documentation was not considered sufficient where the information on the invoices did not match the descriptions and/or costs listed in the CPRs (e.g., documents that were not contemporaneous with the equipment purchase or installation). US West has provided only PROP<<[redacted]>>ENDPROP

Q. Please explain.

A. UTI 14-4 requested "all reports, memorandum, correspondence, analyses and other documents associated with the 'independent review.'" US West's response purports to contain the "supporting documents and reports for the amount detailed in UTI 4-30." PROP<<[redacted]

[redacted]>>ENDPROP

Q. What kinds of explanations and documentation were offered for the items that were identified as "USWC found"?

A. PROP<<[redacted]>>ENDPROP. The following is an example, and in fact relates to the single largest "finding" of equipment that had been identified by the FCC as "not found." PROP<<[redacted]

[redacted]

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[redacted]

[redacted]>>ENDPROP Note that the FCC field audit has a reporting code for "partially found" items - had PROP<<[redacted]>>ENDPROP been identified at the time of the field audit, the item would have been scored as "partially found," rather than "not found." Moreover, if the FCC auditors or the US West technical staff assisting them had found PROP<<[redacted]>>ENDPROP, but were unable to match them to the CPR because, for example, of a lack of identifying numbers, the next step would have been to verify whether the total quantity of these elements in the office met the total quantity of elements recorded in the CPR for that audit (including CPR entries beyond those identified in the audit). Assuming that the total quantity in the office that could be physically verified was as great as the total quantity recorded in the CPR, the field auditors would have scored the items as "found." PROP<<[redacted]>>ENDPROP is really worth very little.

Q. Should the Corporation Commission give any weight to US West's claims that following its own internal review less than 1% of the total plant in service in the Arizona offices reviewed remained "unfound?"

A. No. None of the evidence that I have been able to review to date supports that finding. In fact, review of additional data provided by US West on field audits that it claims to have conducted on its own of PROP<<[redacted]>>ENDPROP (provided in response to UTI 11-3, Attachment B) seem to demonstrate that the FCC's findings are not atypical.

Q. Did US West's field audit of PROP<<[redacted]>>ENDPROP reveal instances where the percentage of equipment that could not be verified was as high as that indicated by the FCC's COE audit?

A. US West's own sample field audit results reveal that PROP<<[redacted]>>ENDPROP!! Although I have not examined all of the audit reports contained in the response to UTI 11-03, even my somewhat cursory review revealed PROP<<[redacted]>>ENDPROP. Consider this entry related to PROP<<[redacted]

[redacted]

[redacted]

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[redacted]

[redacted]

[redacted]

[redacted]>>ENDPROP

The Commission should make a one-time adjustment in US West's Arizona rate base to exclude assets it does not possess or does not utilize, accompanied by a going-forward reduction in depreciation accruals to reflect the new rate base and correspondingly reduced depreciation schedules.

Q. Is it reasonable for this Commission to adopt a regulatory disallowance based upon the FCC's finding of inaccurate CPR records?

A. Yes. Viewed at its most superficial level, it might be argued (and in fact the RBOCs have advanced precisely this claim) that the FCC audits demonstrate little more than the failure of the RBOCs (including US West) to maintain accurate regulatory accounting records. From this perspective, the explanation for the FCC auditors' inability to find particular assets is not that the assets are no longer useful (or perhaps may never even have been purchased), but rather that the RBOCs simply failed to track the movement of assets following the initial CPR entry. Such a notion undermines, at its most fundamental level, the very foundations of regulatory accounting and reporting: If the books and records are inconsistent with reality, blame the bookkeepers, not RBOC management. If audit results may be so lightly dismissed as merely reflecting sloppy recordkeeping rather than a systematic policy of exaggerating the basis for establishing the telephone company's rate level, there would seem to be little purpose in maintaining such records — or the regulatory machinery to review them — in the first place.

But the purpose of a regulatory recordkeeping and reporting requirement is more than an exercise in testing the accuracy of the process: Rates and rate levels are linked, directly or indirectly, to the net book value of the regulated company's rate base. RBOCs confront a substantial financial incentive to overstate that value. Whether accomplished through deliberate deception or through recordkeeping practices that have the same practical effect, the result is just as unacceptable. Indeed, there would be no purpose in auditing BOC records if, in the end, the inconsistencies are dismissed as irrelevant.

Unless affirmative action, i.e., a regulatory disallowance, is taken, the persistence of this "phantom investment" has had and will, unless corrected, continue to have a tremendous impact upon the price levels for telephone services in both the federal and state jurisdictions. While the specific genesis of the mismatch between the RBOCs' capital stock accounting records and their verifiable capital stock in place cannot be determined based upon available information, it stretches credulity in the extreme for the RBOCs in general, and US West in particular, to claim that as much as 20% of their Hard-wired COE has simply been "misplaced."

Q. What are the implications of the FCC's findings for states like Arizona where rate of return regulation is still in place?

A. The obvious implications for states employing rate of return regulation are an inflated rate base, inflated depreciation expenses, and correspondingly inflated rates. The impact of rate base inflation is compounded by its interrelationship with depreciation expenses, in that any overstatement of the rate base ends up impacting both the numerator and denominator of the traditional rate of return calculation. In a rate of return world, rate levels are generally set to achieve a specified rate of return (ROR) calculated as follows:

$$ROR = \frac{Revenues - Expenses}{RateBase}$$

Correcting to account for the findings of the FCC's audit to remove the nonexistent (or at the very least non-useful) plant would result in a reduction in the denominator (*rate base*), and a reduction in the *expense* portion of the numerator (based upon reduced *deprecation expense*). The result is that the *revenues* required to produce the same [authorized] ROR are reduced, translating into reduced prices for consumers.

Q. Dr. Selwyn, how can this "phantom investment" affect the RBOCs (and US West's in particular) depreciation amortization reserve requirements?

A. Some RBOCs have argued that the phantom investment represents little more than "delayed retirements" - that is, plant that has been fully depreciated but never removed from the books.[79] Assuming, hypothetically, that this is true, the failure to debit the plant in service account for the retired equipment combined with the failure to credit the depreciation amortization reserve account, while cancelling out any stand alone *rate base* impact from these delayed retirements, would result in the required amortization reserve being substantially overstated.

In the instant case, assuming that all $78-million of the "missing investment" as representing US West intrastate plant falls into the category of "delayed retirements", that would mean that US West's depreciation amortization reserve requirement is *overstated by as much as $78-million.*

Q. What impact does the amortization reserve requirement have upon the development of rates?

A. The level of the amortization reserve requirement impacts rates primarily in two ways, despite the fact that it is sometimes simplistically viewed as nothing more than a

79. *See*, e.g., BellSouth CPR Audit Response, January 11, 1999 at 3; Ameritech CPR Audit Response, January 11, 1999 at 12-13; and Bell Atlantic CPR Audit Response, January 11, 1999 at 14-15.

component of rate base that does not, in and of itself, have an impact upon rate levels. First, the level of the amortization reserve requirement is frequently cited as evidence that depreciation levels are too low establishing a fairly direct relationship between overstated reserve requirements and rates. Second, amortization reserve requirements that have been characterized as excessive have been a source of RBOC rate increase requests in the past.

Q. Have disallowances based upon improper or unverifiable accounting records been used as the basis for regulatory disallowances in other jurisdictions?

A, Most certainly. As an example, a 1993 review of telephone company CPR accounts associated with the analog switching equipment category (Account 2211) by the District of Columbia Public Service Commission (DCPSC) resulted in a significant disallowance. In particular, the DCPSC disallowed depreciation expense associated with the "unverifiable" items found in those accounts, which translated into rates being set for District consumers that were nearly half a million dollars lower than they would otherwise have been.[80] This type of relatively conservative action (conservative, since there was no downward adjustment to rate base to reflect the "unverifiable" investment) can be implemented as a straightforward expense disallowance in rate of return jurisdictions, or as an exogenous adjustment in jurisdictions regulating via some form of price caps regulation.

80. District of Columbia Public Service Commission Formal Case Number 926, Order 10353, released December 21, 1993, 148 PUR 4th 181.

Q. What should the Arizona Corporation Commission do here?

A. The Corporation Commission should make a one time adjustment to cause the Company's rate base to reflect only those assets it actually has purchased *and* is using, accompanied by a going-forward reduction in rate levels to reflect the new rate base and correspondingly reduced depreciation schedules. AT&T witness Susan Gately estimates the revenue requirement effect of this recommendation in her testimony. This the most conservative and straightforward solution. Even so, while this approach can work to establish valid rates from the decision date forward, it will still do little or nothing to penalize the utility for its misreporting, nor capture for ratepayers any portion of the excessive amounts that they have paid in past years.

COMPENSATION FOR TRANSFER OF YELLOW PAGES

USWC should continue to be required to impute a level of yellow pages revenue that it would have continued to earn were the ILEC still in the business of publishing yellow pages directories.

Q. Is there a specific, historical linkage between yellow pages and local telephone service?

A. Indeed, yes. Prior to 1984, USWC's predecessor company, Mountain States Telephone and Telegraph Company ("Mountain Bell") was in the business of publishing both white and yellow pages directories and distributing them to its customers in Arizona and, for that matter, in the other seven states in which Mountain Bell was providing local telephone service. The directory publishing business — and particularly the yellow pages business — had been highly profitable, generating some substantially more in advertising revenues in excess of the costs of the publication activity itself. Like other incumbent LECs throughout the country, Mountain Bell had used the "profit" from its yellow pages advertising business to contribute to the cost of basic exchange service, thereby producing a lower residual (post-yellow pages contribution) revenue requirement than would have existed absent the yellow pages advertising revenue.

At the time of the break-up of the former Bell System in 1984, US West and its sister Bell Operating Companies (BOCs) were permitted to retain the yellow pages directory business specifically because yellow pages revenues had been and would continue to be used to financially contribute to the overall operation of the BOC, resulting in local service rates that would be lower than they otherwise would absent such contribution.

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When the terms of the MFJ were initially announced on January 8, 1982, the yellow pages were to be assigned not to the Bell Operating Companies, but instead to AT&T. In the *Tunney Act* proceeding that followed the initial settlement agreement by AT&T and the Department of Justice, the BOCs, many state public utilities commissions and the National Association of Regulatory Utility Commissioners (NARUC) argued strongly for the retention of the yellow pages business by the BOCs *expressly because of the enormous amount of revenue that was contributed by yellow pages to support basic exchange access services.*

In response to these arguments, US District Court Judge Harold H. Greene determined that the yellow pages should be retained by the BOCs. In an Order adopting the MFJ issued August 24, 1982, Judge Greene concluded that the yellow pages "provide a significant subsidy to local telephone rates [that] would most likely continue if the [BOCs] were permitted to continue to publish the Yellow Pages."(*U.S. v. AT&T*, 552 F. Supp. 131, 193-194 (D.D.C. 1982)). He went on to state:

> The loss of this large subsidy would have important consequences for the rates for local telephone service. For example, the State of California claims that a two dollar increase in the rates for monthly telephone service would be necessary to offset the loss of revenues from directory advertising. Other states assert that increases of a similar magnitude would be required.(Id. at 194.)

Q. What is the current status of yellow pages publishing and revenue generation within USWC's operating areas in Arizona?

A. Despite the guidance provided by the Court, following the break-up of the former Bell System and the creation of US West Corporation, US West's directory publishing business was permitted to be transferred from the three US West operating telephone companies (Mountain Bell, Northwestern Bell, and Pacific Northwest Bell) to a separate directory publishing subsidiary of US West Corporation known as US West Direct. Even though Mountain Bell's Arizona Yellow Pages publishing business had significant economic value as a "going concern," no specific compensation was paid by US West Direct or US West Corporation for the extraction of this valuable business asset from the operating telephone company. Instead, under the terms of the transfer, the amount of the yellow pages advertising contribution that otherwise would have been realized by Mountain Bell was to be "imputed" as a revenue to Mountain Bell on an ongoing basis.

Q. What is USWC proposing with respect to yellow pages revenue imputation in this proceeding?

A. USWC is in this proceeding seeking to discontinue the annual yellow pages revenue imputation.

Q. What basis is offered for this initiative?

A. According to USWC witness Ms. Ann Koehler-Christensen, the "market price" for the "right to publish directories" "is zero."[81] Ms. Koehler-Christensen contends that US

81. Koehler-Christensen (USWC), Supplemental Direct, at 13.

West Direct (now known as DEX) makes explicit payments, in the form of fees for directory listings, for the services it receives from USWC, and that no imputation of value in excess of those fees is appropriate.

Q. Is Ms. Koehler-Christensen's argument valid?

A. No, it is not. Ms. Koehler-Christensen conveniently ignores the history and circumstances relating to the acquisition of the Arizona yellow pages business by US West Direct and, as such, raises largely irrelevant arguments in support of her proposition that the telephone company is entitled to no compensation other than for certain explicit services currently being received by DEX. Indeed, Ms. Koehler-Christensen appears actually to contend that USWC now receives more value from DEX than DEX receives from USWC:

> ... the current agreement ... obligates DEX to deliver Yellow Pages directories at no charge to U S WEST or it's [sic] customers and also to offer complimentary Yellow Pages listings to each of U S WEST's business customers. ...
>
> 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. ...
>
> All the costs were incurred by DEX and were not passed on to U S WEST. ...

Q. How is the benefit reflected in US West's financial statements?

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A. 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. U S WEST would have incurred an additional $12.8 million in order to meet this obligation. This means that not only would U S WEST's expenses have been $12.8 million higher, the revenue requirement would have been approximately $12.8 million higher as well.[82]

This last observation by Ms. Koehler-Christensen is particularly misleading and is obviously wrong on its face. In fact, "[i]f DEX had not published and distributed Arizona directories to U S WEST's customers under the terms of the Publishing Agreement," USWC would have generated some PROP<< >>ENDPROP (in the test year) of *revenues* from Arizona yellow pages advertising,[83] revenues that have been *diverted* to DEX under the 1984 and subsequent "Publishing Agreements." Offsetting these revenues with the costs that would have been incurred to produce the Arizona directories, "the revenue requirement would have been approximately" PROP<< [84]>>ENDPROP *lower* than it would be under the current structure and assuming no imputation, as Ms. Koehler-Christensen here seeks to achieve. If USWC were still in the Yellow Pages business in Arizona and if it were to have spread the test year Yellow Pages contribution of PROP<< >>ENDPROP across

82. *Id.*, at 3-4.

83. Response UTI-47-013, Confidential Attachment A.

84. *Id.* DEX operating expenses allocated to Arizona were PROP<< >>ENDPROP, resulting in a net profit in the amount stated in the text.

the 2.86-million residential access lines that USWC currently serves in Arizona,[85] the Company would have been able to reduce the average residential access line rate by roughly PROP<< >>ENDPROP per month relative to its existing level.

Q. Why do you say that the arguments being advanced by Ms. Koehler-Christensen are largely irrelevant?

A. The basis for Ms. Koehler-Christensen's position is the *current* relationship between USWC and DEX. Even if, as she contends, DEX receives no ongoing value from USWC (which is probably a gross exaggeration of actual conditions), that fact would not invalidate the economic basis for the ongoing imputation of yellow pages profits into USWC's revenue requirement.

Q. Please explain.

A. There are several separate bases for maintaining imputation even if DEX receives no current value from USWC. First is the fact that when the Arizona Yellow Pages business was transferred out of Mountain Bell and over to the nonregulated affiliate in 1984, Mountain Bell received no compensation for the "going business value" of its Arizona Yellow Pages business. The "going business value" was the then-Net Present Value (NPV) of all future profits that Mountain Bell would have realized had it remained in the Yellow Pages business in Arizona. Absent a one-time payment to the regulated entity for

85. 1999 ARMIS Report 43-08, Table 2, *Switched Access Lines In Service by Technology*

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the transfer of this valuable business asset to a nonregulated affiliate, the annual imputation could be thought of as a "rent" being paid by DEX for the business asset that it had been given back in 1984.

Q. But doesn't Ms. Koehler-Christensen also contend that the Yellow Pages business is competitive, that there are other directory publishers in the Arizona market, and that as such DEX could be in the yellow pages business today even if it had never been given the Arizona Yellow Pages business back in 1984?

A. Yes, that is the essence of her argument, but it fails for a number of reasons. Incumbent LECs do not confront any consequential competition for their yellow pages directories. For all practical purposes, this is a monopoly business for which the prospect of effective competition is extremely remote. Although ILECs frequently point to the presence of other directories as well as the use by others of the ILEC's subscriber lists and exchange carrier lists, there is no evidence that any one of these alternatives poses any serious competitive threat to the ILECs' monopoly control over the yellow pages market. Indeed, the sustained large profit margins that ILECs have been able to amass and retain from their yellow pages business confirms the lack of effective competition and the presence of pervasive market power.

