Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Kathleen M. Folsom. My business address is 1300 S Evergreen Park Dr SW, Olympia, Washington, 98504.

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

A. I am employed by the Washington Utilities and Transportation Commission ("WUTC" or "Commission") as a Utilities Rate Research Specialist.

Q. PLEASE STATE YOUR QUALIFICATIONS TO PROVIDE TESTIMONY IN THESE PROCEEDINGS.

A. I hold a Bachelor of Arts degree in Business Administration from Washington State University. I also hold an MBA, with a concentration in Finance, from Portland State University. I have testified before the Commission on issues related to the establishment of an authorized rate of return for GTE Northwest Incorporated (GTE-NW) in Docket No. UT-931591 and U S West Communications, Inc. (USWC) in Docket No. UT-950200. I have submitted testimony on issues related to transfers of property for GTE-NW in Docket UT-981367. In my capacity as a Utilities Rate Research Specialist, I have presented recommendations to the Commission on security, affiliated interest, and transfer of property applications.

Q. WAS YOUR TESTIMONY PREPARED BY YOU OR UNDER YOUR DIRECTION?

A. Yes.

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

A. The purpose of my testimony is to present to the Commission a recommendation and summary of conditions regarding the proposed merger between U S WEST, Inc. (USWI or Applicant) and Qwest Communications International, Inc. (Qwest or Applicant). I also examined the effect of costs incurred as a result of the proposed merger and the potential impacts of the proposed merger on USWC's bond rating.

Q. WHAT IS STAFF'S RECOMMENDATION?

A. Staff recommends that the Commission not approve the merger of USWI and Qwest unless it is subject to the conditions set out in this testimony and that of the other Staff witnesses.

Q. PLEASE PROVIDE AN OVERVIEW OF THESE RECOMMENDED CONDITIONS.

A. Staff is recommending a reasonable but stringent set of conditions for approval of Qwest's takeover of USWI. The overall purpose of these conditions is to ensure that Qwest dedicates the resources necessary to maintain and improve service to consumers in Washington state and to ensure that local telecommunications markets continue to open to competition.

Q. PLEASE IDENTIFY THE SPECIFIC CONDITIONS THAT STAFF IS RECOMMENDING.

SYNERGIES (As addressed in Staff witness Maurice Twitchell's testimony, Ex. T-___ (MLT-T))

The appropriate amount of synergies that should flow to the state of Washington intrastate operations so that the Commission can find that the proposed merger is consistent with the public interest is **$233,598,713**.

SERVICE QUALITY IMPROVEMENTS (As addressed in Staff witness Suzanne Stillwell's testimony, Ex. T-___ (SLS-T))

The Commission should order U S WEST/Qwest to:

1. Retain the existing held order remedies required in Docket Nos.UT-950200 and UT-970766 and defined in the company's tariff (waiver of installation charges, loan of wireless phones, etc.).

2. Retain the existing $50 missed appointment and commitment credits.

3. Implement a credit of $50 for any customer who experiences an out-of-service condition when it is not restored within 24 hours, or when it recurs within seven days.

4. Implement a credit of one month's service and feature charges when a customer is served by a switch that experiences more than 2% busy-hour, no-dial-tone situation. This credit should be a recurring credit for every month this condition occurs.

5. Adopt and distribute to all customers a Consumer Bill of Rights. In addition to a description of rights regarding privacy, accuracy, courtesy and excellent service, the Bill of Rights must include a description of customer remedies as described in (1) through (4), above.

6. Clear all held orders. The company must complete all orders for local exchange and private line service, including high capacity services, that are held more than 30 days as of the date of merger approval.

7. Improve complaint response. Effective immediately, the company must respond to Commission-referred complaints and inquiries with substantive information within two business days when the complaint is initially reported to the company; and within three business days, with substantive information, when staff requests subsequent information. The company will pay a $100 penalty for each inquiry for which a complete and timely response is not made. This penalty amount will be calculated and paid quarterly.

8. Increase complaint-handling staff dedicated to resolving Washington complaints. Until Commission-referred complaints decrease to the levels reported in 1991, the company must dedicate a minimum of five staff to respond to Washington Commission-referred complaints.

9. Submit a tariff filing to include all customer remedies, (1) through (4) above.

INVESTMENT REQUIREMENTS (As addressed in Staff witness David Griffith's testimony, Ex. T-___ (DG-T))

The Commission should order U S WEST/Qwest to:

1. Replace all analog switches with digital switches by June 30, 2001.

2. Incorporate fiber ring technology with route diversity to all of U S WEST's central offices within three years after the merger closes.

3. Commit an additional $100 million per year for the next five years following merger close to be used for service quality remediation projects and enhancements for advanced digital services, and excluding analog switch replacements and E911 upgrades.

