

BEFORE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Merger of the Parent)
Corporations of Qwest Communications)
Corp., LCI International Telecom Corp.,) DOCKET NO. UT-991358
USLD Communications, Inc., Phoenix)
Networks, Inc. and U S WEST)
Communications, Inc.)

DIRECT TESTIMONY
OF
SARAH J. GOODFRIEND
MCLEODUSA TELECOMMUNICATIONS, INC.
February 1, 2000

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7 **I. INTRODUCTION AND ORGANIZATION OF TESTIMONY**

8

9 **Q. PLEASE STATE YOUR NAME, POSITION AND BUSINESS ADDRESS.**

10 A. My name is Sarah J. Goodfriend. I am an economic consultant in private practice
11 specializing in antitrust and competitive issues in the U.S. electric power and
12 telecommunications industries. My business address is 701 Brazos, Suite 310 in
13 Austin, Texas, 78701.

14

15 **Q. ON WHOSE BEHALF ARE YOU TESTIFYING?**

16 A. McLeodUSA Telecommunication Services, Inc. (McLeodUSA)

17

18 **Q. PLEASE DESCRIBE YOUR EDUCATIONAL AND WORK EXPERIENCE**
19 **RELEVANT TO THIS PROCEEDING.**

20 A. I have spent twenty years as a practitioner of electric, telecommunications and gas
21 regulation, at the state and federal levels. Most of this experience has been gained
22 since completing my doctorate in Economics at the University of North Carolina at
23 Chapel Hill in 1985. My post-doctoral work experience in competition analysis of
24 regulated industries began with employment at the Federal Trade Commission. From
25 1987 to 1992, I worked for the Federal Energy Regulatory Commission's Office of
26 Economic Policy, focusing on competition and merger analysis in energy industries. I
27 returned to the Public Utility Commission of Texas (PUCT), where I had worked in
28 1979 to become the Director of the Economic and Regulatory Policy Division. I
29 became a Commissioner of the PUCT in 1993. As a Commissioner, I was active in

1 both electric and telecommunications regulatory reform. During my PUCT
2 employment, I chaired the Staff Subcommittee on Strategic Electric Issues of the
3 National Association of Regulatory Utility Commissioners (NARUC). As a
4 Commissioner, I served on the NARUC Committee on Communications and the
5 National Regulatory Research Institute Board of Directors. After leaving the PUCT, I
6 joined the Washington DC office of MCI's (now MCIWorldCom) national regulatory
7 analysis group. I was the in-house expert responsible for the development of MCI 's
8 first economic policy testimonies before State Commissions addressing the issues to
9 be arbitrated under Section 252 of the Telecommunications Act of 1996. Leaving
10 MCI to form my consulting firm, I have continued to provide expert consultation and
11 testimony in Section 252 and Section 271 proceedings. Schedule (SJG-1) provides
12 details of these activities, work experience, expert appearances and educational
13 background.

14
15 **HAVE YOU TESTIFIED PREVIOUSLY?**

16 A. A list of my expert appearances and testimonies are provided in Exhibit (SJG-1).

17

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

2 A. I have been asked to examine the effects of the proposed merger on state Commission
3 regulatory effectiveness, particularly in achieving acceptable levels of service quality
4 for retail and wholesale network users. My testimony identifies regulatory strategies
5 the Commission should employ to safeguard consumers and the competitive process
6 during the transition to local exchange competition in Washington. The testimony
7 recognizes that this merger review process presents the Commission with a unique
8 opportunity, by requiring conditions in its merger review, to ensure that neither service
9 quality nor Commission regulatory effectiveness deteriorate as a consequence of this
10 merger.

11

12 **Q. HOW IS YOUR TESTIMONY ORGANIZED?**

13 My testimony proceeds in three sections. Following this introduction, Section II provides a
14 summary recommendation. In Section III, to provide the basis for my
15 recommendation, I discuss: the obligation of the price and entry regulated monopolist
16 to provide sufficient service quality; the difficulties faced by regulators in achieving
17 sufficient service quality from price-entry regulated monopolists; the significance of
18 ILEC service quality in achieving the local exchange competition goals of the
19 Telecommunications Act of 1996 (TA96); the significance of state regulatory
20 effectiveness in assuring nondiscriminatory treatment of unaffiliated entrants in
21 achieving the local exchange goals of TA96; and, the heightened difficulties state
22 regulators will face in assuring service quality and nondiscriminatory treatment of
23 unaffiliated entrants by U S West ILEC operations post-merger.

