EXHIBIT PEG-1T

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Application of QWEST CORPORATION Regarding the Sale and Transfer of Qwest Dex to Dex Holdings, LLC, a Non-Affiliate	Docket No. UT – 021120

DIRECT TESTIMONY OF

PHILIP E. GRATE

ON BEHALF OF

QWEST CORPORATION

JANUARY 17, 2003

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1 IDENTIFICATION OF WITNESS

2 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

3 A. My name is Philip E. (Phil) Grate. My business address is 1600 Bell Plaza, Room 3008,
4 Seattle, Washington 98191.

5 **Q. PLEASE IDENTIFY YOUR EMPLOYER AND EXPLAIN YOUR POSITION AND**
6 **RESPONSIBILITIES.**

7 A. I am employed by Qwest Corporation as a State Finance Director in Qwest Corporation's
8 Finance department. In this position, I am responsible for preparing and presenting
9 regulatory accounting testimony and ratemaking testimony on behalf of Qwest Corporation
10 before state regulatory agencies.

11 **Q. PLEASE DESCRIBE YOUR EDUCATION, PROFESSIONAL CREDENTIALS,**
12 **PROFESSIONAL EXPERIENCE AND TESTIMONY HISTORY.**

13 A. My education, professional credentials, professional experience and prior testimonies are set
14 forth in my vita, which is attached to this testimony as Exhibit PEG-2.

15 **Q. HAVE YOU PREVIOUSLY SUBMITTED TESTIMONY BEFORE THE**
16 **WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION?**

17 A. Yes, I testified concerning cost of service issues before this Commission on behalf of
18 Qwest's predecessor in Washington, U S WEST Communications, Inc. (USWC), in Docket
19 No. UT-970766.

20

1 ## PURPOSE OF TESTIMONY

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

3 A. The purpose of my testimony is to examine the issue of the disposition of the gain on the
4 sale of Dex using the two-step risk and burden test the Commission has previously employed
5 to make such determinations. I will review historic facts that indicate who (ratepayers or
6 investors) has borne the risk of loss and burden of the directory advertising business.
7 Specifically I will evaluate these questions in light of the history of:

8 - the Company's[1] telephone service operations in Washington;
9 - telephone industry competition in Washington;
10 - the Company's directory publishing and advertising operations in Washington;
11 and
12 - regulation of the Company's business in Washington.

13 In order to determine how to allocate the gain from the sale of Dex, I will analyze how and
14 the extent to which changes in the regulatory scheme in Washington has shifted the risk of
15 loss and burden between investors and ratepayers over time.

16

[1] Qwest Corporation has many predecessors in interest in Washington. Specifically, Qwest Corporation was preceded by USWC, which was preceded by Pacific Northwest Bell Telephone Company (PNB) which was preceded by Pacific Telephone & Telegraph Company (PT&T), which was preceded in several parts of Washington by other telephone companies such as the Sunset Telephone and Telegraph Company (serving Seattle and Tacoma), the Inland Telephone and Telegraph Company (serving Spokane) and the Home Telephone and Telegraph Company of Spokane. For purposes of this testimony and its exhibits, I will refer to Qwest Corporation and its predecessors as the "Company" unless the context requires specific identification of the name of the company to which I am referring.

1 **PRINCIPLES OF ALLOCATING GAIN**

2 **Q. WHAT PRINCIPLES DO YOU UNDERSTAND THE COMMISSION EMPLOYS TO**
3 **DETERMINE HOW TO ALLOCATE A GAIN BETWEEN RATEPAYERS AND**
4 **INVESTORS IN WASHINGTON?**

5 A. I understand that to determine who should receive the gain on the sale of a utility asset, the
6 Commission employs principles established in *Democratic Central Committee of the*
7 *District of Columbia v. Washington Metropolitan Transit Commission,* 458 F. 2d 786 (D.C.
8 Cir. 1973), reh den, cert den, 415 US 935 (1973).[2] In *Illinois Pubic Telecommunications*
9 *Association v. FCC,* The DC Circuit Court of Appeals described the principles it established
10 in *Democratic Central Committee* as follows:

11 As a general rule, utility service ratepayers "pay for service" and thus "do not acquire
12 any interest, legal or equitable, in the property ... of the company. Property paid for
13 out of moneys received for service belongs to the company." However, we have held
14 that neither ratepayers nor the company (and thus its shareholders) are necessarily
15 entitled to increases in the value of assets employed in the utility's operations. Rather,
16 such increases are to be allocated under a two-step test in which the court first asks
17 which party "bears the risk of loss" on the assets. The party that bore the risk of loss
18 is the party entitled to the capital gains on the assets. Only if it is difficult to
19 determine who bore the risk of loss will "the second principle come into play,
20 namely, 'that those who bear the financial burden of particular utility activity should
21 also reap the benefits resulting therefrom.'"[3]

22 Therefore, I understand that the allocation of gain between ratepayers and investors is
23 dictated by the Commission's legal policy decision that reward from the disposition of an
24 asset should go to the party that bore the risk of loss on the asset and that if the risk of loss
25 cannot be determined, the benefit derived from the disposition of a utility activity should

[2] In re the Matter of the Application of Avista Corporation for Authority to Sell Its Interest in the Coal-Fired Centralia Power Plant, WUTC Docket Nos. UE-991255, UE-991262 and UE-991409. Second Supplemental Order, March 2000.

