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**OFFICE OF THE JUDGE ADVOCATE GENERAL**
**901 NORTH STUART STREET**
**ARLINGTON, VA 22203-1837**

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REPLY TO
ATTENTION OF

BEFORE THE ARIZONA CORPORATION COMMISSION

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Arizona Corporation Commission
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| IN THE MATTER OF THE APPLICATION OF US WEST COMMUNICATION, INC. A COLORADO CORPORATION, FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY FOR 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 |

NOTICE OF FILING

Enclosed for filing are an original and ten(10) copies of the Summary of Pre-Filed Testimony of Richard B. Lee, and Summary of Pre-Filed Testimony of Charles W. King, on behalf of the United States Department of Defense and All Other Federal Executive Agencies, in the above referenced proceeding.

Copies have been served on all known parties in accordance with the enclosed Service List.

Respectfully submitted this 19th day of September, 2000.

Sincerely,

PETER Q. NYCE, JR.
General Attorney
Regulatory Law Office
Phone: (703) 696-1644
Fax: (703) 696-2960

Enclosure

## CERTIFICATE OF SERVICE

I, Peter Q. Nyce, Jr., certify that I have this day caused the Summary of Pre-Filed Testimony of Richard B. Lee, and Summary of Pre-Filed Testimony of Charles W. King, on behalf of the Department of Defense and All Other Federal Executive Agencies, to be served on all known parties by sending a copy by either Federal Express or by regular U.S. Mail delivery to those on the "Service List" attached hereto.

Executed September 19, 2000, at Arlington Virginia.

Peter Q. Nyce, Jr.

MARY B TRIBBY
AT&T
1857 LAWRENCE ST SUITE 1575
DENVER COLORADO 80202

CHARLES R MILLER
AT&T
2800 N CENTRAL AVE STE 828
PHOENIX ARIZONA 85004

TIMOTHY BERG
FENNEMORE CRAIG
3003 N CENTRAL AVE STE 2600
PHOENIX ARIZONA 85012

THOMAS H CAMPBELL
LEWIS & ROCA
40 N CENTRAL AVENUE
PHOENIX ARIZONA 85004

JERRY RUDIBAUGH
CHIEF HEARING OFFICER
ARIZONA CORP COMMISSION
1200 WEST WASHINGTON AVE
PHOENIX ARIZONA 85007

GREG PATTERSON
RUCO
2828 N CENTRAL AVE STE 1200
PHOENIX ARIZONA 85004

PAUL BULLIS CHIEF COUNSEL
LEGAL DIVISION
ARIZONA CORP COMMISSION
1200 WEST WASHINGTON STREET
PHOENIX ARIZONA 85007

RAY WILLIAMSON
ACTING DIRECTOR
UTILITIES DIVISION
ARIZONA CORP COMMISSION
1200 WEST WASHINGTON STREET
PHOENIX ARIZONA 85007