24 **SUMMARY RECOMMENDATION**

25

26 **WHAT IS YOUR SUMMARY RECOMMENDATION?**

27 A. I recommend that the Commission require as a condition of its merger review process
28 that U S West-Qwest commit to network investments and process improvements that

1 assure sufficient service quality for retail and wholesale consumers of U S West local
2 exchange services. I further recommend that the Commission establish conditions to
3 the merger as outlined in Schedule SJG-2.

4
5 The assurance of sufficient service quality addresses the merged firm’s ability to use
6 poor service quality as a weapon of discrimination against unaffiliated wholesale
7 entrants, such as McLeodUSA. If the merged company will “. . . serve its current
8 customers as efficiently and effectively as possible,” as claimed, and Washington
9 customers “will continue to have access to at least the same products and services” as
10 before the merger,”¹ then the merged firm should willingly accept the condition I
11 recommend. Conditioning assures that U S West’s existing and new customers, and
12 particularly (1) those in-region retail customers who are not viewed as profit centers
13 for broadband deployment post-merger and (2) wholesale customers unaffiliated with
14 the merged firm, will not experience discrimination in ILEC service quality or other
15 critical monopoly services as a consequence of the merger.

16
17 **III. RATIONALE FOR SERVICE QUALITY-RELATED MERGER**
18 **CONDITIONING**

19 *The Obligation of the Price-Entry Regulated Firm to Provide Sufficient Service*
20 *Quality*

21
22 **Q. HOW DO YOU DEFINE ADEQUATE OR SUFFICIENT SERVICE QUALITY**
23 **FOR RETAIL AND WHOLESALE LOCAL EXCHANGE CUSTOMERS?**

24 **A.** Retail and wholesale consumers expect certain levels of service quality in the
25 products they purchase. In a competitive market where consumers can readily assess
26 service quality, individual consumers can easily choose the particular price-quality

¹ Direct Testimony of Paul F. Gallant at pages 7 and 8.

1 combination they desire most. Some prefer “high” quality and are willing to pay the
2 “high” price associated with suppliers’ costs of achieving high quality; other
3 consumers may prefer a “low” quality offering as long as it is priced attractively,
4 reflecting its lower supply cost. In a well functioning competitive market, in the long-
5 run, competition among suppliers can be expected to maximize consumer satisfaction
6 with respect to service quality. This occurs because least cost production ensures that
7 individual consumers obtain their most preferred, i.e.. lowest price-highest quality
8 combination that is technically feasible (and profitable to produce).² In the
9 competitive market, a keen ability to respond to and anticipate customer demands for
10 service quality directly and potently sustains or increases a supplier’s profitability. In
11 a monopoly market, however, such linkage is lost because customers are captive to the
12 monopolist for essential services. Thus, regulatory efforts in this area are efforts to
13 create a regulatory structure that “restores” the role of quality service (at least cost) to
14 monopoly by convincing the monopolist that its best strategy is to offer desired service
15 quality to all customers.

16
17 Consumer expectations of service quality rise with advances in productivity and
18 technical feasibility: previously unprofitable or unfeasible price-quality combinations
19 are introduced and spread through the marketplace. Thus adequate or sufficient
20 service quality should reflect what is feasible and profitable in the market. In the
21 monopoly ILEC environment, regulators have acted on behalf of consumers of ILEC
22 services, developing and revising specific measures of ILEC service quality and
23 performance. As I will discuss later, information about service quality is an essential
24 tool for regulatory effectiveness in this area.

1 ² Of course, only products that are profitable to supply will be available. Where marginal cost-marginal revenue
2 or total cost-total revenue profitability requirements are violated, products will not be available.

1 **Q. WHY DO YOU USE A FULLY EFFICIENT COMPETITIVE MARKET AS YOUR**
2 **STANDARD IN DESCRIBING SUFFICIENT SERVICE QUALITY?**

3 A. Although there are different theories of regulation offered to explain the history and
4 evolution of price and entry regulation of monopolies in the U.S. in the later part of the
5 20th century,³ probably the most sophisticated of these approaches is the transactions
6 cost framework. My approach is consistent with the central tenet of this framework:
7 regulation is initially adopted because it is the efficient organizational response to
8 market conditions. (I will refer to the transaction cost framework again, when I
9 discuss problems for regulators created by this merger).

10

11 **Q. BRIEFLY DESCRIBE THE RELEVANT ASPECTS OF THE TRANSACTION**
12 **COST FRAMEWORK.**

13 A. This framework seeks to describe the creation of price-entry regulation as an
14 economically efficient organizational response to the prevailing economic
15 characteristics of buyers and sellers; price-entry regulation represents an efficient long-
16 term contract between buyers of monopoly services and the monopolist. But the
17 contract is incomplete in the sense that it would be inefficient (too costly or
18 impossible) to predict, write, monitor and enforce the agreement for all possible
19 “states of nature.” The incompleteness of the contract leaves room for new
20 circumstances to create incentives for inefficient behavior. The testimony of Dr.
21 Bridger M. Mitchell on behalf of McLeodUSA in this proceeding describes in detail
22 how an ILEC’s exploitation of cost and information asymmetries provide means to
23 circumvent regulations intended to assure sufficient service quality and
24 nondiscriminatory treatment of wholesale competitors.