[3] *Illinois Public Telecommunications Association v. Federal Communications Commission and United States of America,* 326 U.S. App. D.C. 1 at 43: 117 F3d 555; (July 1, 1997)

1 flow to the party that bore the burden of the utility activity. I also understand that which
2 party bore the risk of loss of an asset or the burden of a utility activity is a question of fact to
3 be found by the Commission.
4
5 **Q. WHAT ASPECT OF RISK OF LOSS AND BURDEN DOES YOUR TESTIMONY**
6 **ADDRESS?**
7 A. My testimony addresses how regulation and competition determine who bears the risk of
8 loss and burden, and then examines the history of the Company's telephone business, its
9 directory line of business and the development of regulation in Washington. I examine the
10 risk of loss and burden throughout this history as regulation in Washington has changed and
11 developed over time.

12 **Q. WHAT PRINCIPLE FACTOR DETERMINES WHETHER RISK OF LOSS AND**
13 **FINANCIAL BURDEN ARE BORNE BY RATEPAYERS OR INVESTORS?**
14 A. As explained in *Illinois v. FCC*, the regulatory scheme in place at a particular time
15 determines which party bears the risk of loss and burden. As a rule, customers of businesses
16 not subject to rate regulation have no claim on gains from the sales of those businesses'
17 assets because they bear none of the "risks of loss" and "burdens" contemplated by the two-
18 step test of *Democratic Central Committee*. The act of purchasing goods or services from a
19 business does not cause a customer to assume the risk of loss or shoulder the burden of that
20 business. However, under appropriate circumstances, a regulatory scheme can shift the risk
21 and/or burden from investors to customers.

22 **Q. WHAT DO YOU UNDERSTAND THE "FINANCIAL BURDEN" OF A UTILITY**
23 **ACTIVITY TO MEAN?**
24 A. I understand "financial burden" to mean the burden of cost recovery. In a competitive
25 business, the burden of recovering costs rests solely on the investors in that business. If

1 revenues are insufficient to recover costs and provide a return on invested capital, the
2 investors suffer the financial consequences.

3 When a form of rate regulation shifts the burden of cost recovery of a utility activity from
4 investors to customers, then the customers can be said to bear the "financial burden" of that
5 activity. The burden of cost recovery can fall on customers only where
6 1) rates they pay are fixed under cost-of-service ratemaking principles;
7 2) where competition is absent; and
8 3) where the rates are designed to recover all necessary and prudent costs, including
9 the cost of capital.

10 **Q. WHY DON'T ALL FORMS OF RATE REGULATION IMPOSE THE FINANCIAL**
11 **BURDEN OF A UTILITY ACTIVITY ON CUSTOMERS?**

12 A. Rates subject only to price cap regulation do not shift the burden of cost recovery onto
13 customers where such rates are not designed to recover the provider's costs. Customers do
14 not bear the financial burden of services that are not subject to rate regulation because the
15 necessary link between rates and costs does not exist. Nor do customers who have
16 competitive choice bear any burden of cost recovery; they can choose to buy services from
17 another provider and leave investors to bear the financial consequences of the lost revenue.

18 **Q. WHAT DOES "RISK OF LOSS ON ASSETS" MEAN?**

19 A. I understand "risk of loss" on an asset means the risk that the asset could be removed from
20 service before its costs are fully recovered. Customers bear the risk of loss on an asset
21 where they are obliged through the application of regulation to provide compensation to
22 investors for loss in the value of an asset that, absent such regulation, they would not be
23 obliged to provide.

1 **Q. DO ALL FORMS OF RATE REGULATION IMPOSE THE RISK OF LOSS ON**
2 **CUSTOMERS?**

3 No. Moreover, changes in regulatory scheme can shift the risk of loss and burden between
4 customers and investors. In a later portion of *Illinois v. FCC,* the DC Circuit Court of
5 Appeals explains how price-cap regulation does not impose risk of loss on customers and
6 how a change in regulatory scheme can shift risk of loss from customers to investors.
7

> 8 As explained above, in allocating increases in asset value under Democratic Central,
> 9 we first ask which party bore the risk of loss on the assets. The answer to that
> 10 question may change over time depending on the regulatory scheme in place. Prior to
> 11 October 1990, the FCC regulated the rates of local telephone exchange companies
> 12 under a rate-of-return regulatory system. Under a rate-of-return system, a company
> 13 "can charge rates no higher than necessary to obtain sufficient revenue to cover" the
> 14 costs of regulated activities and "achieve a fair return on equity." The provision of
> 15 payphone service traditionally has been treated as a regulated activity. Thus, LEC
> 16 shareholders were protected against losses from depreciation expenses on the assets
> 17 of regulated activities; it was ratepayers who bore the risk of loss on such assets.
>
> 18 However, in October 1990, the Commission switched to a "price cap" system of
> 19 regulating the larger LECs (i.e., the BOCs and GTE companies). Under a price cap
> 20 system, "the regulator sets a maximum price, and the firm selects rates at or below
> 21 the cap." Cost reductions under the price cap scheme "do not trigger reductions in
> 22 the cap," but rather increase the company's profits. Thus, after 1990, the ratepayers
> 23 no longer bore the risk of losses from payphone operation assets. To the extent a
> 24 BOC incurred expenses in connection with payphone operations, company and
> 25 shareholder profits declined. As a result, at least since 1990, investors rather than
> 26 ratepayers have borne the risk of loss on payphone assets (tangible and intangible),
> 27 and thus, under Democratic Central, investors should reap the benefit of increases in
> 28 the value of such assets.[4]

29 **Q. DO ALL FORMS OF COST-OF-SERVICE REGULATION IMPOSE ON**
30 **CUSTOMERS THE RISK OF LOSS ON ASSETS?**

31 A. Some do and some do not. It depends on whether the method of cost-of-service ratemaking
32 the regulator employs obliges customers to compensate investors for losses on dispositions
33 of assets. For example, the mass asset method of accounting for depreciable assets shifts the

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[4] *Id.*

1 risk of loss to ratepayers to the extent losses on dispositions are deducted from the
2 depreciation reserve of the asset removed from service. Conversely, "Under a strictly
3 construed current-value theory of ratemaking, the fact that a company failed to recover its
4 outlay in outmoded plant should not give even a shadow of a claim to a recovery of this
5 outlay from future ratepayers."[5] Clearly, not all forms of cost-of-service regulation impose
6 the risk of loss on customers.