4. Establish a base line investment based on the 1995-1999 five-year average (adjusted annually for growth) level investment in telephone plant.

5. Upgrade E911 services to accommodate 10-digit number identification, area code overlays and local number portability.

6. Increase, relative to the 12/31/99 level, its Washington state engineering and construction workforce by 30% within six months after merger close and maintain that level of employment for the first seven years after the merger closes.

7. Provide quarterly updates on progress and annual reviews of the company's planning and implementation process for infrastructure investments.

8. Be subject to penalties of up to $1,000 per day for each instance where the company does not meet deadlines established by the Commission for key infrastructure improvements.

COMPETITION (As addressed in Staff witness Dr. Glenn Blackmon's testimony, Ex. T-___ (GB-T))

A. **Advanced services conditions.** The merged company should be required to implement measures to ensure equitable and efficient deployment of advanced services. These measures should include:

1. Create, prior to closing the merger, one or more separate affiliates to provide all advanced services and Internet access services on a phased-in basis. The advanced services affiliate would be required to operate separately from the operating company (U S WEST

Communications, Inc.).

2. Establish by tariff prior to closing the merger a surrogate line sharing discount. The merged company would be required to offer at a substantial discount an unbundled loop to its advanced services competitors until it provides the same line-sharing capabilities that its own advanced services enjoy.

3. Develop and deploy common electronic operations support system (OSS) interfaces to be used by any provider of advanced services, including the merged firm's advanced services affiliates, for pre-ordering and ordering facilities used to provide advanced services. Until the merged company has developed the required interfaces, it should be required to offer a 25 percent discount from the recurring and non-recurring charges for unbundled loops used to provide advanced services.

4. Target deployment of the merged company's own advanced service offerings to include low-income groups in rural and urban areas.

B. **Interconnection and open access conditions.** The merged company should be required to take all steps necessary to obtain FCC approval of an application for in-region interLATA entry by March 31, 2001. If the company fails to win approval by that date, it should be required to file a separation plan with the Commission. This separation plan would establish a plan for separating the operating company (USWC or its successor) into two separate companies, one providing wholesale functions and one providing retail functions.

RATES FOR NON-COMPETITIVE SERVICES (As addressed in Staff witness Dr. Glenn Blackmon's testimony, Ex. T-___ (GB-T))

The merged company should not be permitted to eliminate or restrict any tariffed service or to increase the rates or charges for any tariffed service for seven years after the merger closes.

MERGER COSTS (As addressed in Staff witness Kathleen M. Folsom's testimony, Ex. T-___ (KMF-T))

1. USWC should not include in future rate filings costs that may occur as a result of the merger transaction.

2. If the debt rating of USWC is downgraded specifically as a result of the merger, an adjustment in the calculation of the cost of debt should be made for ratemaking purposes to remove the effect of the downgrade.

Q. SHOULD THE COMMISSION REDUCE OR EXCLUDE CONDITIONS IF THE

TOTAL COST OF MEETING THE CONDITIONS WOULD EXCEED THE LEVEL OF SYNERGIES IDENTIFIED BY THE APPLICANTS?

A. No. The Commission should adopt the conditions that are necessary to protect the public interest, even if implementation of those exceed the expense savings claimed by the applicants. While Staff has not attempted to quantify the cost of all its recommended merger conditions, it is clear that the total will exceed the $233 million of expense savings claimed by Applicants. The incremental investment for service quality remediation alone amounts to $500 million. However, the investments in service quality remediation, switch replacements, and fiber rings are driven by the demand by customers for additional services, and those additional services will generate additional revenues that will at least in part offset the investment cost. Indeed, the new switches, fiber optic rings, and other facilities are likely to provide a stream of revenue that will last much longer than the six-year period over which the applicants chose to measure expense savings.

<u>Description of the Acquiring Company</u>

Q. PLEASE DESCRIBE QWEST AND ITS SUBSIDIARIES.

A. Qwest is a Delaware corporation organized in 1997 to hold the stock of its indirect principal subsidiary, Qwest Communications Corporation. Four Qwest subsidiaries - Qwest Corp., LCI, USLD, and Phoenix are authorized to provide telecommunications services in Washington. As of December 31, 1998, Qwest employed approximately 8,700 employees.