The yellow pages directory business is characterized by extreme "network externalities" that have made it a de facto monopoly in most markets.

Q. You are not suggesting, are you, that there are any legal barriers to entry by competitors into the yellow pages business, electronic or paper?

A. No, and in fact, competitive entry is allowed as a legal matter. However, as a *practical* matter, this is the type of business activity that typically has only a single dominant provider, due to the presence of formidable, perhaps even insurmountable, economic entry barriers. And once an incumbent has achieved the critical mass to become the dominant provider, it would be virtually impossible for any other firm to "crack" that market dominance. In fact, an examination of competition in the "Yellow Pages" business around the country will confirm that in virtually every instance the entrant's activity is limited to a particular market niche that is not directly served by the incumbent Yellow Pages publisher.

Q. Upon what facts do you base this statement?

A. Shortly after the divestiture, there was a flurry of competitive activity in the Yellow Pages area. For example, Southwestern Bell's directory publishing affiliate tried to compete with New York Telephone by offering its own Manhattan Yellow Pages. Donnelley Directory, a division of the R. H. Donnelley Company, a firm that had long been in the business of publishing and marketing yellow pages directories under contract with Bell and non-Bell local telephone companies, attempted to enter the yellow pages business *de novo* in several markets. Significantly, and notwithstanding the fact that these ventures were initiated by well-financed firms with considerable experience in and knowledge of the directory publishing business, none of them has succeeded in making any consequential inroads into this market. The essential point here is that *had USWC remained in the Yellow Pages business after 1984, there is no possibility that DEX or any other entity could have successfully "taken the market" away from USWC if forced to compete on an arm's length basis.*[86]

Q. What is the explanation for this market outcome?

A. Generally, products/services of this type have a tendency to support only a single provider. The reason for this phenomenon can best be explained by thinking of the directory product as performing a "switching" or an "exchange" function, bringing advertisers together with users and transferring information from the former to the latter. The demand exhibited by individual advertisers and consumers for a particular yellow pages directory, like that for many other products and services that perform switching or exchange functions, is heavily influenced by the actions of other advertisers and consumers with respect to the product.

In economic theory, such demand is said to be influenced by "externalities;" that is, one's demand for access to the "information exchange" function supported by a given

86. That is, assuming that inasmuch as USWC remained in the Yellow Pages business, it would have treated DEX, although an affiliate, no differently than any nonaffiliated rival.

yellow pages product is heavily influenced by the aggregate number of *other* advertisers and users who participate in the exchange. Advertisers are more willing to advertise in, and pay higher rates for, directories with large, perhaps ubiquitous circulation; consumers are more likely to select and use the directory that has the largest compilation of listings and advertisements. No competing directory publication comes even close to the level of user acceptance and penetration that can be found in the incumbent LECs' books.

Moreover, each time a business decides to include its listing in the directory, it increases the value of the directory to consumers and makes it all the less likely that consumers will elect to use a competing book. Indeed, ILECs are constantly promoting precisely this characteristic of their yellow pages directories.

Q. How does the lack of competition in the yellow pages business impact the financial risk faced by US West Direct and its successor company, DEX?

A. Because the yellow pages business engaged in by DEX is a non-competitive line of business, the company has faced substantially less financial risk than would be confronted by firms operating in competitive markets.

Q. How did USWC and the other ILECs come to dominate the yellow pages business?

A. USWC's dominance of the yellow pages business arose because the Company has long dominated the local telephone business in this state and as such retained total control over the business customer data base upon which its yellow pages business was built. Long before anyone spoke of competition in this or in any other sectors of the telephone industry, then-Mountain Bell developed its yellow pages business as a derivative of its exclusive franchise to provide local telephone service on a monopoly basis. Mountain Bell did not come to dominate the directory business by its initiative, management skill, investment, or risk-taking; it did so solely because it was the sole provider of local telephone service and as such owned the underlying customer data bases and had established business relationships with virtually all of the potential advertisers in its yellow pages books. By the time that competition was nominally introduced into the Yellow Pages business, the incumbent LEC had amassed fortress-level dominance of the Yellow Pages directory market.

US West's Yellow Pages directory publishing business maintains an extraordinary degree of fortress-level market power in the Arizona Yellow Pages market.

Q. Is there evidence in this proceeding that DEX is not facing any significant competition in the Arizona Yellow Pages market?

A. Indeed there is. DEX plainly continues to dominate the Arizona Yellow Pages market. DEX generated PROP<<[redacted]>>ENDPROP in Arizona Yellow Pages pre-tax profits during the test year on total Arizona revenues of PROP<<[redacted]>>ENDPROP, representing a truly extraordinary profit margin of

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PROP<<>>ENDPROP on sales. This level of profit could never be sustained under competitive market conditions.

Q. Is it possible to estimate DEX's rate of return on total investment?

A. I have attempted to do so. Although we do not have a balance sheet for DEX and hence do not have a figure for either total assets or total net worth, the 1999 income statement that was provided in response to UTI-47-013 does contain the 1999 annual depreciation accrual, which was PROP<<>>ENDPROP for the total DEX operation. Using the jurisdictional expense allocator for Arizona of PROP<<>>ENDPROP that is also provided in the same response, the 1999 depreciation accrual for Arizona would have been PROP<<>>ENDPROP. Assuming that most of DEX's assets consist of office furniture and equipment, motor vehicles, and printing equipment that is depreciated per IRS regulations over 5 years or less,[87] we can estimate the total DEX Arizona asset base at roughly PROP<<>>ENDPROP. Based upon that estimate and using the DEX Arizona net income of PROP<<>>ENDPROP, I have calculated an approximate value for DEX's realized rate of return for 1999 at PROP<<>>ENDPROP.

Q. Have you attempted to estimate US West's return on its directory business using public, i.e., non-proprietary, data?

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87. *See*, Internal Revenue Service Publication 946, Appendix B, Tables B-1 and B-2.

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A. Yes. US West's Annual Report for 1999 identifies certain financial data for the "Directory Services segment" that appears to include more than DEX, since the revenues and pre-tax profits identified for the "Directory Services segment" as shown in the Annual Report PROP<<[redacted]>>ENDPROP. According to the Annual Report data, total Directory Services revenues were $1.446-billion; "margin," which I interpret to mean segment profits before income taxes, is given at $741-million, and assets assigned to this sector were identified as $819-million.[88] Based upon these figures, the "Directory Services segment" would be generating a return on investment of 90.5%. While this figure is significantly below my PROP<<[redacted]>>ENDPROP estimate for DEX's realized rate of return, its overall magnitude is still entirely consistent with the conclusion that US West maintains fortress-level market power in the directory business.

Q. What portion of US West's total profits are attributed to its directory business?

A. According to US West's Annual Report for 1999, Directory Services segment profits ("margin") were $741-million. Total US West profit from all of its various business activities, including the operating telephone companies and various other ventures, was $1.902-billion. Thus, while the directory business accounts for only 11% of US West's total revenues,[89] the segment generates 39% of US West's pre-tax operating profits.

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88. US West 1999 Annual Report, p. F-25, *Notes to Consolidated Financial Statements.*

89. *Id.* Directory Services segment revenues for 1999 were $1.446-billion; total US West revenues for 1999 were $13.182-billion.

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Q. What conclusion do you reach based upon these net income and rate of return figures?

A. If the market were as competitive as Ms. Koehler-Christensen claims, there is no practical means by which DEX could maintain the extraordinarily high profit levels that it continues to enjoy. Firms operating in competitive markets simply cannot amass *and maintain* returns on investment of the magnitude exhibited by US West's directory business.

Q. Are there any other indications, based upon the evidence offered by USWC, of the presence of substantial market power in DEX's operations?

A. Yes. The fact that DEX is able to obtain listing information from ICOs and CLECs without paying them is additional evidence of DEX's market power. Both the LECs and DEX benefit from the additional listings; however, since DEX dominates the yellow pages business and the smaller LECs cannot afford to have their subscribers excluded from being listed in the DEX directories, they are in no position to demand compensation from DEX for those listings even if DEX benefits as well. If DEX were competing on an equal footing with several competitive directory publishers, it might well have to compensate unaffiliated carriers for their listings, in order to furnish its customers with the fully comprehensive directories it now produces without incurring such costs.

Moreover, while conceding the fact that DEX obtained substantial incumbency benefits from the preexisting relationship with Mountain Bell, Ms. Koehler-Christensen now gives no effect to the ongoing benefit of those initial incumbency benefits in valuing the USWC/DEX relationship.

Q. To what specific incumbency benefits are you referring?

A. Mountain Bell had been in the Yellow Pages business in Arizona for decades. Customers were accustomed to using the Mountain Bell Yellow Pages, and advertisers, relying upon that fact, would place their ads and listings in the Mountain Bell Yellow Pages as a matter of routine. When US West Direct took over the Mountain Bell Yellow Pages, all of those relationships went along with the transfer. In fact, Ms. Koehler-Christensen herself concedes that the Mountain Bell name, which continued to appear on the US West Direct Yellow Pages, was important in establishing US West Direct as the heir to the Mountain Bell Yellow Pages Business:

> From 1984 through mid-1988, DEX published their [sic] Arizona directories with Mountain Bell's name on the cover. U S WEST DIRECT (now DEX) was created in 1984 and their [sic] name was new and an unknown. The three telephone companies, Mountain Bell, Northwestern Bell and Pacific Northwest Bell, had name recognition. Although at divestiture these three companies combined to make up the new U S WEST RBOC, they retained their individual names and continued to do business with their established names and reputations. *In this way, DEX was able to capitalize on both the name recognition and the business relationship that Mountain Bell had with its Yellow Pages advertisers.*[90]

Ms. Koehler-Christensen went on to explain that

90. Koehler-Christensen (USWC) at 15, emphasis supplied.

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> In mid-1988 DEX made the decision to publish its directories without Mountain Bell's name on the cover. By 1988, however, the U S WEST DIRECT name was well known and the publisher had established its own relationship with advertisers.

While all of that may well have occurred, it cannot alter the fact that the initial hand-off of advertisers and users from Mountain Bell to US West Direct was orchestrated in a manner that, as Ms. Koehler-Christensen states, enabled US West Direct "to capitalize on both the name recognition and the business relationship that Mountain Bell had with its Yellow Pages advertisers." When US West Direct took over the Yellow Pages business in 1984, Mountain Bell simultaneously exited the market, affording US West Direct *all* of the same incumbency advantages that had been previously enjoyed by Mountain Bell. The fact that US West Direct subsequently developed an independent name recognition does not and cannot vacate the enormous *and ongoing*, even today, value of the pre-transfer Mountain Bell Yellow Pages business and its relationships with users and advertisers. And if there is any doubt as to the enormous value of the incumbency in the Yellow Pages business that Mountain Bell conveyed to DEX, one need look no further than the extraordinary rate of return that DEX is generating from its Yellow Pages operations.

Q. Is there an alternative to continuing the annual imputation that would nevertheless be fair to USWC's customers in Arizona?

A. Yes. As I have explained, at the time that the transfer of the Yellow Pages business from Mountain Bell to US West Direct took place in 1984, US West Direct never compensated

Mountain Bell for the fair market value of the directory business. If imputation is to cease from this point in time forward, DEX should be required to "buy" the Yellow Pages business from USWC at its *current* fair market value.

Q. Can you provide an approximate estimate of what that fair market value would be?

A. I have not performed a detailed valuation analysis, and thus cannot offer a precise figure. However, I have attempted to develop a range of possible values using two different methods:

- In 1997, the US West Board of Directors valued DEX at $4.75-billion for purposes of the MediaOne spin-off.[91] Using the PROP<< >>ENDPROP Arizona allocation factor, the value of the Arizona Yellow Pages business would be approximately PROP<< >>ENDPROP. This is an extremely conservative estimate in that it does not account for the appreciation in value that has occurred since the MediaOne estimate was developed some two years ago. It also ignores the more recent arm's length transaction between Qwest and US West, under which Qwest acquired US West and, by virtue of that acquisition, acquired DEX as well.

- The market value of the Arizona Yellow Pages operation can also be estimates based upon the arm's length transaction that occurred when Qwest acquired US West.

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91. SEC Form 8-K/A, dated April 13, 1998.

Qwest paid some $44.1-billion in Qwest stock for US West.[92] Since the directory business represents 39% of US West's pre-tax profits, the implicit value of the directory business can be estimated at 39% of the $44.1-billion US West acquisition amount, or some $17.2-billion. That 39% factor may well be conservative, in view of the continual growth in US West's directory revenues and profits. Arizona represents PROP<<[redacted]>>ENDPROP of DEX's total operations, suggesting that the Arizona Yellow Pages business is worth roughly PROP<<[redacted]>>ENDPROP.

Thus, if imputation is to cease, USWC must be compensated for the fair market value of the asset that was transferred to DEX; that fair market value is at least PROP<<[redacted]>>ENDPROP and may well be as much as PROP<<[redacted]>>ENDPROP.

92. According to a Qwest press release dated June 30, 2000, Qwest issued 882-million shares of stock worth $50 a share, for a total value of $44.1-billion. www.qwest.com/splash/merger/pressrelease.html

The use of yellow pages revenue to defray a portion of the cost of providing local telephone service is entirely consistent with economic theory as demonstrated by analogous, long-standing practices in other media.

Q. Notwithstanding the *historic* linkage that you have described as between yellow pages and local telephone service, it has been argued that there is no basis other than historic for utilizing revenue from the former to defray a portion of the costs of the latter. Do you agree?

A. No, I do not. In fact, the historic basis for using yellow pages revenues as a source of contribution to the cost of local telephone service has its foundation in economic theory, and provides compelling economic justifications for this policy. In the late 1800s and early 1900s, and long before regulators and other policymakers *told* incumbent LECs to price basic residential access lines at "affordable" levels and thereby support the public policy goal of universal service, LECs were setting low residential access line rates, sometimes even below cost, *because it was in their own self-interest to do so*. This was because the same kinds of externalities that operate on the demand for yellow pages advertising also affect the demand for essential access to the public network. The larger the membership of the network (i.e., the more subscribers that are connected to it), the more valuable the overall network becomes to each individual subscriber, because more people can now be reached by telephone. It was thus in the LECs' interests to promote universal service because the more universal the network became, the more valuable it became, and the more valuable it became, the more the LEC could ultimately charge for its services. In order to induce residential customers to join the network, LECs typically set rates for "dial tone" sufficiently low so as to stimulate demand, using derivative services, such as toll calling *and yellow pages advertising*, to make up the shortfall.

Yellow pages directories serve primarily *local* markets. That is, the yellow pages directory for a given city, which contains listings of businesses and professionals offering products and services in that community, are utilized almost exclusively by *local* telephone subscribers in that immediate area. The local yellow pages directory is distributed without charge to all households and businesses in the coverage area. Like other advertising media, the willingness of advertisers to pay for their listings and advertisements is directly related to the *circulation* of the book; put another way, the *value* of the yellow pages directory to advertisers is directly related to the total number of telephone subscribers in the coverage area. Moreover, that value is not diminished merely because some individual subscribers may elect to take their local phone service from a competing local carrier, since they would continue to have access to — and to utilize — the incumbent LEC's directory in any event. That yellow page advertisers are willing to pay rates that provide financial contribution toward — and hence that help to achieve — universal residential penetration is confirmed by their continued willingness to do so *despite the fact that these rates are set well in excess of the costs of actually producing the books themselves*. Indeed, absent near universal residential telephone penetration (and all other things being equal), advertisers would likely not be willing to pay as much for their advertising presence in the Yellow Pages books.

I have already noted the fundamentally monopolistic character of the Yellow Pages directory that results from the substantial externalities that have developed over the many years in which the incumbent LEC was the sole monopoly provider of local telephone service. The Yellow Pages monopoly permits the incumbent LEC to set Yellow Pages rates that are greatly in excess of the actual costs of the books themselves.

Q. Is this situation unique to the Yellow Pages industry?

A. No, it certainly is not. The use of advertising revenues to "pay" a portion of the costs of products and services used by consumers is extremely common: Newspapers, magazines, radio and television broadcasters, Internet portals, and other media use revenues derived from advertising to pay for the content of their publications and broadcasts; consumers would not read a newspaper, spend time listening to the radio, or watch television if *only* advertisements, and no content, were carried by these media. Thus, advertisers' fees go to defray the costs of the ads themselves as well as to *contribute* to (and in some cases pay 100% of) the costs of producing programs and writing articles, without which there would be no audience for the ads. Consumers, on the other hand, pay for that content indirectly, through the prices of the various goods and services they purchase from the companies that advertise on the programs they watch and publications they read.