7 ## HISTORICAL ANALYSIS OF RISK OF LOSS AND BURDEN

8 ### Reason for Historical Analysis

9 **Q. WHY IS A HISTORICAL ANALYSIS OF THE RISK OF LOSS AND BURDEN**
10 **RELEVANT TO THIS PROCEEDING?**

11 A. Under the test established in *Democratic Central Committee,* gain realized on assets
12 employed in the utility's operations is to be allocated under a two-step test in which the
13 regulator first asks "which party bore the risk of loss on the assets." The party that bore the
14 risk of loss is the party entitled to the capital gains on the assets. Only if it is difficult to
15 determine who bore the risk of loss will the second principle come into play, namely, that
16 those who bear the financial burden of particular utility activity should also reap the benefits
17 resulting therefrom.

18 In order to help the Commission determine who—customers or investors—bore the risk of
19 loss on the assets being sold and, in cases where it is difficult to make that determination,
20 who bore the financial burden of the activities being sold, it is necessary to review the

[5] Principles of Public Utility Rates, Second Edition, Bonbright, Danielsen and Kamerschen, Public Utility Reports, Inc. 1988, p. 283.

1 relevant history of the assets and the activities being sold and the regulatory scheme under
2 which they were regulated.

3 **Q. HOW IS YOUR TESTIMONY REGARDING THE COMPANY'S HISTORY IN**
4 **WASHINGTON ORGANIZED?**

5 A. As of March 7, 2003, the Company will have been providing telephone service to
6 Washington customers for 120 years. My testimony divides these 120 years into three
7 relatively distinct periods: the first 40 years characterized by high risks, competition and
8 relatively limited regulation; the middle 60 years characterized by little competition and
9 what has come to be known as "traditional" regulation; and the last 20 years characterized by
10 significant changes in organization and regulation aimed at transforming the industry from
11 regulated monopoly to a competitive marketplace, including the operation of the directory
12 advertising business in a separate company.

13 **Q. HOW WILL YOU REFER TO THE PREDECESSORS OF THE WASHINGTON**
14 **UTILITIES AND TRANSPORTATION COMMISSION IN YOUR TESTIMONY?**

15 A. The Commission's predecessors are the Public Service Commission of Washington,
16 established in 1911[6] and the Department of Public Works, which succeeded to the powers
17 and functions of the Public Service Commission under laws the Washington legislature
18 enacted in 1921.[7] I will refer to both as the "Commission" unless the specific context of my
19 reference requires otherwise.

20 **The First 40 Years - 1883 to 1923**

21 **Q. HAVE YOU PREPARED A REPORT OF YOUR RESEARCH ON THE EARLY**
22 **HISTORY OF THE COMPANY IN WASHINGTON?**

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6 Chapter 117, Session laws, 1911, Section 2,

7 Chapter 7, Laws of 1921, p. 20 n1 as discussed in *State ex rel. Spokane Gas Light Company v. Kuykendall*, 119 Wash 107, 205 Pacific 3, (1922).

1 A. Yes. Exhibit PEG-3 is a report entitled "The Early History of Qwest Corporation's
2 Predecessors in Washington, The First 40 Years - 1883 to 1923." I prepared this report
3 based on my research of the early history of the Company, its directory advertising business,
4 and competition and regulation in Washington from 1883 through 1923. My testimony
5 makes frequent reference to this report.

6 **Q. WOULD IT BE FAIR TO CHARACTERIZE THE FIRST 40 YEARS OF THE**
7 **COMPANY'S EXISTENCE AS ONE OF THE RISKIEST PERIODS IN THE**
8 **COMPANY'S HISTORY?**

9 A. Yes. Two major risks affected this period. The first was the risk involved in developing and
10 deploying a new and commercially unproven technology. When the Company began
11 prospecting installation of an exchange in Seattle in 1882 (*See* Exhibit PEG-3, page 2),
12 commercial telephony had existed only five years in the United States.[8] No one could be
13 certain that it would prove to be a financially viable enterprise. Later, once the Bell
14 companies had established that telephony could be profitable, competitors were willing and
15 able to enter the field. *See* Exhibit PEG-3, pages 3 through 6. The Company's rates yielded
16 low earnings (including losses in many exchanges) in Washington during the period 1913
17 through 1922. *See* Exhibit PEG-3, page 7.

18 **Q. DID THE COMPANY BEGIN PUBLISHING DIRECTORIES AND DEVELOP ITS**
19 **DIRECTORY ADVERTISING BUSINESSES DURING THIS PERIOD OF**
20 **SUBSTANTIAL RISK?**

21 A. Yes. By August 1923, the Company had been publishing directories containing substantial
22 amounts of advertising for at least 29 years and probably longer. *See* Exhibit PEG-3, pages
23 8 through 10.

[8] Telephone, by John Brooks, 1975, Harper and Row, New York, p. 59.