ARIZONA REPORTING SRV INC
2627 N 3RD STREET STE 3
PHOENIX ARIZONA 85004-1104

RICHARD LEE
SNAVELY KING & MAJOROS
O'CONNOR & LEE INC
1220 L STREET N W SUITE 410
WASHINGTON DC 20005

LEX SMITH
MICHAEL PATTEN
BROWN AND BAIN
2901 N CENTRAL AVE
PHOENIX AZ 85001-0400

RAYMOND S HEYMAN
ROSHKA HEYMAN & DEWULF
400 N FIFTH STREET
PHOENIX AZ 85004

MAUREEN SCOTT
LEGAL DIVISION
ARIZONA CORP COMMISSION
1200 WEST WASHINGTON AVENUE
PHOENIX ARIZONA 85007

DOCKET CONTROL
ARIZONA CORP COMMISSION
1200 WEST WASHINGTON AVENUE
PHOENIX ARIZONA 85007

THOMAS F DIXON
MCI TELECOMMUNICATIONS CORP
707 17TH STREET SUITE 3900
DENVER COLORADO 80202

DONALD A LOW SENIOR ATTORNEY
SPRINT COMMUNICATIONS COMPANY
8140 WARD PARKWAY - 5E
KANSAS CITY MO 64114

STEVEN J DUFFY
RIDGE & ISAACSON P C
3101 NORTH CENTRAL AVENUE SUITE 432
PHOENIX ARIZONA 85012

DIANE BACON
LEGISLATIVE DIRECTOR
COMMUNICATIONS WORKERS OF AMERICA
5818 NORTH 7TH ST SUITE 206
PHOENIX ARIZONA 85014

JON POSTON
ARIZONANS FOR COMPETITION IN
TELEPHONE SERVICE
6733 E DALE LANE
CAVE CREEK ARIZONA 85331

DEBORAH R SCOTT
ASSOCIATE GENERAL COUNSEL
CITIZENS UTILITIES COMPANY
2901 N CENTRAL AVE SUITE 1660
PHOENIX AZ 85012

FRANK PAGANELLI ESQ
BLUMENFELD & COHEN
1615 M STREET SUITE 700
WASHINGTON DC 20036

JEFFREY W CROCKETT
SNELL & WILMER
ONE ARIZONA CENTER
PHOENIX ARIZONA 85004-001

SCOTT S WAKEFIELD CHIEF COUNSEL
RUCO
2828 NORTH CENTRAL AVENUE SUITE 1200
PHOENIX ARIZONA 85004-1022

DARREN S WEINGARD
NATALIE D WALES
SPRINT COMMUNICATIONS COMPANY L P
1850 GATEWAY DRIVE 7TH FLOOR
SAN MEATEO CA 94404-2467

MARIA ARIAS-CHAPLEAU
RICHARD S WOLTERS
AT&T
1875 LAWRENCE STREET SUITE 1575
DENVER COLORADO 80202

PATRICIA VANMIDDE
AT&T
111 W MONROE SUITE 1201
PHOENIX ARIZONA 85003

CRIAG MARKS
CITIZENS UITLITIES COMPANY
2901 N CENTRAL AVENUE SUITE 1660
PHOENIX ARIZONA 85012

J E & B V McGILLIVRAY
300 S McCORMICK
PRESCOTT ARIZONA 86303

MICHAEL PATTERN
BROWN & BAIN P A
2901 N CENTRAL AVE SUITE 2000
P O BOX 400
PHOENIX ARIZONA 85001-0400

DOUGLAS HSIAO
PHYTHMS LINKS INC
6933 REVERE PARKWAY
ENGLEWOOD COLORADO 80112

JIM SCHELTEMA
BLUMENFELD & COHEN
1625 MASSACHUSETTS AVE N W
SUITE 300
WASHINGTON DC 20036

ALBERT STERMAN
ARIZONA CONSUMERS COUNCIL
2849 E 8TH STREET
TUCSON ARIZONA 85716

MARTIN A ARONSON
WILLIAM D CLEAVELAND
MORRILL & ARONSON P L C
ONE EAST CAMELBACK SUITE 340
PHOENIX ARIZONA 85012-1648

JOAN S BURKE
OSBORN MALEDON P A
2929 N CENTRAL AVENUE SUITE 2100
PHOENIX ARIZONA 85012

MARK N ROGERS
EXCELL AGENT SERVICES L L C
2175 W 14TH STREET
TEMPE ARIZONA 85281

CHUCK TURNER MAYOR
TOWN OF GILA BEND
PO BOX A
644 W PIMA STREET
GILA BEND ARIZONA 85331

LYN FARMER CHIEF COUNSEL
LEGAL DIVISION
ARIZONA CORPORATION COMMISSION
1200 WEST WASHINGTON STREET
PHOENIX ARIZONA 85007

# BEFORE THE ARIZONA CORPORATION COMMISSION

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Commissioner
WILLIAM A. MUNDELL
Commissioner

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| IN THE MATTER OF THE APPLICATION OF U S WEST COMMMUNICATIONS, INC., A COLORADO CORPORATION, FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY, THE FAIR VALUE OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN | **DOCKET NO. T-01051B-99-0105** |