Q. HAS QWEST ENTERED INTO ACQUISITIONS, MERGERS OR OTHER SIMILAR TRANSACTIONS SINCE 1997?

A. Yes. As stated in its 1998 Form 10-K, "A key strategy has been to add strength through investments in and acquisitions of businesses, facilities or other assets. . . ." Since March of 1998, Qwest has made at least the following acquisitions or ventures:

- March 1998 - acquired Phoenix Network, Inc. for .8 million shares of stock, then valued at approximately $27.2 million;
- April 1998 - acquired Amsterdam-based Eunet International Limited for approximately $4.2 million cash and 4 million shares of stock, then valued at approximately $154 million;
- June 1998 - acquired LCI for approximately 129.9 million shares of stock, then valued at approximately $3.9 billion;
- December 1998 - acquired Icon CMT Corp. for approximately $254.1 million in stock;
- December 1998 - entered into a strategic alliance with Microsoft;
- January 1999 - invested in Covad Communications Group for approximately $15 million in cash; and
- entered into a venture with KPN, a Dutch telecommunications company.

<u>Overall Approach of Staff in its Merger Review</u>

Q. DID STAFF EXAMINE THE MERGER APPLICATION AND ACCOMPANYING

EXHIBITS PURSUANT TO RCW 80.12.020 AND CHAPTER 480-143 WAC (TRANSFERS OF PROPERTY)?

A. Yes. Chapter 80.12.020 provides as follows: "No public service company shall sell, lease, assign or otherwise dispose of the whole or any part of its franchises, properties or facilities whatsoever, which are necessary or useful in the performance of its duties to the public, and no public service company shall, by any means whatsoever, directly or indirectly, merge or consolidate any of its franchises, properties or facilities with any other public service company, without having secured from the commission an order authorizing it so to do...."

Staff also examined the merger application pursuant to WAC 480-143-170 which provides as follows: "If, upon the examination of any application and accompanying exhibits, or upon a hearing concerning the same, the commission finds the proposed transaction is not consistent with the public interest, it shall deny the application."

Q. HAS STAFF CONCLUDED THAT THE PROPOSED MERGER, AS DESCRIBED IN THE COMPANIES' JOINT APPLICATION, IS NOT CONSISTENT WITH THE PUBLIC INTEREST?

A. Yes. Staff has conducted a thorough review of the proposed merger, and based on the legal standards established by state law and prior Commission decisions, Staff has concluded that the merger, as proposed, is not consistent with the public interest.

Q. DID STAFF CONSIDER RECOMMENDING THAT THE COMMISSION REJECT THE PROPOSED MERGER OUTRIGHT, RATHER THAN ATTACH NUMEROUS CONDITIONS TO ITS APPROVAL?

A. Yes, Staff gave serious consideration to this option before deciding to develop a set of conditions under which the merger could go forward without harming the public interest.

Q. WHY DID STAFF ADOPT THE APPROACH OF RECOMMENDING APPROVAL WITH CONDITIONS?

A. First, Staff recognized that the merger would create expense savings, as well as revenue and investment opportunities, that could be used to make the necessary improvements in USWC's network and service levels. Second, Staff does not take lightly the approval by stockholders of a change in executive management. As illustrated by the testimony of Staff witnesses Suzanne Stillwell and David Griffith as well as the Commission's decisions in USWC's last two rate cases, the company under existing executive management has provided a level of service lower than customers have a right to expect.

Q. IS IT STAFF'S POSITION THAT THE MANAGEMENT OF QWEST IS BETTER QUALIFIED THAN CURRENT MANAGEMENT TO OPERATE THE COMPANY?

A. No. The change in control of USWI represents an opportunity for change in direction, but Staff does not necessarily believe that the change in management by itself will produce that change in direction. Indeed, we recognize that Qwest could be even more driven toward new ventures and acquisitions and less willing to invest in the core telephone network. Qwest may find that it lacks the management expertise necessary to operate a local telephone network, and it may leave in place many of the executives who have been responsible for the strategic decisions at USWI and USWC over the last few years. It is for these reasons that Staff believes that only with appropriate conditions can the Commission approve the merger as not harming the public interest.

Q. HAS STAFF DISCUSSED WITH QWEST ITS PLANS FOR IMPROVING SERVICE PERFORMANCE AND INCREASING INVESTMENT?

A. Yes. Based on those discussions, I was left with the impression that Qwest recognizes the inadequate nature of existing service and has a general interest in improving it. However, Qwest also appears unable to specify how it would go about making those improvements. Thus Staff was unable to evaluate any specific commitments. Our only alternative was to develop a set of conditions that could reasonably be expected to protect customers, ensure a reliable and adequate telecommunications network, and advance competition.

Q. WHY MIGHT QWEST BE INTERESTED IN ACQUIRING USWI, AND ITS WHOLLY-OWNED SUBSIDIARY USWC, IF NOT TO MAINTAIN AND IMPROVE SERVICE TO EXISTING CUSTOMERS?