1 **Financial Burden During First 40 Years (1883-1923)**

2 **Q. DID CUSTOMERS BEAR THE FINANCIAL BURDEN OF ANY OF THE**
3 **COMPANY'S ACTIVITIES BEFORE AUGUST, 1916 WHEN THE COMPANY'S**
4 **FIRST RATE CASE WAS DECIDED?**

5 A. No. During the period from 1894 to 1923, the company faced a market open to competition
6 for local and toll service. *See* Exhibit PEG-3, pages 3 through 7. It was subject to price cap
7 regulation is some cities. *See* Exhibit PEG-3, page 10. The Commission's record indicates
8 that in 1913, 1914, 1915 and 1916, it lost money in most of its exchanges. *See* Exhibit PEG-
9 3, page 7. Finally, prior to August 5, 1916 (August 1, 1919 in Spokane), its rates had never
10 been subjected to any cost-of-service ratemaking order by the Commission that could have
11 imposed on customers the financial burden of any of the Company's utility activities. *See*
12 Exhibit PEG-3, pages 10 and 11.

13 **Q. DID THE COMMISSION'S AUGUST, 1916 ORDER IMPOSE THE FINANCIAL**
14 **BURDEN OF THE COMPANY'S OVERALL ACTIVITIES ON CUSTOMERS?**

15 A. No. Although the Commission concluded that the Company's earnings were inadequate, it
16 did not fix rates designed to allow the Company to earn a reasonable return on its assets. *See*
17 Exhibit PEG-3, pages 12 and 13. The effect was to leave the Company's investors
18 responsible for recovering the costs of providing service in a competitive environment.

19 **Q. DID THE RATES EFFECTIVE FROM 1919 TO MARCH 31, 1923 IMPOSE THE**
20 **FINANCIAL BURDEN OF THE COMPANY'S TELEPHONE SERVICE**
21 **ACTIVITIES ON CUSTOMERS?**

1
2 A. No. The rates that went into effect August 1, 1919 were never investigated or approved by
3 the Commission.[9] The Commission made no findings that the rates would provide a
4 reasonable opportunity for the Company to recover its costs. *See* Exhibit PEG-3, page 14.
5 Moreover, the rates in effect between 1919 and 1923 provided low rates of return. The
6 achieved returns were: 4.67% in 1919, 4.09% in 1920, 3.52% in 1921 and 3.35% through
7 June 20 of 1922. *See* Exhibit PEG-3, page 7.
8
9 **Q. DURING THIS ENTIRE 40-YEAR PERIOD, FROM 1883 THROUGH 1923, DID**
10 **RATEPAYERS EVER BEAR THE FINANCIAL BURDEN OF THE COMPANY'S**
11 **DIRECTORY PUBLISHING OR DIRECTORY ADVERTISING ACTIVITIES?**
12 A. No. From 1883 through 1916, the Company was not subject to any form of regulation that
13 could have imposed on its customers the financial burden of any of its activities, including
14 directory publishing and directory advertising. During much of this period it also operated
15 in the face of competition. The Commission's 1916 order in the Company's first rate case
16 did not impose the financial burden of any of the Company's activities on ratepayers. The
17 rates in effect from 1919 through March 31, 1923 were never investigated or approved by

[9] Rates established by the Postmaster General were in effect for a short period in 1919. The financial burden during the period of Federal control is of relatively little import because the rates were in effect for only four months in Spokane and five months in the rest of Washington. See Exhibit PEG-3, pages 12 through 14. Reduced rates had been promised categorically as one of the benefits of government as opposed to private operation of the telephone system, and the breaking of the promise was bound to cause public disillusionment. Telephone, John Brooks, 1975, Harper and Row, New York, p. 158. While the Postmaster General's rate increases provided rates intended to allow for depreciation at 5.72% and compensation to the Bell System for interest and dividends, it is not clear that, under the prevailing expectations that rates would decrease instead of increase, the Postmaster General intended for the rate increase to provide the Bell System Companies a reasonable opportunity to recover all their costs and a reasonable return on invested capital at a time when the country was at war. If the Postmaster General's intent was to set rates that recovered the cost of the government's telephone system, the intent was not achieved. Nationwide, Bell operations showed a deficit of $13 million for the period of Federal control, of which four million was made up from AT&T's surplus and nine million from the United States Treasury.

1 the Commission.[10] The Commission made no findings that the rates would provide a
2 reasonable opportunity for the Company to recover its costs and so could not have put the
3 financial burden of directory publishing and advertising on ratepayers.

4 However, there is another reason why ratepayers did not bear this financial burden in
5 Washington. By 1918, the revenues from the sale of unregulated advertising exceeded the
6 Company's directory expenses. *See* Exhibit PEG-3, pages 9 and 10. Consequently, after
7 1917 ratepayers never had to bear the financial burden of the Company's directory expenses.
8 Instead, they enjoyed the support that flowed from the unregulated directory advertising
9 activity to the regulated telephone service activity because the directory advertising revenues
10 and expenses were included in the Company's regulated results of operations under the
11 Interstate Commerce Commission's Uniform System of Accounts. *See* Exhibit PEG-3,
12 pages 9 and 10.