Q. How does this relate to Yellow Pages?

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A. A Yellow Pages telephone directory derives its value, both to advertisers and to the LEC that publishes it, directly from the existence of high penetration to the local network. By paying rates for advertisements that help to achieve such high penetration, Yellow Pages advertisers assure an audience for their insertions that is fully analogous to what is achieved by the sponsor of a TV program in helping to create an audience for the sponsor's message. If one accepts the notion that support of primary residential access at some level is *necessary* in order to assure the achievement and maintenance of high penetration of local telephone service, then the use of Yellow Pages advertising — which benefits directly from this universality — as a source of funding is both appropriate from a policy standpoint and economically efficient: Subscribership to basic residential service creates the externalities that stimulate demand for Yellow Pages advertisements. If consumers will not take telephone service at a price that the LEC would be required to charge absent Yellow Pages contributions, and if Yellow Pages advertisers are willing to pay rates that provide such contributions in order to expand the size of their audience, then social welfare is maximized when the Yellow Pages profits are generated and applied in this manner. Indeed, economic efficiency and social welfare goals are diminished when the substantial profits that are generated by the incumbent LEC from yellow pages advertising are diverted to the LECs' shareholders rather than being used to support the goal of high penetration of local telephone service. As I have noted above, were USWC still publishing the Arizona Yellow Pages directories and were it flowing the contribution therefrom to reduce residential rates, those rates would be some PROP<<[redacted]>>ENDPROP lower per month than their current levels.

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Q. Is it appropriate to characterize Yellow Pages revenues as "subsidizing" basic residential service?

A. No. Basic residential telephone service is a complex amalgam of features and functionalities that confer value in varying ways upon the markets that they serve. For some customers, the "value" of a residential access line is solely that of connectivity to essential and emergency communications; for others, it can support a variety of social, business and employment needs. Customers elect specific service configurations based upon the manner in which they individually perceive the service as conferring value to them; for example, some customers see great value in certain vertical features like call waiting and caller ID, and are willing to pay grossly above-cost prices for these capabilities, while others may see little or no value, and will pay nothing for these features. One might argue that the call waiting/caller ID customer is "subsidizing" the user of a basic, stripped-down access line, particularly if there is no consequential cost difference between the feature-laden and the bare-bones services. All else being equal, if the ILEC were required to charge only a cost-based price for vertical features, that "price" would be at or near zero, and the resulting "price" of the basic dial tone line would have to be increased.

Public policy has long tolerated the use of "value metrics" such as high-value optional features as a means for achieving price discrimination between customers who perceive high vs. low value from their telephone service. Similarly, if Yellow Pages advertisers are willing to pay advertising and listing fees that are set well in excess of cost because they perceive this type of access to the residential market as affording considerable value to their businesses, it is no less unreasonable to utilize Yellow Pages profits in precisely the same manner as vertical features profits have been used — to permit the basic dial tone rate to be set lower than it would otherwise be. Since both residential consumers and Yellow Pages advertisers derive value from residential access line penetration, this method of cost recovery simply apportions that value more broadly than if confined solely to residential customers.

What is *unreasonable* and without any economic rationale or justification would be a policy that permits USWC to charge excessive rates for vertical features and Yellow Pages advertisements and *not* apply the revenues derived therefrom against USWC's regulated revenue requirement, i.e. to divert those profits entirely and exclusively to shareholders.

The Washington Utilities and Transportation Commission has just rejected a similar effort by USWC to eliminate the yellow pages imputation in Washington State.

Q. Dr. Selwyn, have any other regulatory commissions adopted the position you are recommending here with respect to the imputation of yellow pages revenues?

A. Yes, in fact, on July 27, 2000, the Washington Utilities and Transportation Commission (WUTC) issued an order denying USWC's Petition "for an accounting order ending the Commission's practice of imputing, for ratemaking purposes, certain 'excess income'

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earned by an affiliate in publishing directories of USWC subscribers and associates 'Yellow Pages' commercial classified directory listings."[93]

Q. Did you participate in that proceeding?

A. Yes, I testified as a witness for the WUTC Staff.

Q. Were the issues raised and the arguments advanced by USWC in the WUTC case similar to those being raised and advanced by USWC here in support of its effort to eliminate Yellow Pages imputation?

A. Yes, in fact, they were virtually identical.

Q. What conclusions did the WUTC reach with respect to both the Company's arguments and your recommendations?

A. The Washington Commission rejected all of USWC's contentions relating to the nature of the transaction in which the yellow pages business was transferred out of (then) Pacific Northwest Bell (PNB) and into the US West directory publishing affiliate, and adopted substantially all of the specific conclusions and recommendations that I and the WUTC Staff had developed with respect to this issue. It concluded that no such transfer had actually occurred, and that the nature of the transaction was a temporary "outsourcing" or

93. WUTC Yellow Pages Order, *supra.*, footnote 4, at 1.

"lease" of the publishing activity to the affiliate with the telephone company retaining all of its interest in the yellow pages business and the revenues that the yellow pages generated.[94] The Commission rejected USWC's contentions, advanced by Ms. Koehler-Christensen, that its ongoing imputations constituted a series of installment payments against the "fair market value" of the yellow pages business as of 1984, when the affiliate assumed responsibility for producing the directories.[95]

The Commission rejected the Company's contentions that the directory business did not benefit from the trademark recognition associated with the US West affiliation:

> Finally, some of Mr. Johnson's testimony relating to trademarks is not credible. We find no indication that the logo of U S WEST Communications, Inc., connotes in the popular view an entirely different company from that connoted by any other U S WEST corporate family logo. We find it not credible that consumers see the U S WEST Communications logo, with its stylized U S WEST lettering, see the identical U S WEST lettering with the name "Dex," and view them as totally distinct and unrelated companies as opposed to related products under a single umbrella. In any event, the substitution of the U S WEST logo for that of PNB was a choice made by U S WEST, Inc. and PNB and should not be used to justify the evaporation of any publishing rights or financial benefits previously held by PNB.[96]

Finally, the Washington Commission concluded that "USWC retains the [yellow pages directory] asset, both by the factual history of the transaction [in which then-Pacific

94. *Id.*, at para. 154, p. 40.

95. *Id.*, at paras. 145, 146, p. 38.

96. *Id.*, at para. 151, pp. 39-40.

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Northwest Bell transferred its yellow pages business to the US West directory affiliate] and as a matter of law."[97]

Q. In this proceeding, USWC is seeking to eliminate the current $43-million imputation of yellow pages profits. You have recommended that this imputation be retained. However, based upon the WUTC order, would you now recommend any other modifications to the present imputation policy?

A. Yes. As I have just noted, the WUTC found that "USWC retains the [yellow pages directory] asset." As such, *all* of the profits associated with the Yellow Pages business should be imputed for ratemaking purposes, not just the $43-million, which approximated the annual Arizona profit level extant in 1984. As I have noted, DEX reports pre-tax profits attributable to its Arizona directories for 1999 at PROP<< >>ENDPROP. That amount, and not the $43-million, should be the annual imputation for 1999. It is also apparent that the Yellow Pages is a growth business and that continued increases in annual profits can be expected over the coming years. In determining the imputation amount for this general rate case, the Commission should consider the projected growth in Arizona Yellow Pages profits over the next several years, and should apply a levelized imputation amount against the annual revenue requirement that is determined in this proceeding.

97. *Id.*, at para. 169, p. 44.

CONCLUSION

Q. Please summarize your overall recommendations with respect to US West's proposals in this proceeding.

A. My recommendations are as follows:

- The Commission should reject US West's pricing flexibility proposals that were bundled into the current rate case proceeding. US West still exercises significant market power throughout the local exchange market in Arizona, despite the presence of competitors in a number of its urban wire centers. The evidence presented by US West simply does not substantiate its claim that it requires the broad additional pricing flexibility it proposes here in order to respond effectively to the prices and service offerings of new entrants.

- The Commission should resist piecemeal dismantling of the prevailing rate-of-return regulation regime as a means of accommodating even legitimate requests for deregulation and pricing flexibility by US West, unless it is prepared to undertake the requisite complex cost allocation decisions that must be made to ensure that the services that remain under regulation are not burdened with investments made in whole or in part to support the deregulated services. A well-specified price regulation plan, which this Commission has the authority to adopt, would permit the Commission to provide US West with selective pricing flexibility *for truly competitive services* with far less adverse exposure to customers of noncompetitive services.

- In determining US West's revenue requirement, the Commission should be informed by the results of FCC Staff audits of the Continuing Property Records (CPRs), maintained by the Regional Bell Operating Companies as of June 30, 1997. The audits revealed a pattern of systematic overstatements of capital investments on the RBOCs' books relative to assets physically present in their networks — including those of US West's Arizona operations.

- The Commission should repudiate US West's proposal to discontinue the annual $43-million imputation of Yellow Pages contribution. Contrary to its claims, US West's directory publishing affiliate, DEX, continues to possess fortress-level market power in the Arizona Yellow Pages business, and that position is directly attributable to the telephone company's incumbency in that business prior to 1984. The Commission should *increase* the amount of the Yellow Pages imputation to the entirety of the Yellow Pages profits generated by DEX that are attributable to Arizona. The only fair alternative, if imputation were to be discontinued, would be a one-time payment — by DEX to US West — to compensate US West and its customers for the current fair market value of the Arizona Yellow Pages business, which I estimate to be at least PROP<< >>ENDPROP and may well be as much as PROP<< >>ENDPROP.

Q. Does this conclude your direct testimony at this time?

A. Yes, it does.

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Attachment 1

Statement of Qualifications

DR. LEE L. SELWYN

Dr. Lee L. Selwyn has been actively involved in the telecommunications field for more than twenty-five years, and is an internationally recognized authority on telecommunications regulation, economics and public policy. Dr. Selwyn founded the firm of Economics and Technology, Inc. in 1972, and has served as its President since that date. He received his Ph.D. degree from the Alfred P. Sloan School of Management at the Massachusetts Institute of Technology. He also holds a Master of Science degree in Industrial Management from MIT and a Bachelor of Arts degree with honors in Economics from Queens College of the City University of New York.

Dr. Selwyn has testified as an expert on rate design, service cost analysis, form of regulation, and other telecommunications policy issues in telecommunications regulatory proceedings before some forty state commissions, the Federal Communications Commission and the Canadian Radio-television and Telecommunications Commission, among others. He has appeared as a witness on behalf of commercial organizations, non-profit institutions, as well as local, state and federal government authorities responsible for telecommunications regulation and consumer advocacy.

He has served or is now serving as a consultant to numerous state utilities commissions including those in Arizona, Minnesota, Kansas, Kentucky, the District of Columbia, Connecticut, California, Delaware, Maine, Massachusetts, New Hampshire, Vermont, New Mexico, Wisconsin and Washington State, the Office of Telecommunications Policy (Executive Office of the President), the National Telecommunications and Information Administration, the Federal Communications Commission, the Canadian Radio-television and Telecommunications Commission, the United Kingdom Office of Telecommunications, and the Secretaria de Comunicaciones y Transportes of the Republic of Mexico. He has also served as an advisor on telecommunications regulatory matters to the International Communications Association and the Ad Hoc Telecommunications Users Committee, as well as to a number of major corporate telecommunications users, information services providers, paging and cellular carriers, and specialized access services carriers.

Dr. Selwyn has presented testimony as an invited witness before the U.S. House of Representatives Subcommittee on Telecommunications, Consumer Protection and Finance and before the U.S. Senate Judiciary Committee, on subjects dealing with restructuring and deregulation of portions of the telecommunications industry.

In 1970, he was awarded a Post-Doctoral Research Grant in Public Utility Economics under a program sponsored by the American Telephone and Telegraph Company, to conduct research on the economic effects of telephone rate structures upon the computer time sharing industry. This work was conducted at Harvard University's Program on Technology and Society, where he was appointed as a Research Associate. Dr. Selwyn was also a member of the faculty at the College of Business Administration at Boston University from 1968 until 1973, where he taught courses in economics, finance and management information systems.

Dr. Selwyn has published numerous papers and articles in professional and trade journals on the subject of telecommunications service regulation, cost methodology, rate design and pricing policy. These have included:

"Taxes, Corporate Financial Policy and Return to Investors"
National Tax Journal, Vol. XX, No.4, December 1967.

"Pricing Telephone Terminal Equipment Under Competition"
Public Utilities Fortnightly, December 8, 1977.

"Deregulation, Competition, and Regulatory Responsibility in the Telecommunications Industry"
Presented at the 1979 Rate Symposium on Problems of Regulated Industries - Sponsored by: The American University, Foster Associates, Inc., Missouri Public Service Commission, University of Missouri-Columbia, Kansas City, MO, February 11 - 14, 1979.

"Sifting Out the Economic Costs of Terminal Equipment Services"
Telephone Engineer and Management, October 15, 1979.

"Usage-Sensitive Pricing" (with G. F. Borton)
(a three part series)
Telephony, January 7, 28, February 11, 1980.

"Perspectives on Usage-Sensitive Pricing"
Public Utilities Fortnightly, May 7, 1981.

"Diversification, Deregulation, and Increased Uncertainty in the Public Utility Industries"
Comments Presented at the Thirteenth Annual Conference of the Institute of Public Utilities, Williamsburg, VA - December 14 - 16, 1981.

"Local Telephone Pricing: Is There a Better Way?; The Costs of LMS Exceed its Benefits: a Report on Recent U.S. Experience."
Proceedings of a conference held at Montreal, Quebec - Sponsored by Canadian Radio-Television and Telecommunications Commission and The Centre for the Study of Regulated Industries, McGill University, May 2 - 4, 1984.

"Long-Run Regulation of AT&T: A Key Element of A Competitive Telecommunications Policy"
Telematics, August 1984.

"Is Equal Access an Adequate Justification for Removing Restrictions on BOC Diversification?"
Presented at the Institute of Public Utilities Eighteenth Annual Conference, Williamsburg, VA - December 8 - 10, 1986.

"Market Power and Competition Under an Equal Access Environment"
Presented at the Sixteenth Annual Conference, "Impact of Deregulation and Market Forces on Public Utilities: The Future Role of Regulation" Institute of Public Utilities, Michigan State University, Williamsburg, VA - December 3 - 5, 1987.

"Contestable Markets: Theory vs. Fact"
Presented at the Conference on Current Issues in Telephone Regulations: Dominance and Cost Allocation in Interexchange Markets - Center for Legal and Regulatory Studies Department of Management Science and Information Systems - Graduate School of Business, University of Texas at Austin, October 5, 1987.

"The Sources and Exercise of Market Power in the Market for Interexchange Telecommunications Services"
Presented at the Nineteenth Annual Conference - "Alternatives to Traditional Regulation: Options for Reform" - Institute of Public Utilities, Michigan State University, Williamsburg, VA, December, 1987.

"Assessing Market Power and Competition in The Telecommunications Industry: Toward an Empirical Foundation for Regulatory Reform"
Federal Communications Law Journal, Vol. 40 Num. 2, April 1988.

"A Perspective on Price Caps as a Substitute for Traditional Revenue Requirements Regulation"
Presented at the Twentieth Annual Conference - "New Regulatory Concepts, Issues and Controversies" - Institute of Public Utilities, Michigan State University, Williamsburg, VA, December, 1988.

"The Sustainability of Competition in Light of New Technologies" (with D. N. Townsend and P. D. Kravtin)
Presented at the Twentieth Annual Conference - Institute of Public Utilities Michigan State University, Williamsburg, VA, December, 1988.

"Adapting Telecom Regulation to Industry Change: Promoting Development Without Compromising Ratepayer Protection" (with S. C. Lundquist)
IEEE Communications Magazine, January, 1989.

"The Role of Cost Based Pricing of Telecommunications Services in the Age of Technology and Competition"

Presented at National Regulatory Research Institute Conference, Seattle, July 20, 1990.

"A Public Good/Private Good Framework for Identifying POTS Objectives for the Public Switched Network" (with Patricia D. Kravtin and Paul S. Keller) Columbus, Ohio: *National Regulatory Research Institute*, September 1991.

"Telecommunications Regulation and Infrastructure Development: Alternative Models for the Public/Private Partnership"
Prepared for the Economic Symposium of the International Telecommunications Union Europe Telecom '92 Conference, Budapest, Hungary, October 15, 1992.

"Efficient Infrastructure Development and the Local Telephone Company's Role in Competitive Industry Environment" *Presented at the Twenty-Fourth Annual Conference, Institute of Public Utilities, Graduate School of Business, Michigan State University, "Shifting Boundaries between Regulation and Competition in Telecommunications and Energy"*, Williamsburg, VA, December 1992.