A. The customers of USWC generate a huge cash flow. Much of that cash flow must be reinvested in the network to provide adequate service to customers; indeed, telecommunications companies experiencing rapid growth in demand due to new services and new customers can easily require capital infusions because internally-generated cash flow alone is inadequate. However, a company also could decide not to use this cash flow for network reinvestment and instead direct it toward acquisitions of other companies, entry into other markets, or other such unrelated purposes. Staff is not suggesting that Qwest has such a plan; it lacks the information necessary to reach a conclusion one way or the other on this point. Indeed, even if it were possible to conclude that Qwest's management was totally dedicated to providing good service to Washington state, there is no guarantee that further takeovers or management restructurings might eliminate that commitment.

For these reasons, Staff believes that the Commission must consider and guard against the prospect that a company would acquire USWI, not for the opportunity to serve the customers of Washington state, but for the opportunity to redirect USWC’s cash flow elsewhere. That is the purpose of Staff's recommended conditions – to allow the market-driven takeover of USWI to move forward without putting Washington state consumers at risk.

Q. IS STAFF’S RECOMMENDATION IN THIS PROCEEDING CONSISTENT WITH

THE THIRD SUPPLEMENTAL ORDER IN DOCKET NO. UE-981627?

A. Yes. In the PacifiCorp merger with Scottish Power, Docket No. UE-981627, In re PacifiCorp and Scottish Power PLC, Third Supplemental Order (April 1999), the Commission recognized that the approach for determining what is in the public interest varies with the form of the transaction and the attending circumstances. The Commission recently reaffirmed this approach for determining the public interest in this docket. See TR, Vol. II at 69-70 (1999).

Merger Costs

Q. WILL THERE BE DIRECT EXPENSES ASSOCIATED WITH THE MERGER TRANSACTION?

A. Yes.

Q. IF SO, WHO WILL BEAR THOSE DIRECT EXPENSES ASSOCIATED WITH THE MERGER TRANSACTION?

A. The direct testimony of Applicant witness Carl Inouye, at page 5, provides that the direct expenses incurred by the Applicants in connection with the merger will be paid by the party incurring such expenses. Mr. Inouye further states in his direct testimony at page 5, lines 24 - 26, that USWC's "portion of the direct expenses of the merger will be charged to non-operating (or so called "below-the-line") accounts that are ordinarily excluded from cost-of-service rate making." He continues on page 7 of his testimony, at line 14, to state "I do not expect any of those costs to be charged to U S WEST's operating accounts."

Q. SHOULD THESE COSTS BE PASSED ON TO THE RATEPAYER?

A. No. Transaction costs are one-time, non-recurring charges which traditionally have not been recovered from ratepayers. Non-recurring merger charges should be borne by shareholders as part of the risk they incur when approving the merger of the companies in which they own stock.

Q. WILL THE MERGER AFFECT USWC'S COST OF CAPITAL?

A. It could. In response to Staff Data Request 02-022 (Ex. ___ (KMF-1)), Applicants provided rating agency press releases issued after the merger was announced. The press releases indicate that Moody's Investor Service, Duff & Phelps Credit Rating Co., and Standard & Poor's have placed the debt of USWC under credit review for a possible downgrade. Further, in response to Staff Data Request 02-024 (Ex. ___ (KMF-2)), Applicants state that "U S WEST's credit rating has been placed under a 'watch'. If that watch results in a decline in the credit rating, the cost of capital may increase." Likewise, at page 8, lines 5-8 of his testimony, Mr. Inouye states that "[w]ith the merger announcement, credit agencies placed the debt of U S WEST under review with a negative outlook. The result may be a credit rating decline."

Q. WHAT IS MEANT BY A CREDIT RATING WATCH?

A. A watch highlights the potential direction of an issuer's debt rating. It focuses on identifiable events, such as a proposed merger, that cause securities to be placed under special surveillance by a rating agency. A "negative" watch means that a bond rating may be lowered. A lower bond rating is likely to result in an incrementally higher cost of debt for the issuer.

Q. HOW ARE RATEPAYERS IMPACTED BY AN INCREASE IN DEBT COST?

A. An increase in debt cost could be reflected in any future cost of capital calculation (and therefore rates) for USWC.

Q. WHAT IS STAFF'S RECOMMENDATION REGARDING AN INCREASE IN DEBT COST ARISING AS A RESULT OF THE MERGER?

A. Post-merger costs, including cost of debt, to Washington ratepayers should not be higher than they otherwise would have been if the merger had not occurred. If the debt rating of USWC is downgraded specifically as a result of the merger, Staff recommends that an adjustment in the calculation of the cost of debt be made for ratemaking purposes to remove the effect of the downgrade.

Conclusion

Q. SUBJECT TO THE CONDITIONS DISCUSSED ABOVE AND IN THE TESTIMONY OF OTHER STAFF WITNESSES, DOES STAFF RECOMMEND APPROVAL OF THE MERGER APPLICATION?

A. Yes. Staff recommends approval with those conditions.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.