13 **Risk of Loss During First 40 Years (1883 to 1923)**

14 **Q. DID THE PUBLIC SERVICE COMMISSION LAW OR THE CITY FRANCHISES**
15 **IN EFFECT DURING THE FIRST 40 YEARS IMPOSE ON CUSTOMERS THE**
16 **RISK OF LOSS ON ANY OF THE COMPANY'S ASSETS?**

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[10] It is not clear the Postmaster General's rates imposed on customers the risk of loss on the Company's assets but the issue is of little import because the rates were in effect four months in Spokane and five months in the rest of Washington. See Exhibit PEG-3, pages 12 through 14. The Postmaster General's rates were based on a proposal AT&T made to the Postmaster General offering to accept certain compensation for the supervision, possession, control and operation of the Bell System that the government had taken. PT&T notified the Postmaster General October 14, 1918, that it had joined the proposal. AT&T and PT&T also entered into an agreement about what compensation PT&T was to receive under the proposal. It also provided for compensation to the Bell System for interest and amortization charges on all outstanding securities, dividends at the average rate of the previous three years, the cost of additional capital for expenditures requested by the Postmaster General, and interest and dividends required on new securities or share capital issued for the discharge, conversion or renewal of then existing obligations. From this it is clear the contracts intended to provide a return to investors on their invested capital and to provide an allowance for depreciation on the government's property. It is not clear whether by this contract the Postmaster General intended to impose on ratepayers the risk of loss of the government's assets.

1 A. No. Rate regulation under city franchises (*see* Exhibit PEG-3, page 10) did not impose risk
2 of loss on customers because the franchises employed price cap regulation, not cost-of-
3 service regulation.

4 Nor did the enactment of the Public Service Commission Law in 1911 (*see* Exhibit PEG-3,
5 page 11) serve by itself to impose on customers the risk of loss on any of the Company's
6 assets. Nothing in the law explicitly imposed any risk of loss on ratepayers. Although the
7 law provided a means by which customers could seek retroactive refunds with interest from
8 public service companies of charges that the Commission, after an investigation, had found
9 to be excessive or exorbitant,[11] it did not provide a similar means by which public service
10 companies could retroactively recover losses on assets or operations. Nor did the law
11 specify any means by which a public service company could seek reimbursement for losses
12 on assets.

13 **Q. DID THE COMMISSION'S AUGUST 1916 ORDER IN THE COMPANY'S FIRST**
14 **RATE CASE IMPOSE ON CUSTOMERS THE RISK OF LOSS ON ANY OF THE**
15 **COMPANY'S ASSETS?**

16 A. Two factors strongly suggest that they did not. The first is that the Commission declined to
17 adjust the Company's rates even though it acknowledged that if rates were to be adjusted,
18 they would have to be adjusted upwards (*see* Exhibit PEG-3, page 12). This inaction
19 indicates the Commission did not intend to hold customers responsible for providing the
20 company full cost recovery. It is implausible that the Commission intended to impose the
21 risk of loss on customers when it declined to impose responsibility for full cost recovery on
22 them.

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[11] Chapter 117, Session laws, 1911. Section 91.

1 The second factor is that the Commission's method of establishing rate base and cost of
2 service in the first rate case did not serve to hold customers accountable for losses on the
3 Company's assets.

4 Under modern methods of mass asset accounting for depreciable plant, losses on depreciable
5 assets are recoverable automatically because, through the entries used to record retirements
6 in mass asset accounts, the net losses reduce the depreciation reserve in those accounts.[12]
7 The reserve reduction provides the utility an opportunity to recover the loss through future
8 depreciation on other assets in the same mass asset account. Only when <u>all</u> the assets in a
9 mass asset account are retired is the regulator faced with deciding whether to allow recovery
10 of any un-recovered losses which manifest themselves as reserve deficiencies.

11 I found no evidence that the Commission used the mass asset method of accounting in the
12 Company's 1916 rate case. In fact, it appears the Commission did not then—as the
13 Commission does today—compute asset depreciation on the original cost of the assets for
14 ratemaking purposes. Instead, it estimated depreciation as a reduction to the reproduction
15 cost of the plant.[13] In the Commission's 1923 order in the Company's second rate case
16 discussed below, the Commission explained that it had never adopted the "method of using
17 the depreciated value of the actual investment in property."[14]

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[12] This same mass asset accounting mechanism allows ratepayers to automatically recover gains on dispositions of depreciable assets.

[13] Findings III and IV, Findings and Order entered July 17, 1917 in Docket No. 1516, reported in the Seventh Annual Report of the Public Service Commission of Washington to the Governor, p. 179.

[14] Finding of Fact XVII, Findings of Fact, Order and Opinion issued March 31, 1923 in Department of Public Works Docket No. 5344, reported in the Third Annual Report of the Department of Public Works of Washington Division of Transportation and Public Utilities to the Governor. p. 330.

1 **Q. DID THE COMMISSION'S 1916 RATE CASE ORDER IMPOSE ON CUSTOMERS**
2 **THE RISK OF LOSS ON THE ASSETS THAT SUPPORTED THE DIRECTORY**
3 **ADVERTISING BUSINESS?**

4 A. No. By 1916, two kinds of assets—tangible and intangible—supported the directory
5 advertising business. The tangible assets were the items of property, plant and equipment
6 necessary to conduct the directory advertising business. As just explained, the Commission
7 did not impose on customers the risk of loss on these assets.

8 The other asset was the intangible asset of goodwill. Goodwill is the fixed and favorable
9 consideration of customers arising from an established and well-conducted business. It is
10 the custom or patronage of any established trade or business; the benefit or advantage of
11 having established a business and secured its patronage by the public.[15] Goodwill
12 contributes to the market value of a business.

13 However, the value of goodwill is not recorded on a company's books unless an accounting
14 event occurs that causes the goodwill to be recognized for accounting purposes. Generally,
15 that event is the sale or merger of the business. The price paid for a business in excess of its
16 net assets is attributable to goodwill and recorded as such.