"Measurement of Telecommunications Productivity: Methods, Applications and Limitations" (with Françoise M. Clottes)
Presented at Organisation for Economic Cooperation and Development, Working Party on Telecommunication and Information Services Policies, '93 Conference "Defining Performance Indicators for Competitive Telecommunications Markets", Paris, France, February 8-9, 1993.

"Telecommunications Investment and Economic Development: Achieving efficiency and balance among competing public policy and stakeholder interests"
Presented at the 105th Annual Convention and Regulatory Symposium, National Association of Regulatory Utility Commissioners, New York, November 18, 1993.

"The Potential for Competition in the Market for Local Telephone Services" (with David N. Townsend and Paul S. Keller)
Presented at the Organization for Economic Cooperation and Development Workshop on Telecommunication Infrastructure Competition, December 6-7, 1993.

"Market Failure in Open Telecommunications Networks: Defining the new natural monopoly," *Utilities Policy*, Vol. 4, No. 1, January 1994.

The Enduring Local Bottleneck: Monopoly Power and the Local Exchange Carriers, (with Susan M. Gately, et al) a report prepared by ETI and Hatfield Associates, Inc. for AT&T, MCI and CompTel, February 1994.

Commercially Feasible Resale of Local Telecommunications Services: An Essential Step in the Transition to Effective Local Competition, (Susan M. Gately, et al) a report prepared by ETI for AT&T, July 1995.

"Efficient Public Investment in Telecommunications Infrastructure" *Land Economics*, Vol 71, No.3, August 1995.

Funding Universal Service: Maximizing Penetration and Efficiency in a Competitive Local Service Environment, Lee L. Selwyn with Susan M. Baldwin, under the direction of Donald Shepheard, A Time Warner Communications Policy White Paper, September 1995.

Stranded Investment and the New Regulatory Bargain, Lee L. Selwyn with Susan M. Baldwin, under the direction of Donald Shepheard, A Time Warner Communications Policy White Paper, September 1995

"Market Failure in Open Telecommunications Networks: Defining the new natural monopoly," in *Networks, Infrastructure, and the New Task for Regulation*, by Werner Sichel and Donal L. Alexander, eds., University of Michigan Press, 1996.

Establishing Effective Local Exchange Competition: A Recommended Approach Based Upon an Analysis of the United States Experience, Lee L. Selwyn, paper prepared for the Canadian Cable Television Association and filed as evidence in Telecom Public Notice CRTC 95-96, Local Interconnection and Network Component, January 26, 1996.

The Cost of Universal Service, A Critical Assessment of the Benchmark Cost Model, Susan M. Baldwin with Lee L. Selwyn, a report prepared by Economics and Technology, Inc. on behalf of the National Cable Television Association and submitted with Comments in FCC Docket No. CC-96-45, April 1996.

Economic Considerations in the Evaluation of Alternative Digital Television Proposals, Lee L. Selwyn (as Economic Consultant), paper prepared for the Computer Industry Coalition on Advanced Television Service, filed with comments in FCC MM Docket No. 87-268, In the Matter of Advanced Television Systems and Their Impact Upon the Existing Television Broadcast Service, July 11, 1996.

Assessing Incumbent LEC Claims to Special Revenue Recovery Mechanisms: Revenue opportunities, market assessments, and further empirical analysis of the "Gap" between embedded and forward-looking costs, Patricia D. Kravtin and Lee L. Selwyn, In the Matter of Access Charge Reform, in CC Docket No. 96-262, January 29, 1997.

The Use of Forward-Looking Economic Cost Proxy Models, Susan M. Baldwin and Lee L. Selwyn, Economics and Technology, Inc., February 1997.

The Effect of Internet Use On The Nation's Telephone Network, Lee L. Selwyn and Joseph W. Laszlo, a report prepared for the Internet Access Coalition, July 22, 1997.

Regulatory Treatment of ILEC Operations Support Systems Costs, Lee L. Selwyn, Economics and Technology, Inc., September 1997.

The "Connecticut Experience" with Telecommunications Competition: A Case in Getting it Wrong, Lee L. Selwyn, Helen E. Golding and Susan M. Gately, Economics and Technology, Inc., February 1998.

Where Have All The Numbers Gone?: Long-term Area Code Relief Policies and the Need for Short-term Reform, prepared by Economics and Technology, Inc. for the Ad Hoc Telecommunications Users Committee, International Communications Association, March 1998.

Broken Promises: A Review of Bell Atlantic-Pennsylvania's Performance Under Chapter 30, Lee L. Selwyn, Sonia N. Jorge and Patricia D. Kravtin, Economics and Technology, Inc., June 1998.

Building A Broadband America: The Competitive Keys to the Future of the Internet, Lee L. Selwyn, Patricia D. Kravtin and Scott A. Coleman, a report prepared for the Competitive Broadband Coalition, May 1999.

Bringing Broadband to Rural America: Investment and Innovation In the Wake of the Telecom Act, Lee L. Selwyn, Scott C. Lundquist and Scott A. Coleman, a report prepared for the Competitive Broadband Coalition, September 1999.

Dr. Selwyn has been an invited speaker at numerous seminars and conferences on telecommunications regulation and policy, including meetings and workshops sponsored by the National Telecommunications and Information Administration, the National Association of Regulatory Utility Commissioners, the U.S. General Services Administration, the Institute of Public Utilities at Michigan State University, the National Regulatory Research Institute at Ohio State University, the Harvard University Program on Information Resources Policy, the Columbia University Institute for Tele-Information, the International Communications Association, the Tele-Communications Association, the Western Conference of Public Service Commissioners, at the New England, Mid-America, Southern and Western regional PUC/PSC conferences, as well as at numerous conferences and workshops sponsored by individual regulatory agencies.

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DOCUMENT CONTROL

BEFORE THE ARIZONA CORPORATION COMMISSION

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

DIRECT TESTIMONY OF

SUSAN M. GATELY

ON BEHALF OF

AT&T COMMUNICATIONS

OF THE MOUNTAIN STATES, INC.

AUGUST 9, 2000

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TABLE OF CONTENTS

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I. BACKGROUND

Q. Please state your name, position, and business address?

A. My name is Susan M. Gately. I am the Senior Vice President of Economics and Technology, Inc., (ETI), One Washington Mall, Boston, Massachusetts. Economics and Technology, Inc is a research and consulting firm specializing in telecommunications economics, regulation, management, and public policy.

Q. What is your employment background?

A. I have been employed at ETI since 1981. During this time I have gained a detailed familiarity with the rate structures and operating characteristics of telephone companies and the regulatory mechanisms used in the oversight of those companies. I have close to twenty years of experience analyzing LECs' intrastate and interstate access tariffs participating in virtually every FCC proceeding on access charges and price caps during that time. Among those issues recently addressed at the FCC has been the appropriate level of cost to be recovered from the implementation of local number portability (LNP) and the appropriate method of recovering those costs. I have also been involved in modeling and analysis related to the most recent step in the FCC's reformation of its access charge and price caps plan, the so-called CALLS plan.

Aside from participation in FCC proceedings, I was particularly involved in the development of avoided cost estimates for use in setting wholesale prices in a resale environment. I managed and co-authored (with Dr. Lee L. Selwyn) *Commercially Feasible Resale of Local Telecommunications Services: An Essential Step in the Transition to Effective Local*

Competition. I have participated in resale proceedings and or interconnection arbitrations (relative to wholesale pricing) in California, Hawaii, Illinois, Ohio, Nevada, and Louisiana.

More recently I've been involved in the analysis of issues related to the application of several of the Bell Companies for Section 271 authority to enter the interLATA long distance market. I've also undertaken a detailed analysis of the Continuing Property Record (CPR) audits conducted by the Accounting and Audits Division of the FCC.

I have also co-authored a number of papers of note not mentioned above. Specifically, I co-authored (acting also as project manager) a report authored jointly by ETI and Hatfield Associates, Inc. entitled: *The Enduring Local Bottleneck: Monopoly Power and the Local Exchange Carriers*. I also managed and co-authored (with Dr. Lee. L. Selwyn) *Access and Competition: The Vital Link* (submitted to the FCC in support of a petition by the Ad Hoc Telecommunications Committee requesting initiation of combined access charge and separation reform proceeding) as well as a paper entitled *LEC Price Cap Regulation: Fixing the Problems, Fulfilling the Promise* (co-authored with Dr. Lee L. Selwyn, Dr. David J. Roddy, Scott C. Lunquist and Sonia N. Jorge) filed in support of the Ad Hoc Telecommunications Committee's comments in the FCC's Docket 94-1 review of the LEC Price Caps Plan. I was also one of the authors of *The "Connecticut Experience" with Telecommunications Competition: A Case in Getting it Wrong*, with Lee L. Selwyn and Helen E. Golding.

Q. Have you previously testified before the Arizona Corporation Commission?

A. Yes. I testified before the Arizona Corporation Commission in Docket E-1051-88-306, In the Matter of the Commission's examination of the rates and charges of the Mountain States Telephone and Telegraph Company.

Q. What was your assignment in this proceeding?

A. Economics and Technology, Inc, has been engaged in this proceeding by AT&T Communications of the Mountain States, Inc. (AT&T) to make recommendations relative to U S WEST's revenue requirement request in Docket No. T-01051B-99-0105.

II. PURPOSE OF TESTIMONY

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to demonstrate to the Arizona Corporation Commission ("Commission") that U S WEST's alleged revenue deficiency is vastly overstated. In fact, U S WEST is over earning. U S WEST has inflated its revenue requirement by overstating telephone plant investment and operating expenses through inappropriate or unsubstantiated adjustments made to its test year as well as through adjustments it has failed to make.

Q. Why should the Commission be concerned by U S WEST's $201-million revenue requirement increase if it is only asking for revenue increases to recover $89-million?

A. Although U S WEST is initially asking for recovery of only $89-million of the $201-million revenue deficiency it has calculated,[1] the full $201 is at risk. U S WEST has indicated that it may amend its application to recover the full deficiency if it does not gain the regulatory freedom it seeks for various services.[2] Additionally, this may be the last opportunity the Commission will have to evaluate U S WEST's rates in a rate-of-return environment. U S WEST is presently regulated under some form of alternative regulation within many of the states in which it operates. The Commission Staff is presently evaluating the merits of using

1. The revenue increase requested by U S WEST is the sum of the revenue impact on wholesale services outlined by Scott McIntyre and the revenue impact on retail services outlined by David Teitzel in their respective Supplemental Direct Testimony filed May 19, 2000. The total revenue requirement is noted on Exhibit GAR-S1 to George Redding's May 3, 2000 Supplemental Direct Testimony.

2. U S WEST states in its response to UTI 01-032 that it is initially willing to allow the Commission to set rates that afford U S WEST the opportunity to freely compete in areas where competitive alternatives are available. Apparently, U S WEST believes that gaining pricing flexibility and pricing freedom will allow it to make up the additional revenue requirement it has identified. Consequently, the corollary to this position appears to be that if the Commission determines that U S WEST's request for pricing freedom and flexibility is without merit, U S WEST reserves the right to ask for its full revenue requirement. U S WEST reinforced this in its response to AT&T 10-075, "It is U S WEST's position that the Arizona Constitution requires the ACC to set rates so that U S WEST is able to recover its full authorized revenue requirement. U S WEST will determine the course of action it will take when the Commission renders its decision on the pricing flexibility request."

price cap regulation for U S WEST in this proceeding. Therefore, it is imperative that the Commission scrutinize U S WEST's current rates and revenue requirement now to ensure a proper baseline is set before any alternative form of regulation is implemented. To achieve the appropriate baseline, the Commission must consider the cumulative effect of adjustments recommended by AT&T and other intervenors to reduce or eliminate any revenue deficiency claimed by U S WEST. It is my belief that in doing so, the Commission will find that U S WEST is in fact over-earning, not under-earning, and should be forced to *reduce* rates.

Q. How would a reduction or elimination of U S WEST's alleged revenue deficiency benefit AT&T if U S WEST has already proposed reductions in its switched access rates?

A. As AT&T witness Arleen Starr discusses, U S WEST's switched access rates are significantly above the service's forward looking economic cost. U S WEST's proposed switched access rate reduction of only $5-million dollars does not do much to improve the situation. Given the need to reduce switched access charges demonstrated in Ms. Starr's testimony, denial of U S WEST's revenue requirement increase would allow the Commission greater latitude to implement the switched access pricing recommendations made by Ms. Starr. A reduction in the overall revenue requirement would allow this to occur without requiring corresponding increases in the rates for other services such as residential local exchange. AT&T's proposed adjustments alone demonstrate that U S WEST is over earning. The cumulative effect of adjustments proposed by all intervenors in this case will certainly give the Commission the ability to reduce access to cost while denying most, if not all, of the rate increases requested by U S WEST.

III. SUMMARY OF RECOMMENDATIONS AND ADJUSTMENTS

Q. Based on your investigation, what action are you recommending the Commission take?

A. I recommend that the Commission adopt AT&T's proposed adjustments detailed in Exhibit SMG-1, pages 1 through 8, to eliminate U S WEST's alleged revenue requirement shortfall in this proceeding. Based solely on these adjustments, U S WEST is substantially over earning, not under earning. Assuming the Commission uses the 10.86% rate of return being proposed by U S WEST in this proceeding, U S WEST is generating [redacted]-million in excess revenues.[3] Assuming instead that the Commission rejects U S WEST's proposed rate of return and requires it to use the previously approved rate of 9.75%, the amount of over earnings is at least $[redacted][4]. I urge the Commission to take immediate action to address this over earnings situation by reducing switched access rates according to the recommendations made by Ms. Starr.

Q. What are the types of adjustments you are proposing to U S WEST's revenue requirement?

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3. *See* Exhibit SMG-1 to my direct testimony, page 1, line 11, "Adjusted Revenue Requirement" column.

4. *Id.* "Approved Rate of Return" column.

A. The adjustments that I am proposing fall into two main categories: (1) adjustments that U S WEST has failed to make and (2) inappropriate or unsubstantiated adjustments proposed by U S WEST. In compiling these adjustments, I focused on issues with a significant financial and competitive impact. By no means are my adjustments representative of the full spectrum of adjustments that may be required in this proceeding, since I did not evaluate all aspects of U S WEST's application. My adjustments represent big-ticket items that affect the rate base and revenue requirement calculated by U S WEST. Therefore, my recommended adjustments should be considered cumulative to the adjustments proposed by all other intervenors in this proceeding.

Q. Referring to the first category of adjustments that you discuss, what types of adjustments has U S WEST failed to make to its test year revenue requirement?

A. U S WEST has failed to make adjustments for:

1. The removal of all Local Number Portability ("LNP") investment and expense;
2. The removal of all other interconnection investment and expense;
3. The Arizona impact of the Continuing Property Records ("CPR") audit conducted by the FCC;
4. The ACC requirement to remove 50% of losses on FCC deregulated services;
5. Imputation of Yellow Pages Directory revenues.

The net impact of making these adjustments alone (continuing to use the 10.86% ROR proposed by U S WEST) would eliminate the need for U S WEST's requested revenue requirement increase of approximately $201-million, revealing that U S WEST's revenue requirement should decrease by $[redacted]-million.[5]

Q. Referring to the second category of adjustments that you discuss, what types of inappropriate or unsubstantiated adjustments has U S WEST made to its test year revenue requirement?

A. U S WEST has included inappropriate adjustments for:

1. A pension asset created by accumulated pension credits;
2. The impact of converting to the accrual method of accounting for post-retirement benefits other than pension;
3. A revenue requirement increase for net operating income foregone on access lines being sold; and
4. The introduction of an automatic adjustment mechanism for reciprocal compensation.

The net impact of making these adjustments alone would reduce U S WEST's requested revenue requirement increase from approximately $201-million to $139-million.[6] When

5. *Id.* page 2, line 11, "Adjusted Revenue Requirement" column.

6. *Id.* page 3, line 11, "Adjusted Revenue Requirement" column.

combined with the other category of adjustments discussed previously, U S WEST's alleged revenue requirement becomes an over earnings situation of at least $[redacted]-million as shown on page 1 of Exhibit SMG-1.

IV. ADJUSTMENTS U S WEST HAS FAILED TO MAKE

A. Removal of LNP Investment and Expenses

Q. Why are you proposing an adjustment to remove LNP investment and expenses from U S WEST's test year revenue requirement?

A. U S WEST has inappropriately included LNP investment and expenses in its revenue requirement. The costs associated with implementing the long-term number portability requirements of §251(e) the Telecommunications Act of 1996 ("the Act") are subject to FCC oversight and are recoverable exclusively through the federal recovery mechanism approved by the FCC.[7] The FCC noted that this exclusively federal number portability cost recovery mechanism is to recover all allowable costs, and no costs are to be recovered from

7. In the Matter of Long-Term Number Portability Tariff Filings – U S WEST Communications, Inc. CC Docket No. 99-35, Memorandum Opinion and Order, FCC 99-169, July 9, 1999, ¶ 88.

the intrastate jurisdiction. Furthermore, the FCC reviewed all of U S WEST's number portability costs and determined which costs are reasonable and therefore recoverable. All other amounts are non-recoverable. Therefore, inclusion of any LNP costs in U S WEST's Arizona intrastate revenue requirement would result in over-recovery of number portability costs.