SUMMARY OF PRE-FILED TESTIMONY
of

## RICHARD B. LEE

on behalf of

THE UNITED STATES DEPARTMENT OF DEFENSE
And
ALL OTHER FEDERAL EXECUTIVE AGENCIES


ROBERT N. KITTEL, CHIEF
Regulatory Law Office
Office of The Judge Advocate General
U.S. Army Litigation Center
901 N. Stuart Street, Suite 713
Arlington, Virginia 22203-1837

by

Peter Q. Nyce, Jr.
General Attorney

My name is Richard B. Lee. I am Vice President of the economic consulting firm of Snavely King Majoros O'Connor & Lee, Inc. with offices in Washington, D.C. My testimony proposes eight adjustments to the revenue requirement presented in the testimony of Qwest witness George Redding. My adjustments have the effect of changing Qwest's revenue requirement deficiency of $201.2 million to an excess of $46.2 million.

**<u>Adjustment 1 – Customer Operations Expense</u>**

**<u>Adjustment 2 – Corporate Operations Expense</u>**

These adjustments reduce Qwest's revenue requirement by <u>$20.5 million</u> for customer operations expense and <u>$11.7 million</u> for corporate operations expense. These adjustments reduce expenses to the level appropriate for the test period (December 31, 1999) based upon the trend of these expenses from January 1997 through December 1999.

In my surrebuttal testimony, I explain that Mr. Redding's challenge to my calculations based upon booked expenses subsequent to the test period should be rejected. As Qwest itself has conceded, financial bookings beyond the test period are irrelevant to the determination of appropriate test period adjustments.

**Adjustment 3 – Services Deregulated by FCC**

This adjustment reduces Qwest's revenue requirement by $2.4 million to reflect the removal of half of the losses for services deregulated by the Federal Communications Commission ("FCC"). This policy adjustment is consistent with that made by the Commission in Qwest's last rate case, and ensures that intrastate ratepayers are not burdened with the full effect of losses incurred in providing services deregulated by the FCC.

**Adjustment 4 – Directory Advertising**

This adjustment reduces Qwest's revenue requirement by $41.3 million to reflect the long-standing imputation of directory advertising revenues in the determination of intrastate revenue requirements. This policy adjustment is based upon the decision of the court to transfer the directory function to the Bell Operating Companies in 1984 so that the significant profits of this operation would continue to be used to reduce local telephone rates.

In my surrebuttal testimony, I explain that the 1988 Settlement Agreement on this matter does not require the discontinuance of this policy adjustment. While the 1988 Agreement requires the Commission to consider the fees and value of services received by Qwest from DEX, the basis for imputation remains the value of the directory function transferred to DEX.

**Adjustment 5 – Productivity**

This adjustment reduces Qwest's revenue requirement by $25.6 million to reflect productivity improvement beyond the test period. As I explain in my direct testimony, if the Commission allows adjustment for input price increases beyond the test period, as proposed by Mr. Redding, it must also allow an adjustment for expected productivity improvement. My adjustment is based upon Qwest's average productivity since 1994.

In my surrebuttal testimony, I explain that Mr. Redding's challenge to my calculations based upon booked expenses subsequent to the test period should be rejected. As noted above, such bookings are irrelevant to the determination of appropriate test period adjustments. The Commission should expect no less than average productivity gains from Qwest in this proceeding.

**Adjustment 6 – Depreciation**

This adjustment reduces Qwest's revenue requirement by $110.5 million based upon a calculation which assumes that the lives approved by the Commission in Decision No. 62507 became effective on the depreciation study date, January 1, 1997. Depreciation rates prescribed by the FCC have been made effective coincident with the depreciation study date since 1991. My calculation also updates depreciation rates as of the test period, December 31, 1999. I note that this calculation is consistent with FCC rules which allow the use of very short depreciation lives, such as adopted by the Commission, only in conjunction with a below-the-line increase in depreciation reserve levels.

In my surrebuttal testimony, I explain that the use of very short depreciation lives without a depreciation reserve increase would result in excessive depreciation expense. The court had found that excessive depreciation expense represents, in effect, capital contributions paid by subscribers. I contend that the Commission is not empowered to require telephone subscribers to contribute capital to finance Qwest's operations.