1 ³ An example of the economic approach is provided by Paul Joskow in *The Role of Transaction Cost Economics*
2 *in Antitrust and Public Utility Regulatory Policies*, in the Journal of Law, Economics and Organization, Volume
3 7, Spring 1991. For a more politically-oriented approach, see Thomas K. McCraw’s Prophets of Regulation,
4 1984.

1 With respect to regulatory effectiveness, the incomplete contract paradigm reveals that
2 it is the cost of obtaining information which diminish regulatory effectiveness.⁴
3 Regulatory history provides concrete illustrations of how the regulated monopolist has
4 used information advantages to mislead and confuse regulators, competitors, courts
5 and customers.⁵
6

7 **Q. DESCRIBE THE IMPORTANCE OF SUFFICIENT SERVICE QUALITY TO**
8 **EFFECTIVE PRICE-ENTRY REGULATION USING THIS CONTRACTING**
9 **FRAMEWORK.**

10 A. By blockading entry and limiting prices to below monopoly levels, the static
11 efficiencies of price-entry regulation described by standard economic textbooks are
12 obtained. Price-entry regulation avoids wasteful duplication of facilities, secures the
13 cost-lowering efficiencies of natural monopoly production and the increase in output
14 stimulated by lowering the product price paid by consumers. The transaction cost
15 framework emphasizes that the monopolist must deploy specialized, immobile and
16 durable capital. Thus, this framework explains why a Constitutional protection was
17 assured and a quasi-judicial process was employed to defend the monopolist's
18 opportunity to earn, through regulation, returns commensurate with investments of like

1 ⁴ Formally, economists define an incomplete contract as a contract that either (1) fails to specify
2 performance obligations for the parties in all states of nature or (2) fails to specify the nature of the
3 performance itself. The first case emphasizes the costliness of enumerating future states or agreeing in
4 advance about what performance obligations are in a given state. The second case emphasizes costs of
5 agreeing or specifying performance obligations generally, irrespective of future states. If a third party, e.g.,
6 court or regulator, finds it impossible to verify the occurrence of a state or identify a performance
7 obligation, this fact also generates contract incompleteness. This description of incomplete contracts is
8 provided by Martin K. Perry in *Chapter 4 Vertical Integration: Determinants and Effects*, Handbook of
9 Industrial Organization, Vol. 1, 1989.

1 ⁵ A recent Iowa illustration can be found in the proceeding for Board review of U S WEST's proposed
2 intrastate interconnection tariff (Docket No. RPU-96-9). In that proceeding, the Board rejected U S
3 WEST's RLCAP cost model because the model had not been evaluated by the industry and was difficult to
4 audit, concluding for those reasons that "it is not possible to come to a conclusion about whether RLCAP is
5 a reasonable representation of U S West's costs." Final Decision and Order, *In re U S WEST*
6 *Communications, Inc.*, Docket No. RPU-96-9, at 17 (Ia. Util. Bd. Apr. 23, 1998).

1 risk for capital “prudently” invested in the enterprise. This assurance kept large
2 amounts of necessary capital flowing to basic infrastructure industries --water, gas,
3 electricity, telephone--where capital is used intensively in production, is specialized,
4 durable, and not readily or easily employed in alternative uses.

5
6 In addition, the exclusive right to serve provided to the monopolist by the award of an
7 exclusive service franchise is generally counterbalanced by *an obligation to serve*.
8 The obligation to serve includes the requirement that the monopolist not exploit its
9 potential to restrict supply, and thereby raise price (and profits) toward monopoly
10 levels. Rather the monopolist must serve all (qualified) customers.

11
12 Deterioration in service quality, (while holding regulated price constant), is an
13 expression of the exercise of monopoly power that price-entry regulation seeks to
14 control. Deterioration in service quality, like other supply restrictions or price
15 increases, will increase monopoly profits, and shift the balance of benefit of price-
16 entry regulation to the monopolist at the expense of product consumers. These kinds
17 of opportunistic behaviors by the regulated monopolist are prohibited by law and the
18 failure of the monopolist to provide adequate service can be the legal grounds for
19 revoking or modifying a franchise license or, Certificate of Public Convenience and
20 Necessity.