Q. What FCC Order governs recovery of these costs by U S WEST?

A. On July 9, 1999, the FCC adopted its Memorandum and Opinion Order which concluded its investigation of U S WEST's LNP tariff transmittals and approved recovery of authorized LNP costs through two federal charges. Approved were (1) a monthly number portability charge recoverable from end-users; and (2) a number portability query-service charge that applies to carriers on whose behalf a LEC performs queries.[8] The FCC stated that LNP costs are not subject to jurisdictional separation in ¶¶ 88-97 and therefore are not recoverable through intrastate rates.

Q. Did U S WEST acknowledge that it included LNP costs in its jurisdictional separations process?

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8. *Id.* ¶¶ 1-4.

A. Yes, U S WEST acknowledges that until the Order in FCC 99-169 was issued on July 9, 1999, LNP costs were included in its separated results. First, U S WEST admitted in its direct case to the FCC in CC Docket No. 99-35 that it included these costs in the jurisdictional process in prior years. However, U S WEST asserted that this had little impact on its intrastate rates since most of these rates were established before it incurred LNP costs.[9] U S WEST then told the FCC that it expected to adjust its Arizona test period as soon as the FCC determined the final level of long-term number portability cost recovery.[10]

Second, U S WEST also stated in response to discovery in this proceeding (UTI 13-023), that approximately $341-million in total company LNP investment and expense incurred from 1996 through 1998 would be accounted for and recovered in the normal course of business, net of the federally recovered portion of LNP. Based on this response, U S WEST intended to keep all costs attributable to its Arizona operations in excess of the federal recovery charge in its Arizona revenue requirement. However, none of the LNP costs U S WEST has incurred should be in its test year.

Q. How did U S WEST originally intend to adjust its Arizona test period to account for federal recovery of LNP costs?

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9. *Id.* ¶ 91.

10. *Id.* ¶ 92.

A. In response to UTI 13-023 in this proceeding and in CC Docket No. 99-35, U S WEST proposed to keep LNP costs in its separations process, but give intrastate customers a revenue credit for federally-allowed LNP costs.[11] The FCC found this proposal to be unjust and unreasonable because it continues to apply separations to LNP costs and revenues. Additionally, U S WEST's proposal would place the burden on U S WEST or the states to monitor the possibility of even accidental double or over recovery of LNP costs.[12] In response to these criticisms, U S WEST agreed that on a prospective basis, its claimed LNP costs are not, and will not be, subject to separations treatment.[13]

Q. What is U S WEST's current position on LNP investment, revenue and expenses in this proceeding?

A. U S WEST now claims that none of the LNP costs or revenues are included in the Arizona intrastate jurisdiction because it removed all such amounts entirely from the separations process in 1999.[14] Additionally, U S WEST asserts in its response to AT&T 11-107, that the

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11. *Id.* ¶¶ 94-95.

12. *Id.* ¶ 95.

13. *Id.* ¶ 96.

14. See George Redding's Supplemental Direct Testimony, May 19, 2000, page 13, lines 1-

revised amount for LNP capital expenditures incurred through 1998 is $55.5-million as opposed to the $221-million provided in response to UTI 13-023. The Arizona portion of the $55.5-million in investment is purported to be $13.8-million.

Q. Do you believe this position is accurate?

A. No, I do not. Based on information U S WEST provided in response to UTI 13-023 and AT&T 10-086, I believe that U S WEST has only removed LNP-related investment and expense approved by the FCC in the LNP order discussed previously, and associated with specific FCC rate elements. All of U S WEST's descriptions of LNP investment and expense in its data response supporting the 1999 test year refer only to those amounts associated with the LNP surcharge. Specifically, in response to AT&T 11-107 U S WEST indicates that the "current study" (the $55-million study) is related specifically to "LNP surcharges." In essence, it looks as if U S WEST is attempting to leave in rate base, and recover from Arizona ratepayers, costs that it has clearly identified as associated with LNP (per AT&T 11-104) based upon an FCC finding that a special revenue recovery mechanism was appropriate only for a smaller base of capital.

If the LNP amounts provided in UTI 13-023 were indeed accounted for in the normal course of business, the required adjustment is much larger than the $13.8-million dollars removed by U S WEST. Consequently, the investment and expense not recovered through the End User Surcharge is still within the U S WEST regional account balances that are allocated to its fourteen states for financial reporting purposes.

Q. What information do you have that leads you to this conclusion?

A. LNP costs are primarily incurred at the corporate or holding company level since they relate to systems used throughout the U S WEST region. U S WEST confirmed this in two data responses. In UTI 13-023, U S WEST stated that LNP costs are for switch enhancements, software and database systems interfaces and service delivery processes. In response to UTI 01-010, U S WEST confirmed that it does not normally track these costs at the state level. Therefore, these costs have to be allocated through the general investment and expense allocation process used to calculate state results. To test the adequacy of the U S WEST's LNP adjustment in AT&T 10-086, I estimated the total LNP investment attributable to Arizona since 1997 based on information provided by U S WEST in discovery.

Q. How did you calculate the impact of U S WEST's LNP cost recovery in this proceeding?

A. I calculated the Arizona-specific impact of LNP cost recovery in U S WEST's test year by starting with the investment and expense provided by U S WEST in UTI 13-023 and AT&T 11-104 through 107. I then applied a state allocation factor provided by U S WEST for LNP costs to calculate an Arizona intrastate rate base and operating income adjustment. Exhibit SMG-1, page 4, demonstrates my calculations in detail and shows my recommended adjustments.

		(A)		(B)		(C)=(A)*(B)*75%
LINE #	(results in thousands)	TOTAL COMPANY LNP INVESTMENT / EXPENSES		ARIZONA COST ALLOCATION FACTOR		ARIZONA INTRASTATE LNP CAPITAL COSTS (75%)
1	1996 CAPITAL INVESTMENT	$ -	*	25.0%	**	$ -
2	1997 CAPITAL INVESTMENT	$ 122,000	*	25.0%	**	$ 22,875
3	1998 CAPITAL INVESTMENT	$ 99,000	*	25.0%	**	$ 18,563
4	1999 CAPITAL INVESTMENT	$ 51,000	*	25.0%	**	$ 9,563
5	**LNP INVESTMENT TO BE REMOVED**	**$ 272,000**				**$ 51,000**
6	**ADJUSTMENT MADE BY U S WEST (ATT-11-107: $13.8-m ALLOCATED 75% TO INTRASTATE)**					**$ 10,350**
7	**NET LNP INVESTMENT ADJUSTMENT**					**$ 40,650**

Q. Please describe how the rate base adjustment to remove LNP capital costs was calculated.

A. Using U S WEST's Arizona allocation factor provided in response to AT&T 11-107, I calculated the gross LNP investment attributable to Arizona intrastate operations from the total company LNP amounts provided by U S WEST in response to UTI 13-023 and AT&T 11-104 through 107. The following excerpt from Exhibit SMG-1, page 4, demonstrates that a rate base adjustment of approximately $40-million is required to remove LNP investment from the test year. This proposed adjustment is net of the adjustment made by U S WEST to remove LNP costs associated with the LNP End User Surcharge detailed in AT&T 11-107.

Even though the test year starts at January 1, 1999, all LNP investment costs incurred since 1996 must be removed because capital investment is accounted for in a cumulative fashion from the date it is placed in service through the end of the test year.

Q. How was the operating income adjustment to remove LNP expenses performed?

A. Using the LNP expense information provided by U S WEST in response to AT&T 11-104 and 105, I calculated total company LNP expense for the 1999 test year. I then allocated the test year LNP expense to Arizona intrastate operations using the factor provided by U S WEST in AT&T 11-107. The following excerpt from Exhibit SMG-1, page 4, demonstrates that a test year expense decrease of approximately $6.5-million is required:

		(A)	(B)	(D)=(A)*(B)
LINE #	(results in thousands)	TOTAL COMPANY LNP INVESTMENT / EXPENSES	ARIZONA COST ALLOCATION FACTOR	ARIZONA LNP EXPENSES
8	1999 EXPENSES X ARIZONA ALLOCATION FACTOR (AT&T 11-104)	$ 35,000 *	25.0%	$ 8,750
9	**LNP EXPENSE ALLOCATED TO ARIZONA INTRASTATE (LINE 8, COLUMN D * 75%)**			**$ 6,563**

Q. What is the net revenue requirement impact of your proposed rate base and operating income adjustments to remove LNP costs?

A. As shown on page 1, line 11 of Exhibit SMG-1, the reduction in rate causes a $18.7-million reduction in revenue requirement.

Q. What is the impact on AT&T's proposed LNP adjustment if U S WEST's LNP adjustment is correct?

A. If AT&T's proposed adjustment to remove additional LNP investment and expense is denied, there will be no net change in AT&T's overall revenue requirement adjustment. The justification for this conclusion is within U S WEST's own description of how it accounted for all interconnection costs. In response to UTI 13-022, U S WEST stated that interconnection costs were inclusive of LNP costs. U S WEST's response to AT&T 10-087 provided the amount spent during 1999 for all interconnection costs and the cumulative amount since 1996. The sum of the cumulative balance for the years 1996 through 1998 provided in UTI 13-022 and the amount incurred during 1999 equals the new cumulative balance for the years 1996 through 1999. Therefore, a higher accounting for other interconnection costs would offset any purported reduction in LNP costs. Since AT&T's adjustments remove all interconnection costs, inclusive of LNP, there would be no net change in AT&T's calculations.

B. Removal of Other Interconnection Investment and Expenses

Q. How has U S WEST accounted for interconnection costs associated with implementation of the Act in this proceeding?

A. According to its response to UTI 13-022, U S WEST has included all of its interconnection costs in the jurisdictional separations process since it intends to recover them in the normal course of business. This means that the $1.547-billion in capital costs and expenses incurred by U S WEST from 1996 through 1999[15] would be subject to the state allocation process used to allocate company-wide expenses to Arizona operations.

Q. Is U S WEST's accounting for interconnection costs appropriate?

A. No. Recovery of extraordinary and non-recurring start-up costs designed to facilitate competition in accordance with the Act should not be included in the general rate structure of the incumbent LEC if it is seeking recovery of those costs elsewhere. Interconnection costs are recoverable in amounts assessed competitors pursuant to negotiated or arbitrated interconnection or resale agreements and in interconnection cost dockets setting unbundled network element ("UNE") prices. These are the only proceedings that allow a commission to fully evaluate the appropriateness of these costs. If such costs are buried within U S WEST's overall rate base and revenue requirement in this proceeding, U S WEST is attempting to recover these costs without an appropriate level of review and approval. This could result in double recovery – once from competitors and once from retail and wholesale customers.

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15. *See* U S WEST's response to AT&T 10-087.

Q. Have other commissions in U S WEST's region disallowed recovery of interconnection costs through a general rate case?

A. Yes. I am familiar with at least one example. In a recent rate case, the Utah Public Service Commission disallowed recovery of U S WEST's interconnection costs through general intrastate rates since these costs were the subject of separate proceedings designed to evaluate costing and pricing evidence directly related to the services U S WEST provides to competitors.[16]

Q. Have you calculated the impact of U S WEST's interconnection cost accounting on its test year in this proceeding?

A. Yes. I used the amounts provided by U S WEST in response to AT&T 10-087 and AT&T 11-104 through 107 to calculate the adjustment required to remove interconnection capital costs and expenses from U S WEST's test year.

Q. How did you calculate the rate base adjustment to remove interconnection capital costs?

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16. In the Matter of the Request of U S WEST Communications, Inc. for Approval of an Increase in its Rates and Charges, Utah Docket No. 97-049-08, Report and Order issued December 4, 1997, p. 17.

A. Using the Arizona Adjusted Plant In Service allocation factors provided in UTI 8-003, I calculated the gross interconnection capital costs attributable to Arizona intrastate operations from the total company interconnection capital costs provided by U S WEST in response to UTI 13-022 and AT&T 10-087. However, an additional adjustment was required to exclude the LNP costs discussed previously in my testimony, because U S WEST included these amounts in its interconnection cost summary. I estimated the Arizona-specific impact of all other interconnection costs in U S WEST's test year by taking the difference between the amounts provided by U S WEST in UTI 13-022 and AT&T 10-087 and the amounts provided in UTI 13-023, AT&T 10-086 and AT&T 11-104 through 107 which detail LNP costs. Exhibit SMG-1, page 5, describes my calculations in detail with the following excerpt showing that a rate base reduction of at least $38-million is required:

LINE #	(results in thousands)	(A) TOTAL COMPANY INTER-CONNECTION CAPITAL COSTS & EXPENSES	(B) ARIZONA COST ALLOCATION FACTOR	(C)=(A)*(B)*75% ARIZONA INTRASTATE INTER-CONNECTION CAPITAL COSTS (75%)
1	1996 CAPITAL INVESTMENT	$ 16,000 *	14.839% **	1,781
2	1997 CAPITAL INVESTMENT	$ 188,000 *	14.839% **	20,923
3	1998 CAPITAL INVESTMENT	$ 224,000 *	14.839% **	24,930
	1999 CAPITAL INVESTMENT	$ 367,000 *	15.023% ***	41,351
4	LESS: LNP INVESTMENT PER LNP SCHEDULE, LINE 5	$ (272,000)		(51,000)
5	**NET INTERCONNECTION INVESTMENT TO BE REMOVED**	**$ 523,000**		**37,984**

Q. How did you calculate an operating income adjustment to remove interconnection expenses?

A. My operating income adjustment to remove interconnection expenses was based on the amounts provided by U S WEST in response to AT&T 10-087 and AT&T 11-104 through 105. I calculated total company interconnection expenses for the 1999 test year. LNP expenses were then subtracted out from total company interconnection expenses since they were accounted for in a separate adjustment. I then allocated the test year interconnection expenses, net of LNP, to Arizona intrastate operations using U S WEST's COE expense factor provided in response to UTI 8-001. The following excerpt from Exhibit SMG-1, page 5, demonstrates that a test year increase in net operating income of approximately $32-million is required:

LINE #	(results in thousands)	(A) TOTAL COMPANY INTER-CONNECTION CAPITAL COSTS & EXPENSES	(B) ARIZONA COST ALLOCATION FACTOR	(D) ARIZONA INTER-CONNECTION EXPENSES (EXCLUDING LNP)
6	1999 EXPENSES X ARIZONA ALLOCATION FACTOR (AT&T 10-087)	$ 332,000.00 *	15.419% * *	51,191
7	LESS: 1999 LNP EXPENSES PER LNP SCHEDULE, LINE 8	$ (35,000)		(8,750)
8	TOTAL ARIZONA TEST YEAR INTERCONNECTION EXPENSES EXCLUDING LNP	$ 297,000		42,441
9	**INTERCONNECTION EXPENSE ALLOCATED TO ARIZONA INTRASTATE (LINE 8, COLUMN D * 75%)**			**31,831**

Q. What is the net revenue requirement impact of your proposed rate base and operating income adjustments to remove all other interconnection costs?

A. As shown on page 1, line 11 of Exhibit SMG-1, the reduction in rate base and increase in operating income causes a $74-million reduction in revenue requirement.

C. CPR Audit Findings

Q. What was the purpose of the FCC's CPR Audit?

A. The Audits Branch of the Accounting Safeguards Division within the Common Carrier Bureau examined the accounting records related to central office equipment ("COE") of all of the Regional Bell Operating Companies ("RBOCs") to determine whether their reported investment in COE represents property used and useful in the provision of telecommunications services. Descriptions of equipment in each company's continuing property records, or CPR, were compared to its physical equipment to verify the existence of the equipment described in the records. The Audits Branch examined the CPR for U S WEST's entire COE as of June 30, 1997.[17]

17. *See* FCC Common Carrier Bureau Accounting Safeguards Division findings in the *Audit of the Continuing Property Records of U S WEST Telephone Operating Companies As of June 30, 1997*, ¶ 14.