**<u>Adjustment 7 – Rate of Return</u>**

This adjustment reduces Qwest's revenue requirement by <u>$26.1 million</u> to reflect the rate of return found appropriate by DOD/FEA witness Charles W. King.

**<u>Adjustment 8 – Revenues</u>**

This adjustment reduces Qwests revenue requirement by <u>$15.0 million</u> to reflect the level of revenues appropriate for the test period. This adjustment is based upon the trend of intrastate revenues from January 1997 through December 1999.

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SUMMARY OF PRE-FILED TESTIMONY
of
## CHARLES W. KING

on behalf of

THE UNITED STATES DEPARTMENT OF DEFENSE
And
ALL OTHER FEDERAL EXECUTIVE AGENCIES

ROBERT N. KITTEL, CHIEF
Regulatory Law Office
Office of The Judge Advocate General
U.S. Army Litigation Center
901 N. Stuart Street, Suite 713
Arlington, Virginia 22203-1837

by

Peter Q. Nyce, Jr.
General Attorney

My name is Charles W. King. I am President of the economic consulting firm of Snavely King Majoros O'Connor & Lee, Inc. with offices in Washington, DC. I am appearing on behalf of the Department of Defense and all Federal Executive Agencies. My testimony, both direct and surrebuttal, deals with the rate of return that should be authorized on an original cost rate base for the Arizona intrastate operations of US WEST, now renamed Qwest. For purposes of this testimony, I refer the subject company as "US WEST" or "the Company." Much of my direct testimony and all of my surrebuttal testimony responds to the testimony of US WEST's rate-of-return witness Peter Cummings.

**Direct Testimony**

In my direct testimony, I find that a fair rate of return on the original cost rate base for US WEST's Arizona intrastate operations is 9.54 percent. When applied to the fair value rate base, this return percentage should be adjusted to produce the same amount of return dollars.

In developing this return, I have accepted US WEST's claimed capital structure of 47.6 debt and 52.4 percent equity. I have also accepted US WEST's claimed cost of debt of 7.39 percent.

The cost of equity must be determined in a manner that responds to the mandates of the U.S. Supreme Court as laid down in a series of decisions, the most relevant of which is *F.P.C. v. Hope Natural Gas.* In that decision, the Court found that a fair equity return is one that is commensurate with returns of enterprises having corresponding risk and one that will allow the enterprise to maintain credit and attract capital.

I find that "enterprises having corresponding risk" to US WEST's Arizona intrastate telephone operations are other Bell Regional Holding Companies ("RBHCs") and electric utilities with bond ratings equivalent to or higher than US WEST. I challenge Mr. Cummings' claim that unregulated industrial, service or financial enterprises have risks similar to that of US WEST.

I consider the Discounted Cash Flow ("DCF") procedure to be the most accurate test of a market return to equity capital. The basic premise of this procedure is that the market establishes a price for each stock at the discounted present value of all future flows of cash that investors expect from purchasing that stock. These cash flows consist of two components, the immediate cash flow in the form of a dividend and the prospect for future growth in dividends. The DCF return to equity is therefore the sum of the dividend yield and the expected rate of growth in dividends.

The "classic" DCF formulation, which the Federal Communications Commission ("FCC") believes should be given the greatest weight in determining equity return, combines the dividend yield in the immediate period (coming year) with consensus estimates of the rate of growth in earnings as determined by surveys of investment analysts.

For US WEST, I find that the immediate dividend yield is 3.0 percent, and the consensus of forecasts of growth is 7.22 percent for a classic DCF indication of 10.22 percent. The corresponding DCF indications for the other RBHCs are 12.01 percent for Verizon, 12.73 percent for BellSouth and 15.18 percent for SBC. For a comparison group of 34 electric utilities with Moody's bond ratings of A3 or better, the classic DCF returns range from 9.06 to 14.83 percent, with an average of 11.53 percent.

An alternative to the classic DCF model extrapolates the historical trend in earnings per share growth to estimate the rate of future earnings growth. I develop these DCF returns but find that they are so varied as to question their reasonableness.