17 By 1916, the Company had been providing telephone service to the public for a 33-year
18 period characterized by substantial risk and competition. It had established a going concern
19 with an extensive customer base. It had developed a directory advertising business that was
20 able to sell hundreds of ads and was, by that time, generating revenues that offset almost all
21 directory expense.

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[15] Black's Law Dictionary.

1 The Commission's 1916 order found a market value for the Company in Washington that
2 was 13.5% greater than the amount it found as the Company's rate base. This finding would
3 indicate the Commission perceived that the Company had established some level of
4 goodwill. So it is likely the Company as a whole and its directory advertising business in
5 particular had amassed some goodwill value, although the precise amount could not be
6 known because the business was not involved in a transaction where the value of the
7 goodwill would have been established and recorded.

8 A year earlier in other cases involving rate base valuations[16] the Commission had been
9 explicit in excluding "franchise value" and "going concern value" from rate base. Similarly,
10 in the Company's first rate case, the Commission did not establish rate base based on the
11 market value the Commission had found for the Company. In fact, the Company itself had
12 proposed that the Commission establish rate base that was not based on the Company's
13 market value. The Commission agreed, concluding:

14 We, therefore, adopt and approve the plan suggested by respondents, that rates are to
15 be based on facts, rather than theories; that "fair value" if the words are to be used in
16 the usual and ordinary sense, cannot be the basis for rates, that a utility is entitled to a
17 reasonable compensation based upon the reasonable and necessary detriment suffered
18 in preparation for and in the service of its patrons, and not upon values created by the
19 public.[17]

**20 Q. HOW DID THE COMMISSION'S DECISION NOT TO ESTABLISH RATE BASE
21 ON MARKET VALUE ALLOW CUSTOMERS TO AVOID THE RISK OF LOSS
22 ON GOODWILL?**

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[16] February 27, 1915 order in Docket No. 1600 and 1601; April 30, 1915 order in Docket No. 1709;

[17] Opinion, Findings of Fact and Order entered August 5, 1916 in PSC Docket No. 1825, as reported in the Sixth Annual Report of the Public Service Commission of Washington to the Governor, p. 178.

1 A. In rejecting market value as a basis for establishing rate base in 1916, the Commission
2 established a principle that it follows to this day. It does not include realized or unrealized
3 goodwill in rate base. By excluding goodwill from rate base, the Commission has always
4 prevented regulated companies from earning a return on goodwill or from recovering losses
5 in the value of goodwill. Thus, Washington ratepayers have never borne the risk of loss on
6 goodwill, including the goodwill of the directory advertising business. Most of the gain on
7 the sale of Dex is attributable to Dex's goodwill; the value of Dex's tangible assets is a
8 relatively minute portion of the total value the Buyers have agreed to pay for Dex.

9 **Q. DID THE RATES THAT WENT INTO EFFECT ON AUGUST 1, 1919—THE DAY**
10 **FOLLOWING THE EXPIRATION OF THE POSTMASTER GENERAL'S RATES—**
11 **IMPOSE ON CUSTOMERS THE RISK OF LOSS ON THE COMPANY'S ASSETS?**

12 A. No. The rates were in effect from 1919 and remained effective until March 31, 1923, were
13 never approved by the Commission.[18] The Commission simply allowed them to be filed and
14 to go into effect without the normal 30-day notice required by statute. At no time did the
15 Commission make any findings regarding the reasonableness of those rates. Because the
16 Commission never acted to approve them, those rates did not obligate ratepayers to pay rates
17 based on the company's costs or to bear losses on the Company's assets. No linkage existed
18 between rates and losses on dispositions of assets. Moreover, the rates the Commission
19 allowed to go into effect on one day's notice, in fact, provided only a minimal return on the
20 Company's assets during the period 1919 through June of 1922. *See* Exhibit PEG-3, page 7.

21 **Q. DURING THIS ENTIRE 40-YEAR PERIOD, FROM 1883 THROUGH 1923, DID**
22 **RATEPAYERS BEAR THE RISK OF LOSS ON ANY OF THE COMPANY'S**
23 **ASSETS?**

18

1 A. With the possible exception of the five month period when the Postmaster General's rates
2 were in effect during 1919, the answer is no. From 1883 through 1916, the Company was
3 not subject to any form of regulation that could have imposed the risk of loss on its
4 customers. The Commission's 1916 order in the Company's first rate case did not impose
5 the risk of loss on ratepayers. The first time the Commission asserted jurisdiction over the
6 rates of HT&T-Spokane was August 1, 1919.[19] The rates in effect August 1, 1919 through
7 March 31, 1923 were never investigated or approved by the Commission. The statutes in
8 effect made no specific provision for regulated companies to recover losses on assets.
9 Moreover, during this period, the Commission employed a method of determining rate base
10 and depreciation that did not create an opportunity for recovery of actual losses incurred.
11 Finally, the Company operated during much of this period in the face of substantial
12 competition and generated minimal returns. The regulatory scheme in effect during this
13 period clearly left the risk of loss on all of the Company's asset on its investors.

14 **The Middle 60 Years - 1923 to 1984**

15 **Financial Burden**

16 **Q. DID THE COMMISSION'S MARCH 31, 1923 ORDER SHIFT TO RATEPAYERS**
17 **THE FINANCIAL BURDEN OF THE COMPANY'S TELEPHONE SERVICE**
18 **OPERATIONS?**
19 A. Yes. In ordering rates that the Commission had found to be sufficient (*see* Exhibit PEG-3,
20 page 15) the Commission shifted the financial burden of telephone service operations from

[19] In *State ex rel. Home Tel. & Tel. v. Superior Court,* 110 Wash. 396, 188 Pac. 404 (1920) the court held that until the commission acted in 1919 to supersede the franchise rates which Home Tel. Co. had accepted in Spokane in 1905, those rates remained the only lawful rates.