Q. What were the initial findings and conclusions of the Audits Branch of the FCC's Accounting Safeguards Division?

A. The general finding and conclusions of the Audits Branch in its review of U S WEST's CPR are best illustrated in the following statements from its audit report:

> 35. We conclude that U S WEST has not maintained its basic property records and its CPR in a manner consistent with the Commission's rules. We base this conclusion on the findings of our statistical sampling of Hard-wired Equipment and actual records of Undetailed Investment and Unallocated Other Costs that show a high percentage of records with substantive deficiencies such as inadequate or no asset descriptions, inaccurate quantities, missing and inaccurate location descriptions, and the high percentage of assets that could not be found by either our auditors or U S WEST's technical staff. We also base this conclusion on U S WEST's inability to provide supporting cost information and other data to substantiate the existence of a large number of entries in its CPR.
>
> 36. We believe the problems revealed in this audit are longstanding and unlikely to self-correct. This is indicated by the fact that similar problems were found in our 1994 audit of U S WEST's records. Since that audit, U S WEST conducted an inventory over a substantial portion of its COE. Despite these efforts, the current audit demonstrates that substantive problems in U S WEST's plant records persist.
>
> 37. The inability of the company to demonstrate the existence of such a high percentage of the equipment contained in its records raises significant questions about the valuation of U S WEST's plant accounts. At its worst, failure to provide sufficient and convincing documentation for the acquisition of the assets in question and for their placement into regulated accounts *raises doubts about whether policymakers can rely on the records*. [emphasis added]

> 38. We believe that corrective action concerning the accounting treatment of the overstated amounts is necessary to address the deficiencies found in our audit. We believe that the amounts associated with Hard-wired Equipment that was not found ($378.6-million) and Undetailed Investment that could not be substantiated ($218.6-million) should be written off U S WEST's plant accounts. [18]

Q. Was there any modification made to the FCC's original findings in the U S WEST CPR Audit?

A. Yes. According to Public Notice DA 99-2282 released on October 22, 1999, the FCC's auditors inadvertently omitted over $125-million of hard-wired COE from their statistical calculations. This omission adds $127.2-million to the original finding of $378.6-million for a revised write-off of $505.8-million[19] in total hard-wired COE. The revised total recommended COE write-off is now $724.4-million[20] versus the original amount of $597.2-million.

18. *Id.* ¶¶ 35-38.

19. *See* FCC Common Carrier Bureau Accounting Safeguards Division findings in the *Audit of the Continuing Property Records of U S WEST Telephone Operating Companies As of June 30, 1997;Revised Audit Report, Pursuant to Public Notice DA 99-2282, October 22, 1999, ¶38.*

20. *Id.* ¶42.

AT&T witness, Lee Selwyn, discusses in his direct testimony the CPR audit process in detail and why the findings made by the Audits Branch should be relied upon by the ACC to adjust U S WEST's accounting records.

Q. Is there a rate base impact associated with U S WEST's failure to adjust its test year for the Arizona portion of the CPR Audit results?

A. Yes, there is a strong possibility that the CPR audit findings impact U S WEST's Arizona test year rate base. As Dr. Selwyn explains, the possible explanations for the CPR audit findings include:

1. Assets never placed in service (otherwise known as "phantom investment"),
2. Assets that were placed in service, are not fully depreciated, but should no longer be considered used and useful (given U S WEST's inability to locate them during the course of the audit), and
3. Delayed retirements (i.e., assets fully depreciated but never retired).

For all three possible explanations there is either a rate base or (corresponding) depreciation reserve deficiency impact. Given U S WEST's inability to provide the FCC with the required cost documentation demonstrating that the assets were ever even purchased, the going-in presumption in this case should be that those assets were, in fact, never placed in service. Alternatively, the ACC staff could perform a detailed review of the Audits Branch's audit workpapers to assist in the determination into which category the asset overstatements fit.

If the FCC-recommended write-off is based upon phantom investment or assets that are no longer used and useful, U S WEST's rate base should be considered overstated. These two asset categories would overstate the rate base by virtue of plant cost being greater than the depreciation reserve since rate base consists of the difference between these two amounts otherwise known as net plant. If the assets recorded on the CPR are fairly new, the rate base overstatement will closely approximate the recommended asset write-off. The closer the investment is to fully depreciated, the smaller the rate base impact would be.

If the recommended CPR write-off is due to delayed retirements (assets fully depreciated but not removed from the CPR), there would be no rate base adjustment required since there would be no net investment.

Q. What is the maximum rate base adjustment required if the CPR Audit write-off is due to phantom investment or assets no longer used and useful?

A. Based on the approach recommended by Dr. Selwyn to adjust U S WEST's plant balances, I have developed a maximum rate base adjustment which assumes that none of the missing plant was put in place or ever depreciated (as if it were recorded in the CPR during the year the audit was performed). The magnitude of this amount is large enough that the ACC staff should calculate and implement an exact adjustment.

My adjustment starts with the same premise outlined in Dr. Selwyn's testimony. I calculated an Arizona intrastate plant adjustment of approximately $78-million.[21] This amount represents the 100% write-off required if the assets in question were never placed in service physically and were recorded in the CPR in the year of the audit. Given this assumption, the rate base adjustment would also be $78-million. This amount is included on page 6 of Exhibit SMG-1 to my direct testimony. To the extent that U S WEST can specifically demonstrate that the investments from which the FCC extrapolation was done have been depreciated (and the extent of such depreciation), the $78-million amount could be adjusted downward to compensate.

Q. What is the revenue requirement impact if the overstatement is due to phantom investment, assets that are no long used or useful, or delayed retirements?

A. In addition to the rate base effect discussed above, if gross plant was overstated due to phantom investment, assets that are no longer used and useful or delayed retirements, depreciation expense would be overstated. To estimate the depreciation expense reduction required in U S WEST's test year, I used the depreciation rates filed by U S WEST

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21. *Id.* ¶ 42. Total write-off of $724.4-million recommended (Hard-wired Equipment that was not found ($505.8-million) and Undetailed Investment that could not be substantiated ($218.6-million)). Arizona intrastate amount is equal to ($724.4-million X 14.3% Arizona factor from ARMIS 43-02 X 75% intrastate factor).

witness, K. Dennis Wu, in his May 19, 2000 Supplemental Direct Testimony. Since the FCC's CPR audit focused primarily on switching and circuit equipment, I used Mr. Wu's rates for Digital Switching (Account No. 2212) and Circuit Digital equipment (Account No. 2232).[22] Assuming the plant overstatement is evenly split between Digital Switching and Circuit Digital equipment, the resulting net operating income increase calculated on page 6 of Exhibit SMG-1 is approximately $8.1-million.

Q. Has U S WEST even addressed this issue in its application or testimony?

A. No, it has not. U S WEST only addressed this critical issue in its response to discovery requests. In its response to UTI 04-30, U S WEST suggests that the only adjustment required is an $11,000 write-off of plant investment it could not locate. Unfortunately, this is too little, too late. U S WEST had its chance to provide additional documentation to the FCC auditors during the time frame of the audit to substantiate its claims. As Dr. Selwyn describes in his testimony, the FCC reviewed additional support provided by the RBOCs at the conclusion of the audits and made adjustments to its findings where warranted. If U S WEST failed to make its case at that time, it should not be allowed to reassert its position in this case by its failure to make the appropriate write-offs.

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22. *See* Exhibit KDW-1 to K. Dennis Wu's May 19, 2000 testimony.

D. Losses From FCC Deregulated Services

Q. What concerns do you have with U S WEST's proposal to include 100% of the investment and losses of most of its FCC deregulated services in its intrastate test year?

A. Since U S WEST has the flexibility to price its FCC deregulated services at a level to recover its costs and earn a profit, it is inappropriate to include the investment and losses generated on such services in its test year. U S WEST acknowledged in its last Arizona rate case that its prices for FCC deregulated purposes are market based.[23] If U S WEST is experiencing losses due to competitive pressures, that is a consequence of competition. There is no guarantee of success in contrast to the regulated rate-of-return environment. Therefore, this Commission should disallow recovery of all losses on services where it does not exercise oversight over U S WEST's pricing. This is consistent with the Commission's own rules; R14-2-1409 prohibits a competitive telecommunications service from being subsidized by non-competitive services and further requires that the competitive service provide revenues that equal or exceed the total long run incremental cost of

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23. 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, Commission Decision No. 58927, Docket No. E-1051-93-183, January 3, 1995, page 21.

providing the service. CLECs cannot cross-subsidize; U S WEST, should not be permitted to cross-subsidize either. Making Arizona retail customers subsidize federally detariffed services only compounds the problem. Not only are intrastate rate payers paying for U S WEST's losses on interstate competitive services, CLECs cannot compete if U S WEST can sell services at a loss and recover the short fall from monopoly ratepayers. The Commission should reconsider its prior decision and disallow 100% of this loss on interstate deregulated services. To the extent the Commission believes there should be some recovery attributable to the intrastate jurisdiction, it should certainly be no more than the 50% recovery of losses allowed previously by this Commission.[24]

Q. Have your calculated the adjustments required under both scenarios you described above?

A. Yes, I have. Exhibit SMG-1, pages 7 and 8, show the adjustments required under either scenario. Despite my strong belief that full amount should be disallowed, I have conservatively only included the results from disallowing 50% of the losses on FCC deregulated services in my summary of adjustments on pages 1 and 2 of Exhibit SMG-1 (adhering to the Commission's ruling in the previous rate case). The decrease in revenue requirement under this scenario is approximately $2.8-million; the revenue requirement adjustment assuming a full disallowance would be twice the decrease in the 50% scenario (a

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24. *Id.* Page 23.

$5.6-million reduction). The underlying financial information for this exhibit comes from the Microsoft Excel file supporting U S WEST's test year rate base and net income calculations. This file was provided by U S WEST in response to UTI 42-001. I started with U S WEST's worksheet entitled *Interface-1990Financials* and added columns J and K to the far right to show the effect of AT&T's recommended adjustments.

1. If the Commission decides to remove 100% of the net investment and losses from FCC deregulated services, page 8, line 43, column J of Exhibit SMG-1 indicates that at least a $19-million reduction in U S WEST's rate base is required; line 33 shows that a $1-million increase in net operating income is required.
2. If the Commission decides to remove only 50% of the net investment and losses from these services, page 7, line 43, column J of Exhibit SMG-1 shows that a $9.5-million reduction to U S WEST's rate base is required; line 33 indicates a $500,000 increase in U S WEST's net operating income is required.

E. Prior Rate Case Adjustment Ordered by the ACC: Imputation of Yellow Pages Directory Revenues

Q. Is U S WEST proposing to impute any revenues from the Yellow Pages operation of U S WEST DEX to its Arizona Intrastate Operations?

A. No. Incredibly, U S WEST intends to exclude even the relatively small amount of the stipulated revenue it agreed to impute from the Yellow Page directory operations of U S WEST DEX. The Settlement Agreement reached between the Commission and U S WEST in 1988, which was approved in Decision No. 56020, requires imputation, or inclusion, of approximately $43-million of revenue into U S WEST's revenue requirement calculation for rate making purposes.

Q. Why do you describe the $43-million stipulated imputation amount as "relatively small?"

A. I view the $43-million amount that was stipulated to a dozen years ago as a small amount relative to the magnitude of Yellow Pages revenue being generated by U S WEST DEX today.

Q. Why has U S WEST chosen not to include the stipulated revenue amount from U S WEST DEX?

A. U S WEST claims that the value of goods and services received by U S WEST DEX from U S WEST are significantly less than the $43-million that was representative of the value for such services back in 1988. U S WEST's witness Ann Koehler-Christensen goes to great lengths in her Supplemental Direct Testimony to demonstrate that U S WEST DEX receives relatively little value from its relationship with U S WEST.

Q. Should the Commission adopt Ms. Koehler-Christensen's recommendation to eliminate the $43-million in imputed yellow pages revenue?

A. No, most certainly not. As Dr. Selwyn amply demonstrates in his testimony, the $43-million agreed upon in the 1988 Settlement is the minimum amount that should be imputed from Yellow Pages to the rate payers of Arizona.

Q. What course of action do you recommend that the commission take regarding Yellow Pages revenue imputation?

A. The Commission should continue to require revenue imputation from the Yellow Pages operation of U S WEST DEX unless U S WEST is willing to pay its customers the current fair market value attributable to Arizona for the assets it transferred to U S WEST DEX. U S WEST clearly has not, and cannot meet its burden of proof in demonstrating that the imputed revenue stream should be less than the $43-million in the 1988 Settlement Agreement. At a bare minimum, the $43-million agreed upon in the 1988 Settlement needs to be added to U S WEST's test year revenue stream which, using U S WEST's gross revenue conversion factor, results in a $73-million reduction in revenue requirement. The $43-million from the 1988 Settlement, however, is the absolute minimum that should be imputed. In reality the amount should be the much larger amount identified in Dr. Selwyn's testimony reflected on page 1 of Exhibit SMG-1.

Q. In his testimony, Dr. Selwyn notes a July 27, 2000 WUTC Order in which that agency rejected a U S WEST proposal very similar to the one being advanced in this case. Dr. Selwyn notes that in that Order the Commission finds that USWC retains the Directory asset as a matter of law. On that basis Dr. Selwyn is recommending that the imputation amount in this case be increased to the full amount of yellow pages revenues (net expenses) attributable to Arizona: $[redacted]-million. Have you reflected Dr. Selwyn's recommendation in your exhibit?

A. Yes, the $[redacted]-million is incorporated on pages 1 and 2 of Exhibit SMG-1, and is a component of my overall recommendation for a revenue requirement reduction of at least $[redacted]-million.

Q. What would be the impact upon the bottom line revenue requirement impact of using the $43-million imputation amount agreed upon in the 1988 settlement rather than the $[redacted]-million imputation amount you are recommending here?

A. Imputing $43-million in yellow pages revenue rather than the recommended $[redacted]-million, would result in a recommendation for an overall revenue requirement reduction of at least $45-million.

V. INAPPROPRIATE OR UNSUBSTANTIATED ADJUSTMENTS

A. Inclusion of a Pension Asset in the Rate Base

Q. Describe U S WEST's proposal to include pension assets created from prior period over-funding to the Arizona rate base?

A. In another example of blatantly disregarding previous Arizona Corporation Commission finding, U S WEST has included an adjustment to increase its rate base by approximately $66-million for the pension asset created by credits from periods of over funding.

Q. How would a reduction in revenue requirement caused by a credit related to previous over-funding result in an increase in the rate base?

A. It should not. However, in discussing the rationale for this adjustment, Mr. Redding (at page 15, line 20 through page 16, line 4 of his original Direct Testimony filed on January 8, 1999) claims that U S WEST's shareholders need to be compensated for the reduction in revenue requirement caused by pension credits since the earnings on the pension credits cannot be withdrawn and distributed to shareholders.

Q. Do you agree with Mr. Redding?

A. No, I do not, nor did this Commission the last time U S WEST attempted to increase the rate base for an almost identical pension credit. At that time the Commission clearly outlined a requirement that U S WEST had to meet in the last rate case before it would require U S WEST's customers to compensate the shareholders for the existence of such an asset. On page 5, lines 17-21 of Decision No. 58927 in Docket No. E-1051-93-183, the Commission stated:

> Based on all of 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 the rate base.

Q. Has U S WEST presented sufficient evidence this time?

A. Not only has U S WEST not presented "sufficient evidence," it has not presented any evidence at all. Despite a clear directive in Decision 58927, U S WEST has not even attempted to support its position in this proceeding with any sort of showing that details how much, if any, of this asset is due to shareholder contributions. Therefore, U S WEST has clearly not met its burden of proof, and the Commission should summarily reject its proposed adjustment. Page 1 of Exhibit SMG-1 includes an adjustment removing the $66-million from rate base, resulting in a $12-million reduction in revenue requirement.

B. Adjustment for Post-retirement Benefits Other than Pension ("PBOP")

Q. Has U S WEST met the conditions established by the ACC as a necessary precondition for switching to the accrual method of account for PBOP?

A. No, it has not. U S WEST proposed a similar adjustment in its last rate case that was rejected by the Commission (pages 40-45 of Decision No. 58927). Mr. Redding claims that the Arizona regulatory landscape has changed since then (at pages 18-19 of his original Direct Testimony filed on January 8, 1999). He cites a number of Commission Decisions involving other Arizona utilities that have been allowed to switch to accrual accounting for PBOPs since U S WEST's last rate case. From these citations, Mr. Redding has listed a series of ten conditions that must be met before the Commission will accept accrual accounting.

Q. Has U S WEST met the ten requirements?

A. No, by its own admission it has not. Redding claims that U S WEST meets 9 of the 10 conditions, apparently believing that getting close to the Commission's findings is good enough.

Q. Should the Commission reject this proposed U S WEST adjustment?

A. Yes, in view of the Commission's requirements, and U S WEST's failure to meet the requirements, the Commission should reject the adjustment. The impact of denying U S

WEST's request is shown on page 1, line 11 of Exhibit SMG-1 and would result in a $29-million decrease in revenue requirement.