An alternative to the DCF procedure is the Capital Asset Pricing Model ("CAPM") on which US WEST witness Cummings places considerable reliance. This model is based on the proposition that investors, through diversification, can eliminate most of the specific risk of an individual stock, but they cannot avoid the overall risk of the stock market as a whole. The CAPM employs a measure called "beta" to assess the relative risk of an individual stock to that of the overall market. Beta reflects the covariance of the fluctuations in the price of the individual stock with that of the market:

a beta of 1.0 means that the stock fluctuates to the same degree as the market, a beta of .5 means that the stock price fluctuates with the market at only half the rate as the market.

I find that all four of the measures required to implement the CAPM are highly uncertain and to some extent subjective. (1) The determination of the risk-free return is subjective because the yields on U.S. Government securities, which are the traditional measure, vary depending upon the term of the instrument. (2) The measurement of beta is uncertain because beta varies by time period and because there is considerable debate over whether "adjusted" of "unadjusted" betas should be used. (3) The measurement of the risk premium of the market as a whole is highly controversial. The historical risk premium approach, which uses the recorded difference between stock and bond yields over more than seven decades, is so conceptually and statistically flawed as to be without value. The <u>ex ante</u> measurement of the market's risk premium used by Mr. Cummings is conceptually acceptable, but it is redundant with the DCF procedure because it applies that theory to a large number of companies to arrive at the market return. (4) Finally, the assumption that beta and risk premium are linearly and proportionately related has no conceptual or empirical basis.

The beta measure may have some value, however, as a test of <u>relative</u> riskiness, as it appears to explain some of the variation in the DCF return indications of among the four Regional Bell Holding Companies. Specifically, the relatively low beta for US WEST may explain its low DCF return requirement.

Using the 10.22 percent DCF return for US WEST as the bottom of the range, and the 12.73 percent for BellSouth as the top, I select **11.5 percent**, the approximate midpoint, as the appropriate return to equity for US WEST.

Unlike Mr. Cummings, I do not adjust this DCF-based return for the costs of stock flotation. I demonstrate that Mr. Cummings' adjustment grossly over-recovers the stock flotation costs that US WEST has incurred since 1984.

The 11.5 percent equity return, when weighted with the debt portion of US WEST's capital, yields a composite return to total capital of **9.54 percent.**

**Surrebuttal Testimony**

My surrebuttal testimony responds to six criticisms of my testimony made by Mr. Cummings in his rebuttal testimony.

First, Mr. Cummings asserts that my statement that all market returns are comparable to all other market returns is incorrect. I respond that Mr. Cummings either did not or chose not to understand this statement. Investors establish the price they are willing to pay for any stock by balancing their valuation three things: the dividend yield, the expected growth in earnings, and the confidence in that future earnings growth. Investors compare these three elements for all stocks with all other stocks in setting prices they are willing to pay.

Second, Mr. Cummings states that the electric companies I use for comparison purposes have much lower risk than telephone companies. I concede that the companies are less risky, but the activities at issue in these proceedings, which are the Arizona intrastate landline service of US WEST, are quite comparable with the predominant activities of the electric companies.

Third, Mr. Cummings states that I understated the forecast dividend yield of Verizon. The dividend yield I used was based on the initial investors' services' forecasts of Verizon's dividend. Those have since been revised, and I accept Mr. Cummings' update.

Fourth, Mr. Cummings states that I inappropriately included a DCF return analysis for the pre-merger US WEST company. I point out that the analysts' forecasts I used for my DCF analysis were made prior to the final approval of the merger with Qwest. I include the DCF study of US WEST that I performed in October 1999 when the merger with Qwest was far from certain. Both studies show a very low return requirement consistent with US WEST's low beta and its very high proportion of revenue from low-risk local telephone services.

Fifth, Mr. Cummings argues that I inappropriately dismissed the historical risk premium model as flawed. Mr. Cummings fails, however, to address, let alone rebut the demonstration in my direct testimony that this approach is so conceptually and statistically flawed as to be without value.

Finally, Mr. Cummings contends that I failed to provide adequate allowance for stock issuance expense. Using Mr. Cummings' own numbers, I demonstrate that stock flotation costs are negligible and that his allowance would grossly over-compensate the Company for those costs.