1 investors to ratepayers where it has remained until relatively recently when competition has
2 shifted the financial burden of many services back to investors.

3 **Q. DID THE ORDER ALSO SHIFT TO RATEPAYERS THE FINANCIAL BURDEN**
4 **OF THE COMPANY'S DIRECTORY PUBLISHING AND ADVERTISING**
5 **ACTIVITIES?**

6 A. No. At no point during this 60-year period did ratepayers bear the financial burden of
7 directory publishing or advertising. In the 1922 test year in this case and in every year since,
8 the revenues from directory sales and advertising substantially exceeded the directory
9 expenses. *See* Exhibit PEG-4. Revenues from unregulated sales of advertising provided a
10 steady and growing stream of rate support to the Company's regulated telephone operations.
11 Ratepayers enjoyed a rate support; they did not bear a burden.

12 **Risk of Loss**

13 **Q. DID THE COMMISSION'S MARCH 31, 1923 ORDER IN THE COMPANY'S**
14 **SECOND RATE CASE SHIFT TO RATEPAYERS THE RISK OF LOSS ON ANY**
15 **OF THE COMPANY'S ASSETS?**

16 A. The evidence is not clear. This was the first Company rate case in which the Commission
17 expressed concern that the depreciation reserve be at a level approximately equal to the
18 Commission's finding of the percent "physical condition."[20] Whether it was the
19 Commission's intent to ensure that the reserve would be sufficient to cover all losses on
20 physical plant retirements, it did not say. However, in a water rates case decided in 1920,
21 the Commission had noted that:

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[20] Finding of Fact II, Findings of Fact, Order and Opinion issued March 31, 1923 in Department of Public Works Docket No. 4902-5344, reported in the Third Annual Report of the Department of Public Works of Washington Division of Transportation and Public Utilities to the Governor. p. 336.

1 Depreciation is both actual and latent; so that it is necessary to create a fund to make
2 replacements when and as required so as to guarantee the utility against loss of
3 property in the public service, and to guarantee to the public adequate and efficient
4 services as required. The depreciation reserve cannot be paid out in dividends, as it
5 is in reality a trust fund created by the public.[21]

6 If the Commission intended to guarantee the Company against loss of property, then it would
7 follow that the risk of loss on depreciable assets had shifted from the investors to the
8 ratepayers. Whether the deprecation reserve the Commission described would serve this
9 purpose is not clear. If a utility had suffered a catastrophic loss, and replacement of the lost
10 plant had cost more than the amount in the reserve, we do not know whether the
11 Commission would have held ratepayers accountable to make up the difference in future
12 rates.

13 Under modern day mass asset accounting the utility has the opportunity to recover even large
14 losses through future depreciation, so long as some assets remain in the mass asset account
15 upon which the loss was incurred. The record from the early 1920's does not suggest that
16 the assurance of an opportunity to recover losses on retirements through future depreciation
17 had yet been provided. Whether ratepayers were at risk for losses on depreciable assets
18 beginning in 1923 is an open question.

19 There is no evidence in the Commission's order suggesting it had departed from its practice
20 of excluding goodwill from ratebase. In fact, in the same case quoted just above, the
21 Commission made clear with regard to valuations of utility property that:

[21] Order issued October 5, 1920 in Docket No. 5012.

1 The valuations do not include going value or development costs which are frequently
2 allowed by rate-making bodies and which often materially increase the value upon
3 which the utility is allowed to make an earning.[22]

4 Hence, ratepayers were not at risk for losses on goodwill. There is no evidence to suggest
5 that had any of the Company's operations (including its directory operations) been sold at a
6 loss, the Commission would have ordered ratepayers to compensate investors for such loss.

7 **The Last 20 Years - 1984 to 2003**

8 **Q. WERE THE LAST 20 YEARS RISKIER THAN THE PRIOR 60 YEARS?**

9 A. Yes. Several factors have caused the last 20 years to be considerably more risky than the
10 prior 60 for both the telephone business in general and for the directory business. The
11 largest provider of telephone service, the Bell System, was broken into a number of separate
12 companies. Changes in social policy resulting in court decisions and new legislation
13 encouraged the opening up of an industry that had functioned as a regulated monopoly for
14 the prior 60 years. Technological advances required significant investment in new and
15 different plant and equipment as well as requiring significant changes in network planning
16 and business strategies. The booming economy encouraged the development of a number of
17 newly created competitors that operated from a different financial position and obligation.
18 The decade of the 1990s saw an unprecedented number of mergers and acquisitions followed
19 by a sudden decline in the economy that created a financial crisis affecting many companies
20 in the industry.

21 **Q. DID ANY OF THESE CHANGES AFFECT THE DIRECTORY PUBLISHING**
22 **BUSINESS?**

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[22] *Id.*

1 A. Yes, most of these changes affected the directory publishing business either directly or
2 indirectly. Court decisions ruled that white pages directories could no longer be
3 copyrighted. The loss of copyright protection created opportunities for directory competitors
4 to obtain listings with little or no investment. Eventually the FCC prescribed not only the
5 availability of customer listings but also the prices carriers can charge for listings.
6 Computerization has significantly changed the everyday operations of the directory
7 publishing business over the last twenty years, and the Internet has further changed the
8 business. The entrance and departure of a number of directory publishers over the last
9 twenty years is a clear indication of a competitive market. The entrance of competitive local
10 exchange carriers has also changed the operating environment for publishers. There is no
11 longer a direct relationship of one carrier to one publisher. Multiple directory publishers
12 publish directories that include the listings of multiple exchange carriers in a single
13 geographic area. Risk in the directory publishing business during the past twenty-year period
14 has been significantly greater than in the sixty-year period that preceded it.