C. Impact of Proposed Sale of Exchanges

Q. Has U S WEST factored in any impact of its proposed sale of exchanges on its test year revenue requirement?

A. Yes, it appears to have removed investment, revenue and expense associated with the 38 exchanges being sold to Citizens Utilities, but in what can fairly be described as a bizarre and unexpected outcome, its adjustment includes a revenue requirement *increase* associated with alleged loss of net operating income. This adjustment has been summarized through Exhibit GAR-S7G in George Redding's Supplemental Direct Testimony.

Q. What is surprising about U S WEST's revenue requirement *increase* flowing from a reduction in net operating income?

A. This outcome is surprising because the sale of these exchanges has been thought of by most observers as occurring because U S WEST was not making a profit on these exchanges. Now that it comes time to adjust the Arizona intrastate net operating income figures to reflect the sale, U S WEST is alleging positive cash flow from these exchanges. U S WEST, not the Arizona ratepayers, made a business decision to sell approximately 500,000 lines throughout its region to Citizens, including lines in Arizona. These lines are primarily located in rural, presumably high cost, areas. Since this sale is at U S WEST's discretion, and U S WEST profits from the gain it seems highly inappropriate for its regulated customers to have to cover *any* purported loss in net income on these lines? This sale is for U S WEST's benefit, not its remaining customers. U S WEST's adjustment should be limited to the removal of net investment in these access lines since it appropriately reduces U S WEST's rate base.

U S WEST is asking the Commission to let it have it both ways. It cannot be allowed to reap the benefits of selling rural exchanges at a profit and then ask its remaining customers to make up any prospective shortfall in net operating income.

Q. You characterize the shortfall in net operating income as "alleged", why is that?

A. The net operating income results developed by U S WEST are based upon hard revenue results and *soft* (estimated) expense results. The positive net income result could become negative (requiring the expected revenue requirement reduction) with changes in some of the arbitrary expense assumptions. For example, although all of the lines in 38 exchanges in Arizona are being sold, and Corporate Operations expenses are traditionally allocations by relative access line counts, no Corporate Operations expenses were included in the tabulation of expenses associated with the provision of services in the exchanges being sold. (P-07 Operating Adjustments).

Q. What is your recommendation relative to the adjustments U S WEST has made to its test year revenue requirement based upon the sale of exchanges?

A. I recommend that the Commission conservatively reduce U S WEST's revenue requirement by the $7-million impact of including U S WEST's foregone net operating income. This proposed adjustment is shown on page 1, line 11 of Exhibit SMG-1. Alternatively, as a more aggressive, and arguably more appropriate, treatment the Commission could require U S WEST to make a more reasonable assessment of the expenses associated with the sale of the exchanges. Such an assessment would most likely demonstrate negative net operating revenue for those exchanges.

D. Removal of Reciprocal Compensation Adjustment

Q. Should the Commission accept U S WEST's request for an automatic adjustment mechanism to recover reciprocal compensation losses?

A. No. As described by Ms. Starr in her Direct Testimony the Commission should reject U S WEST's proposal for an automatic adjustment mechanism to recover expenses greater than its revenue from reciprocal compensation agreements. These are competitive losses that should not be recovered from U S WEST's regulated ratepayers. The impact of removing this U S WEST adjustment is a $13-million reduction in revenue requirement.

VI. CONCLUSION AND RECOMMENDATIONS

Q. What are your conclusions regarding U S WEST's alleged revenue requirement increase?

A. I believe that U S WEST has significantly overstated its need for additional revenue. In fact, my adjustments demonstrate that U S WEST is significantly over earning by at least $[redacted]-million due to its failure to make certain adjustments as well as inclusion of inappropriate adjustments.[25] If the Commission were to use U S WEST's last approved rate of return, the amount of over earnings would be at least $[redacted]-million. When my adjustments are considered in conjunction with those that will likely be proposed by all other intervenors in this proceeding, U S WEST's over earnings will most likely be significantly greater than the amount I have calculated.

Although U S WEST is currently asking for a revenue increase of $89-million, it has filed schedules claiming a $201-million revenue requirement increase. As discussed earlier, if the Commission does not grant U S WEST's proposal for competitive zone pricing

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25. If the Commission does not adopt my recommended $[redacted]-million yellow pages imputation, and instead falls back upon the $43-million stipulated in the 1988 Settlement Agreement, the over earnings would drop to $45-million.

flexibility, U S WEST will likely seek to raise rates even further to recover the full $201-million.

Q. What are your recommendations?

A. I recommend the Commission adopt all of the adjustments proposed in Exhibit SMG-1, and I urge the Commission to require U S WEST to reduce rates to eliminate its over earnings situation. I recommend that rate reductions be targeted to switched access rates first as proposed by Ms. Starr. Since other forms of regulation are being considered for U S WEST in this proceeding, it is imperative that the Commission scrutinize U S WEST's current rates and revenue requirement now to ensure a proper baseline is set before any alternative form of regulation is implemented.

Q. Does this conclude your testimony?

A. Yes, it does.

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF US WEST COMMUNICATIONS, INC., A COLORADO CORPORATION, FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY, THE FAIR VALUE OF THE COMPANY FOR 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

EXHIBIT OF

SUSAN M. GATELY

ON BEHALF OF

AT&T COMMUNICATIONS

OF THE MOUNTAIN STATES, INC.

AUGUST 9, 2000

Allegedly Proprietary Data
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AT&T'S ADJUSTMENTS TO U S WEST'S RATE BASE AND REVENUE REQUIREMENT
(results in thousands)

LINE #		U S WEST APPLICATION *	SUMMARY OF AT&T'S ADJUSTMENTS										ADJUSTED REVENUE REQUIREMENT	APPROVED RATE OF RETURN
			ADJUSTMENTS NOT MADE BY U S WEST (from page 2)					INAPPROPRIATE U S WEST ADJUSTMENTS (from page 3)						
			LNP CAPITAL COSTS & EXPENSES	ALL OTHER INTERCONNECTION CAPITAL COSTS & EXPENSES	CPR FCC AUDIT ADJUSTMENT	ACC DISALLOWANCE OF 50% OF FCC DEREGULATED SERVICES	YELLOW PAGE REVENUE IMPUTATION	PENSION ASSET	PBOP	ACCESS LINE SALE NET INCOME	RECIPROCAL COMPENSATION ADJUSTMENT	TOTAL ADJUSTMENTS		Decision No. 58927, Page 69
1	ADJUSTED RATE BASE	1,421,145	(40,650)	(37,984)	(77,692)	(9,457)		(66,221)	(5,585)	-		(237,589)	1,183,556	1,183,556
2	ADJUSTED NET OPERATING INCOME	43,832	6,563	31,831	8,080	593		-	16,626	4,347				
3	CURRENT RATE OF RETURN (line 2 / line 1)	3.08%												
4	REQUIRED RATE OF RETURN (per U S WEST)	10.86%	10.86%	10.86%	10.86%	10.86%	10.86%	10.86%	10.86%	10.86%	10.86%	10.86%	10.86%	9.75%
5	REQUIRED OPERATING INCOME (line 4 * line 1)	154,336	(4,415)	(4,125)	(8,437)	(1,027)	-	(7,192)	(607)	-	-	(25,802)	128,534	115,397
6	OPERATING INCOME DEFICIENCY (line 5 - line 2)	110,504	(10,977)	(35,956)	(16,517)	(1,620)		(7,192)	(17,233)	(4,347)	-			
7	GROSS REVENUE CONVERSION FACTOR (per U S WEST)	1.7056	1.7056	1.7056	1.7056	1.7056	1.7056	1.7056	1.7056	1.7056	1.7056	1.7056	1.7056	1.7056
8	INCREASE IN GROSS REVENUE REQUIREMENTS (line 6 * line 7)	188,476	(18,723)	(61,327)	(28,172)	(2,763)		(12,266)	(29,392)	(7,414)	-			
9	BELCORE 3 YEAR ADJUSTMENT	(686)										-	(686)	(686)
10	RECIPROCAL COMPENSATION ADJUSTMENT	13,252									(13,252)	(13,252)	-	-
11	TOTAL INCREASE (DECREASE) IN REVENUE REQUIREMENT (line 8 + line 9 + line 10)	201,042	(18,723)	(61,327)	(28,172)	(2,763)		(12,266)	(29,392)	(7,414)	(13,252)			

* Per Supplemental Testimony of George Redding, EXHIBIT GAR S-1

** Per U S WEST's Settlement Agreement with ACC as set forth in Decision No. 56020.

Allegedly Proprietary Data
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AT&T'S ADJUSTMENTS TO U S WEST'S RATE BASE AND REVENUE REQUIREMENT
(results in thousands)

LINE #		U S WEST APPLICATION *	ADJUSTMENTS NOT MADE BY U S WEST						ADJUSTED REVENUE REQUIREMENT	*APPROVED RATE OF RETURN*
			PAGE 4	*PAGE 6*	*PAGE 7*	*PAGE 9*	*SEE ***			
			LNP CAPITAL COSTS & EXPENSES	ALL OTHER INTERCONNECTION CAPITAL COSTS & EXPENSES	CPR FCC AUDIT ADJUSTMENT	ACC DISALLOWANCE OF 50% OF FCC DEREGULATED SERVICES	YELLOW PAGE REVENUE IMPUTATION	TOTAL ADJUSTMENTS		Decision No. 58927, Page 69
1	ADJUSTED RATE BASE	1,422,099	(40,650)	(37,984)	(77,692)	(9,457)		(165,783)	1,256,316	1,256,316
2	ADJUSTED NET OPERATING INCOME	43,833	6,563	31,831	8,080	593				
3	CURRENT RATE OF RETURN (line 2 / line 1)	3.08%								
4	REQUIRED RATE OF RETURN (per U S WEST)	10.85%	10.85%	10.85%	10.85%	10.85%	10.85%	10.85%	10.85%	9.75%
5	REQUIRED OPERATING INCOME (line 4 * line 1)	154,350	(4,412)	(4,123)	(8,432)	(1,026)	-	(17,993)	136,356	122,491
6	OPERATING INCOME DEFICIENCY (line 5 - line	110,517	(10,975)	(35,953)	(16,512)	(1,620)				
7	GROSS REVENUE CONVERSION FACTOR (per U S WEST)	1.7056	1.7056	1.7056	1.7056	1.7056	1.7056	1.7056	1.7056	1.7056
8	INCREASE IN GROSS REVENUE REQUIREMENTS (line 6 * line 7)	188,500	(18,718)	(61,323)	(28,164)	(2,762)				
9	BELCORE 3 YEAR ADJUSTMENT	(686)						-	(686)	(686)
10	RECIPROCAL COMPENSATION ADJUSTMENT	13,252						-	13,252	13,252
11	TOTAL INCREASE (DECREASE) IN REVENUE REQUIREMENT (line 8 + line 9 + line 10)	201,066	(18,718)	(61,323)	(28,164)	(2,762)				

* Per Supplemental Testimony of George Redding, EXHIBIT GAR S-1

** Per U S WEST's Settlement Agreement with ACC as set forth in Decision No. 56020.

Allegedly Proprietary Data
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AT&T'S ADJUSTMENTS TO U S WEST'S RATE BASE AND REVENUE REQUIREMENT
(results in thousands)

LINE #		U S WEST APPLICATION *	INAPPROPRIATE ADJUSTMENTS BY U S WEST					ADJUSTED REVENUE REQUIREMENT	APPROVED RATE OF RETURN
			GAR-S7D	GAR-S7E	GAR -S7G	GAR-S9			
			PENSION ASSET	PBOP	ACCESS LINE SALE NET INCOME	RECIPROCAL COMPENSATION ADJUSTMENT	TOTAL ADJUSTMENTS		Decision No. 58927, Page 69
1	ADJUSTED RATE BASE	1,422,099	(66,221)	(5,585)			(71,806)	1,350,293	1,350,293
2	ADJUSTED NET OPERATING INCOME	43,833	-	16,626	4,347		20,973	64,806	64,806
3	CURRENT RATE OF RETURN (line 2 / line 1)	3.08%						4.80%	4.80%
4	REQUIRED RATE OF RETURN (per U S WEST)	10.85%	10.85%	10.85%	10.85%	10.85%		10.85%	*9.75%*
5	REQUIRED OPERATING INCOME (line 4 * line 1)	154,350	(7,187)	(606)	-	-	(7,794)	146,556	131,654
6	OPERATING INCOME DEFICIENCY (line 5 - line 2)	110,517	(7,187)	(17,232)	(4,347)	-	(28,767)	81,750	66,848
7	GROSS REVENUE CONVERSION FACTOR (per U S WEST)	1.7056	1.7056	1.7056	1.7056	1.7056		1.7056	1.7056
8	INCREASE IN GROSS REVENUE REQUIREMENTS (line 6 * line 7)	188,500	(12,259)	(29,392)	(7,414)	-	(49,065)	139,435	114,017
9	BELCORE 3 YEAR ADJUSTMENT	(686)					-	(686)	(686)
10	RECIPROCAL COMPENSATION ADJUSTMENT	13,252				(13,252)	(13,252)	-	-
11	**TOTAL INCREASE (DECREASE) IN REVENUE REQUIREMENT** ***(line 8 + line 9 + line 10)***	***201,066***	**(12,259)**	**(29,392)**	**(7,414)**	**(13,252)**	**(62,317)**	**138,749**	**113,331**

* **Per Supplemental Testimony of George Redding, EXHIBIT GAR S-1**

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LNP CAPITAL COSTS AND EXPENSES
RATE BASE AND REVENUE REQUIREMENT ADJUSTMENTS
(results in thousands)

LINE #	(results in thousands)	(A) TOTAL COMPANY LNP INVESTMENT / EXPENSES	(B) ARIZONA COST ALLOCATION FACTOR	(C)=(A)*(B)*75% ARIZONA INTRASTATE LNP CAPITAL COSTS (75%)	(D)=(A)*(B) ARIZONA LNP EXPENSES
1	1996 CAPITAL INVESTMENT	$ - *	25.0% **	$ -	
2	1997 CAPITAL INVESTMENT	$ 122,000 *	25.0% **	$ 22,875	
3	1998 CAPITAL INVESTMENT	$ 99,000 *	25.0% **	$ 18,563	
4	1999 CAPITAL INVESTMENT	$ 51,000 *	25.0% **	$ 9,563	
5	**LNP INVESTMENT TO BE REMOVED**	**$ 272,000**		**$ 51,000**	
6	**ADJUSTMENT MADE BY U S WEST (ATT-11-107: $13.8-m ALLOCATED 75% TO INTRASTATE)**			**$ 10,350**	
7	**NET LNP INVESTMENT ADJUSTMENT**			**$ 40,650**	
8	1999 EXPENSES X ARIZONA ALLOCATION FACTOR (AT&T 11-104)	$ 35,000 *	25.0% **		$ 8,750
9	**LNP EXPENSE ALLOCATED TO ARIZONA INTRASTATE (LINE 8, COLUMN D * 75%)**				**$ 6,563**

* Capital investment and operating expense amounts are from U S WEST's response to UTI 13-023 and AT&T 11- 104 through 107.
** Per U S WEST's response to AT&T 11-107, a factor of 25% was used to allocate total company LNP costs to Arizona.

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INTERCONNECTION CAPITAL COSTS & EXPENSES
RATE BASE & REVENUE REQ. ADJ.
(results in thousands)

LINE #	(results in thousands)	(A) TOTAL COMPANY INTER-CONNECTION CAPITAL COSTS & EXPENSES	(B) ARIZONA COST ALLOCATION FACTOR	(C)=(A)*(B)*75% ARIZONA INTRASTATE INTER-CONNECTION CAPITAL COSTS (75%)	(D) ARIZONA INTER-CONNECTIO N EXPENSES (EXCLUDING LNP)
1	1996 CAPITAL INVESTMENT	$ 16,000 *	14.839% **	1,781	
2	1997 CAPITAL INVESTMENT	$ 188,000 *	14.839% **	20,923	
3	1998 CAPITAL INVESTMENT	$ 224,000 *	14.839% **	24,930	
	1999 CAPITAL INVESTMENT	$ 367,000 *	15.023% ***	41,351	
4	LESS: LNP INVESTMENT PER LNP SCHEDULE, LINE 5	$ (272,000)		(51,000)	
5	**NET INTERCONNECTION INVESTMENT TO BE REMOVED**	**$ 523,000**		**37,984**	
6	1999 EXPENSES X ARIZONA ALLOCATION FACTOR (AT&T 10-087)	$ 332,000.00 *	15.419% ***		51,191
7	LESS: 1999 LNP EXPENSES PER LNP SCHEDULE, LINE 8	$ (35,000)			(8,750)
8	TOTAL ARIZONA TEST YEAR INTERCONNECTION EXPENSES EXCLUDING LNP	$ 297,000			42,441
9	**INTERCONNECTION EXPENSE ALLOCATED TO ARIZONA INTRASTATE (LINE 8, COLUMN D * 75%)**				**31,831**

* Capital investment and operating expense amounts are from U S WEST's response to UTI 13-022 and AT&T 10-087.