15 **Q. WHAT HAPPENED TO THE DIRECTORY ASSETS IN THE 1984 TRANSFER**
16 **FROM THE REGULATED COMPANY TO AN UNREGULATED AFFILIATE?**

17 A. Ms. Jensen describes the 1984 transfer. It removed the small amount of tangible assets
18 supporting the directory operations from the regulated rate base. These tangible assets were
19 the only assets upon which the ratepayers have ever been exposed to any risk of loss. Once
20 the transfer was complete, ratepayers ceased to bear any risk of loss associated with the
21 directory publishing activity.

22 **Q. WHO HAS BORNE THE RISK OF LOSS AND FINANCIAL BURDEN RELATED**
23 **TO THE DIRECTORY PUBLISHING ACTIVITY FOR THE LAST 20 YEARS?**

24 A. The investors have borne all of the risk of loss. As of January 1, 1984, the tangible assets
25 were no longer included in the Company's ratebase and, therefore, could not present a risk of

1 loss to ratepayers. Because the goodwill of the directory operations was never in ratebase, it
2 never presented ratepayers with a risk of loss.

3 After the transfer of the directory publishing activity, it was not possible for ratepayers to
4 bear any of its financial burdens; none of its assets were in ratebase and none of its expenses
5 were included in regulated results of operations. However, it continued to provide support
6 for local rates through publishing fees and imputations of revenues that Ms. Jensen describes
7 in her testimony.

8 <u>SUMMARY</u>

9 **Q. PLEASE SUMMARIZE YOUR TESTIMONY.**

10 A. My testimony and exhibits have examined the regulation of the Company since its inception
11 in 1883. The historical evidence I have reviewed shows that ratepayers have never borne the
12 financial burden of the Company's directory publishing and advertising activities. Until
13 1923, ratepayers did not bear any of the Company's financial burdens. When the Company
14 came under cost of service regulation that shifted the burden of the Company's telephone
15 service from investors to ratepayers in 1923, the directory publishing and advertising
16 activities were already generating unregulated advertising revenues substantially in excess of
17 directory expenses. For as long as ratepayers have borne the financial burden of the
18 Company's telephone operations, they have also enjoyed a rate support from directory
19 advertising revenues.

20 Ratepayers did not bear any risk of loss on the Company's tangible assets prior to 1923.
21 However, at some point after 1922, ratepayers did begin to bear the risk of loss on tangible

1 assets, although the exact date when that occurred is not clear. The tangible assets included
2 the assets used in support of the directory publishing and advertising business. The
3 ratepayers bore the risk on these assets from sometime after 1922 until the end of 1983.
4 When the assets were transferred to a separate subsidiary at the beginning of 1984, the
5 ratepayers no longer bore any risk of loss on them.

6 The majority of the gain on the sale of Dex is attributable to its goodwill; its depreciable
7 assets make up a small fraction of its value. For ratemaking purposes the Commission has
8 never allowed the Company to earn a return on the goodwill developed by the directory
9 publishing and directory advertising business. No allowance for depreciation or
10 amortization of that goodwill has ever been allowed in the Company's rates. Ratepayers did
11 not bear the burden of developing the goodwill of the directory publishing and directory
12 advertising business, which the Company had developed over the 40 years before ratepayers
13 came to bear any risk of loss on any of the Company's assets. No mechanism has ever
14 existed whereby the Company's investors could recover a loss of goodwill in the directory
15 publishing and directory advertising business. It follows that ratepayers have never borne
16 the risk of loss on the goodwill of the directory publishing and directory advertising
17 activities.

18 <u>CONCLUSION</u>

19 **Q. WHAT SHARE OF GAIN ON THE SALE OF DEX IS DUE THE RATEPAYERS**
20 **UNDER THE GUIDELINES ESTABLISHED IN *DEMOCRATIC CENTRAL***
21 ***COMMITTEE*?**

22 A. Under those guidelines, the gain must be allocated between the investors and the ratepayers
23 according to the share of risk of loss on assets that each has borne. If the risk of loss is not

1 determinable, then the gain is to be allocated based on who bore the financial burden of the
2 activity.

3 Ratepayers have never borne any of the financial burden of the Company's directory
4 publishing and advertising activities. Under this step of the two-step test, they are entitled to
5 none of the gain.

6 Ratepayers bore the risk of loss on the tangible assets that supported the Company's
7 directory publishing and advertising activities for a maximum of 60 out of the 120 years the
8 Company has been providing service in Washington. This 60-year period was less risky
9 than the preceding and following periods during which the Company bore the risk of loss.
10 Accordingly, ratepayers should receive no more than 50% of the gain realized from the
11 disposition of the tangible assets.

12 The vast majority of the gain on the sale of Dex is derived from the goodwill the business
13 has built up over a period of more than 100 years of directory advertising sales. Ratepayers
14 have borne none of the risk of loss of this goodwill. Accordingly, under the two-step test
15 they are entitled to none of the gain attributable to the goodwill of the business.

16 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**
17 A. Yes, it does.