** Arizona allocation factors are from the Microsoft Excel files provided by USWC in response to UTI 8-003, Attachment A (HQPR99_AZ) and UTI 8-001, Attachment A (HQPRO_97_98_99.XLS). Plant In Service uses the Adjusted Plant In Service factor in HQPR99_AZ, Sheet DIST_COPY, cell # D29. Expenses use the COE factor in HQPRO_97_98_99.XLS, Sheet 1997, cell # E89 , and Sheet 1999, cell # E89.

*** Amount represents the 1999 Arizona Prorate factor provided in the Excel file AZ1299ft.xls, sheet WP2-AzProrate.

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CONTINUING PROPERTY RECORD AUDIT - FCC FINDINGS
RATE BASE & REVENUE REQ. ADJ.
(results in thousands)

LINE #		(A) ALLOCATION OF FCC FINDINGS TO ARIZONA PER LEE SELWYN'S TESTIMONY		(B)	
1	TELEPHONE PLANT OVERSTATEMENT IF ASSETS NEVER PLACED IN SERVICE	77,692	*		
2	**MAXIMUM RATE BASE ADJUSTMENT (Line 1)**	**77,692**			
3	**DEPRECIATION EXPENSE ADJUSTMENT (applies rates from K. Dennis Wu's Exhibit KDW-1 for Digital Switching & Circuit Digital equipment on a 50/50 basis to the gross plant overstatement on Line 1)**			**8,080**	**

* CPR Audit adjustment is calculated using $724.4 million write-off recommended by FCC audit report X 14.3% Arizona factor from ARMIS 43-02 X 75% intrastate factor.

** [$77.7 million X 11.0% for Digital Switching Equipment (Account No. 2212) X 50%] + [$77.7 million X 9.8% for Circuit Digital Equipment (Account No. 2232) X 50%]. Depreciation rates are per K. Dennis Wu's Exhibit KDW-1 filed with his Supplemental Direct Testimony on behalf of U S WEST.

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ARIZONA
AT&T COMMUNICATIONS OF
THE MOUNTAIN STATES, INC.

50% EXCLUSION OF FCC DEREGULATED SERVICES
USING FINANCIAL STATEMENTS IN UTI 42-001
(whole dollars)

DIRECT TESTIMONY
OF SUSAN M. GATELY
DOCKET NO. T-1051B-99-105
EXHIBIT SMG-1

	(A)	(B)	(C=A + B)	(D)	(E)	(F)	(G)	(H=D+E-F-G)	(I = G / C)	(J = E - F)*50%	(K)
	Total State MR ☐ Annualize	Total State JD	Total State JR	Intrastate JR	FCC Dereg Excludes Billing & Collection	Payphone & Wireless	State Dereg (Mobile)	Regulated Intrastate	Regulated Intrastate Factors	ADJUSTMENT FOR ACC DISALLOWANCE OF FCC DEREG. (50%)	ADJUSTED REGULATED INTRASTATE
Revenues											
1 Local Service Revenues	954,933,510	0	954,933,510	954,933,510	0	0	0	954,933,510	100.00%		
2 Network Access Service Revenues	603,899,634	0	603,899,634	121,079,275	0	0	0	121,079,275	20.05%		
3 Long Distance Network Service Rev.	30,371,863	0	30,371,863	30,318,408	0	0	0	30,318,408	99.82%		
4 Miscellaneous	178,544,239	0	178,544,239	56,957,039	102,104,368	16,625,712	0	142,435,695	79.78%		
5 Total Oper. Rev. (L1 thru L4)	1,767,749,246	0	1,767,749,246	1,163,288,232	102,104,368	16,625,712	0	1,248,766,888	70.64%		
Expenses	0	0	0	0	0	0	0				
6 Maintenance	357,833,823	(197,627)	357,636,196	228,065,407	43,974,712	5,977,110	0	266,063,009	74.39%		
7 Engineering Expense	14,061,421	0	14,061,421	9,621,260	830,731	(257,820)	0	10,709,811	76.16%		
8 Network Operations	55,375,419	0	55,375,419	35,120,336	6,896,637	442,366	0	41,574,607	75.08%		
9 Network Administration	2,834,672	0	2,834,672	2,039,722	11,962	0	0	2,051,684	72.38%		
10 Access Expense	34,298,658	0	34,298,658	20,801,064	0	0	0	20,801,064	60.65%		
11 Other	666,121	0	666,121	438,267	64,472	30,580	0	472,159	70.88%		
12 Total Cost of Services & Products(L6 thru L	465,070,114	(197,627)	464,872,487	296,086,056	51,778,514	6,192,236	0	341,672,334	73.50%		
13 Customer Operations	244,845,308	0	244,845,308	175,807,054	26,492,765	12,056,399	0	190,243,420	77.70%		
14 Corporate Operations	204,386,153	31,036,120	235,422,273	165,922,800	26,416,021	5,848,360	0	186,490,461	79.22%		
15 Property & Other Taxes	71,165,545	0	71,165,545	50,730,583	2,813,257	1,958,238	0	51,585,602	72.49%		
16 Uncollectibles	20,272,457	0	20,272,457	18,235,984	410,726	2,480	0	18,644,230	91.97%		
17 Tot Selling, General & Admin.(L13 thru L1	540,669,463	31,036,120	571,705,583	410,696,422	56,132,769	19,865,477	0	446,963,714	78.18%		
18 Other Operating Income & Expense	13,607	0	13,607	(366,413)	509,838	125,328	0	18,097	133.00%		
19 Depreciation Expense	363,709,774	(21,631,550)	342,078,224	235,204,331	8,644,268	4,134,396	0	239,714,203	70.08%		
20 Universal Service Fund	0	0	0	(1,369,596)	0	0	0	(1,369,596)	0.00%		
21 Link Up America	0	0	0	(88,374)	0	0	0	(88,374)	0.00%		
22 Total Operating Expense(L12+L17 thru L21	1,369,462,958	9,206,943	1,378,669,901	940,162,425	117,065,389	30,317,437	0	1,026,910,377	74.49%		
23 Income From Operations (L5-L22)	398,286,288	(9,206,943)	389,079,345	223,125,807	(14,961,021)	(13,691,725)	0	221,856,511	57.02%	634,648	222,491,159
Taxes	0	0	0	0	0	0	0				
24 Federal Income Tax	103,960,088	(1,982,471)	101,977,617	56,978,015	(5,978,925)	(4,903,828)	0	55,902,918	54.82%		
25 State & Local Income Tax	31,769,184	(498,340)	31,270,844	16,940,420	(1,369,843)	(1,440,704)	0	17,011,281	54.40%		
26 ***Net Operating Income (L23-L24-L25)***	262,557,016	(6,726,132)	255,830,884	149,207,371	(7,612,253)	(7,347,193)	0	148,942,311	58.22%	132,530	149,074,841
Other	0	0	0	0	0	0	0				
27 Nonoperating Income & Expense	29,602,302	(1,860,958)	27,741,344	19,736,893	269,210	48,185	0	19,957,918	71.94%		
28 Nonoperating Income Tax	387,635	0	387,635	230,061	74,602	74,379	0	230,284	59.41%		
29 Net Operating Earnings (L26-L27-L28)	232,567,079	(4,865,174)	227,701,905	129,240,417	(7,956,065)	(7,469,757)	0	128,754,109	56.55%		
30 Interest Expense	63,078,546	0	63,078,546	44,741,788	1,708,491	1,008,505	0	45,441,774	72.04%		
31 Juris Diff & Nonreg Net Income	4,865,171	(4,865,171)	0	0	0	0	0	0	0.00%		
32 Extraordinary Items	0	0	0	0	0	0	0	0	0.00%		
33 ***Net Income (L29-L30-L31-L32)***	164,623,362	(3)	164,623,359	84,498,629	(9,664,556)	(8,478,262)	0	83,312,335	50.61%	593,147	83,905,482
	0	0	0	0	0	0	0				
Rate Base	0	0	0	0	0	0	0				
34. 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	0	3,699,106,969	72.30%	(22,234,094)	
35. Short-Term Plant Under Construction	0	0	0	0	0	0	0	0	0.00%	0	
36. Materials and Supplies	25,353,734	0	25,353,734	17,820,166	1,189,341	623,909	0	18,385,598	72.52%	(282,716)	
37. Allowance for Cash Working Capital	0	0	0	(24,398,365)	0	0	0	(24,398,365)	0.00%	0	
38. Accumulated Depreciation & Amortization Reserve	2,578,617,059	(50,166,662)	2,528,450,397	1,795,617,425	39,384,691	16,514,403	0	1,818,487,713	71.92%	(11,435,144)	
39. Accumulated Deferred Income Tax	389,102,118	25,611,636	414,713,754	306,015,636	7,460,794	4,416,554	0	309,059,876	74.52%	(1,522,120)	
40. Customer Deposits	7,711,169	0	7,711,169	5,490,899	204,959	0	0	5,695,858	73.87%	(102,480)	
41. Land Development Agreement Deposits	24,660,882	0	24,660,882	18,039,780	0	0	0	18,039,780	73.15%	0	
42. Other Assets & Liabilities	0	0	0	0	0	0	0	0	0.00%	0	
43. End-of-Period Rate Base (L34+L35+L36+L37-L38-L39-L40-L41+L42)	2,120,104,183	45,756,776	2,165,860,959	1,522,896,842	58,042,185	39,128,052	0	1,541,810,975	71.19%	(9,457,067)	1,532,353,909

Allegedly Proprietary Data
Has Been Deleted

100% EXCLUSION OF FCC DEREGULATED SERVICES USING FINANCIAL STATEMENTS IN UTI 42-001
(whole dollars)

	(A)	(B)	(C=A + B)	(D)	(E)	(F)	(G)	(H=D+E-F-G)	(H = G / C)	(J = E - F)	(K)
	Total State MR ☐ Annualize	Total State JD	Total State JR	Intrastate JR	FCC Dereg Excludes Billing & Collection	Payphone & Wireless	State Dereg (Mobile)	Regulated Intrastate	Regulated Intrastate Factors	EXCLUSION OF ALL FCC DEREGULATED SERVICES	ADJUSTED REGULATED INTRASTATE
Revenues											
1 Local Service Revenues	954,933,510	0	954,933,510	954,933,510	0	0	0	954,933,510	100.00%		
2 Network Access Service Revenues	603,899,634	0	603,899,634	121,079,275	0	0	0	121,079,275	20.05%		
3 Long Distance Network Service Rev.	30,371,863	0	30,371,863	30,318,408	0	0	0	30,318,408	99.82%		
4 Miscellaneous	178,544,239	0	178,544,239	56,957,039	102,104,368	16,625,712	0	142,435,695	79.78%		
5 Total Oper. Rev. (L1 thru L4)	1,767,749,246	0	1,767,749,246	1,163,288,232	102,104,368	16,625,712	0	1,248,766,888	70.64%		
Expenses											
6 Maintenance	357,833,823	(197,627)	357,636,196	228,065,407	43,974,712	5,977,110	0	266,063,009	74.39%		
7 Engineering Expense	14,061,421	0	14,061,421	9,621,260	830,731	(257,820)	0	10,709,811	76.16%		
8 Network Operations	55,375,419	0	55,375,419	35,120,336	6,896,637	442,366	0	41,574,607	75.08%		
9 Network Administration	2,834,672	0	2,834,672	2,039,722	11,962	0	0	2,051,684	72.38%		
10 Access Expense	34,298,658	0	34,298,658	20,801,064	0	0	0	20,801,064	60.65%		
11 Other	666,121	0	666,121	438,267	64,472	30,580	0	472,159	70.88%		
12 Total Cost of Services & Products(L6 thru 1	465,070,114	(197,627)	464,872,487	296,086,056	51,778,514	6,192,236	0	341,672,334	73.50%		
13 Customer Operations	244,845,308	0	244,845,308	175,807,054	26,492,765	12,056,399	0	190,243,420	77.70%		
14 Corporate Operations	204,386,153	31,036,120	235,422,273	165,922,800	26,416,021	5,848,360	0	186,490,461	79.22%		
15 Property & Other Taxes	71,165,545	0	71,165,545	50,730,583	2,813,257	1,958,238	0	51,585,602	72.49%		
16 Uncollectibles	20,272,457	0	20,272,457	18,235,984	410,726	2,480	0	18,644,230	91.97%		
17 Tot Selling, General & Admin.(L13 thru L1(	540,669,463	31,036,120	571,705,583	410,696,422	56,132,769	19,865,477	0	446,963,714	78.18%		
18 Other Operating Income & Expense	13,607	0	13,607	(366,413)	509,838	125,328	0	18,097	133.00%		
19 Depreciation Expense	363,709,774	(21,631,550)	342,078,224	235,204,331	8,644,268	4,134,396	0	239,714,203	70.08%		
20 Universal Service Fund	0	0	0	(1,369,596)	0	0	0	(1,369,596)	0.00%		
21 Link Up America	0	0	0	(88,374)	0	0	0	(88,374)	0.00%		
22 Total Operating Expense(L12+L17 thru L21	1,369,462,958	9,206,943	1,378,669,901	940,162,425	117,065,389	30,317,437	0	1,026,910,377	74.49%		
23 Income From Operations (L5-L22)	398,286,288	(9,206,943)	389,079,345	223,125,807	(14,961,021)	(13,691,725)	0	221,856,511	57.02%	1,269,296	223,125,807
Taxes											
24 Federal Income Tax	103,960,088	(1,982,471)	101,977,617	56,978,015	(5,978,925)	(4,903,828)	0	55,902,918	54.82%		
25 State & Local Income Tax	31,769,184	(498,340)	31,270,844	16,940,420	(1,369,843)	(1,440,704)	0	17,011,281	54.40%		
26 **Net Operating Income (L23-L24-L25)**	262,557,016	(6,726,132)	255,830,884	149,207,371	(7,612,253)	(7,347,193)	0	148,942,311	58.22%	265,060	149,207,371
Other											
27 Nonoperating Income & Expense	29,602,302	(1,860,958)	27,741,344	19,736,893	269,210	48,185	0	19,957,918	71.94%		
28 Nonoperating Income Tax	387,635	0	387,635	230,061	74,602	74,379	0	230,284	59.41%		
29 Net Operating Earnings (L26-L27-L28)	232,567,079	(4,865,174)	227,701,905	129,240,417	(7,956,065)	(7,469,757)	0	128,754,109	56.55%		
30 Interest Expense	63,078,546	0	63,078,546	44,741,788	1,708,491	1,008,505	0	45,441,774	72.04%		
31 Juris Diff & Nonreg Net Income	4,865,171	(4,865,171)	0	0	0	0	0	0	0.00%		
32 Extraordinary Items	0	0	0	0	0	0	0	0	0.00%		
33 **Net Income (L29-L30-L31-L32)**	164,623,362	(3)	164,623,359	84,498,629	(9,664,556)	(8,478,262)	0	83,312,335	50.61%	1,186,294	84,498,629
Rate Base											
34. 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	0	3,699,106,969	72.30%	(44,468,188)	
35. Short-Term Plant Under Construction	0	0	0	0	0	0	0	0	0.00%	0	
36. Materials and Supplies	25,353,734	0	25,353,734	17,820,166	1,189,341	623,909	0	18,385,598	72.52%	(565,432)	
37. Allowance for Cash Working Capital			0	(24,398,365)			0	(24,398,365)	0.00%	0	
38. Accumulated Depreciation & Amortization Reserve	2,578,617,059	(50,166,662)	2,528,450,397	1,795,617,425	39,384,691	16,514,403	0	1,818,487,713	71.92%	(22,870,288)	
39. Accumulated Deferred Income Tax	389,102,118	25,611,636	414,713,754	306,015,636	7,460,794	4,416,554	0	309,059,876	74.52%	(3,044,240)	
40. Customer Deposits	7,711,169	0	7,711,169	5,490,899	204,959	0	0	5,695,858	73.87%	(204,959)	
41. Land Development Agreement Deposits	24,660,882	0	24,660,882	18,039,780	0	0	0	18,039,780	73.15%	0	
42. Other Assets & Liabilities	0	0	0	0	0	0	0	0	0.00%	0	
43. End-of-Period Rate Base (L34+L35+L36+L37-L38-L39-L40-L41+L42)	2,120,104,183	45,756,776	2,165,860,959	1,522,896,842	58,042,185	39,128,052	0	1,541,810,975	71.19%	(18,914,133)	1,522,896,842

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Has Been Deleted