21 For example, in Washington, WAC 480-121-060, regarding revocation of registration,
22 provides that the Commission may revoke a registration, after hearing, for good cause.
23 Good cause includes, but is not limited to, failure to provide adequate service.
24 Such statutes and regulations are consistent with the contracting model I describe as
25 well as *ad hoc* explanations of the regulatory bargain between producers and
26 consumers expressed in State Commission price-entry regulations.

1 *The difficulties faced by regulators in achieving sufficient service quality from*
2 *price-entry regulated monopolists*

3
4 **Q. WHAT KINDS OF DIFFICULTIES DO REGULATORS FACE IN ASSURING**
5 **SUFFICIENT SERVICE QUALITY FROM ILECs?**

6 A. The regulator’s first task was (and is today) to identify, procure (or promote) the level
7 of service quality that customers would most desire in the current period and through
8 time.⁶ Pragmatically defining this theoretical construct is difficult. Revising service
9 quality requirements through time is especially difficult. Regulators are required to
10 estimate what cost-reducing and service enhancing investments customers are willing
11 to pay for. Regulators are required to assess the realistically achievable “least cost” of
12 production. These calculations must be undertaken in a world where it is in the
13 regulated firm’s interest to withhold or strategically manipulate information about
14 service cost and quality and service quality expenditures. (The specific manipulations
15 depend on the specifics of the regulatory regime). Consumers and regulators lack the
16 information to confidently identify the efficient level and composition of service
17 quality that would be forthcoming in the fully efficient market of the transaction cost
18 model.

19
20 The basic difficulty the regulator confronts is the inherent and ubiquitous information
21 advantage the ILEC possesses. This information advantage manifests in many ways.
22 Examples of areas of information where the ILEC will possess superior information
23 include: what the ILEC knows about the cost and cost-structure of its existing
24 network and delivery infrastructure; what the ILEC knows about the likely incremental
25 cost and cost-structure of alternative network improvements to its existing plant; the
26 effect of different expenditure plans on quality of service as measured by its regulator
27 versus the effect of such plans on all (present and future, measured and unmeasured)

1 ⁶ *See supra.*

1 service quality dimensions; the effect of different expenditure plans on the cost and
2 quality of products which are substitutes for or compliments to its existing (or
3 planned) service offerings and the effects of alternative ILEC expenditure plans on the
4 corporate interests of ILEC affiliates.

5
6 **Q. WHAT TOOLS HAVE REGULATORS USED TO ADDRESS THE ILEC**
7 **INFORMATION ADVANTAGE WHEN IDENTIFYING SUFFICIENT SERVICE**
8 **QUALITY?**

9 A. State regulators have developed measurable minimum quality standards and revised
10 these standards over time. In a 1998 survey, the National Regulatory Research
11 Institute found that the Commissions of 45 states and the District of Columbia
12 imposed or monitored some form of quality-of-service standard.⁷

13
14 Because of the concern that price cap regulation creates additional pressures for the
15 ILEC to deteriorate service quality, state regulators adopting price cap regulation often
16 include service quality provisions that raise requirements above standards prevailing
17 under rate-of-return regulation. Some state regulators (or legislatures) add penalties to
18 existing regulation or add penalties to price cap plans.⁸

19
20 *The Significance of ILEC Service Quality In Achieving the Local Exchange*
21 *Competition Goals of TA96*

22
23 **Q. WHAT PLACE DOES STATE COMMISSION ASSURANCE OF SERVICE**
24 **QUALITY HAVE IN THE TRANSITION TO LOCAL EXCHANGE**

1 ⁷ National Regulatory Research Institute, *Recent Developments in Telecommunications Service Quality*
2 *Regulation* (Columbus OH: National Regulatory Research Institute, 1998).

1 ⁸ Thirteen states have special provisions for service quality in their price cap or alternative regulation plans
2 according to Vivian Davis and Michael Clements, *Recent Developments in Telecommunications Service Quality*
3 *Regulation*, NRRI, n.d. available at <http://www.nrri.ohio-state.edu/squality.htm>.

1 **COMPETITION?**

2 A. The State Commission historically has been the first-line-defense and advance for
3 ILEC service quality. Thus, TA96 explicitly states: nothing...shall affect the ability of
4 a State to impose, on a competitively neutral basis...requirements necessary
5 to...ensure the continued quality of telecommunications services, and safeguard the
6 rights of consumers.⁹

7
8 The State Commission's role in assuring sufficient ILEC service quality takes on
9 added significance in the framework of TA96. As Mr. Stacey Stewart testifies, the
10 ability of a potential entrant to differentiate its product, in both kind and quality of
11 service, depends critically on the sufficiency of service quality the entrant receives
12 from the ILEC. Moreover, interconnection into a network with insufficient service
13 quality harms the entrant's reputation, since the customer may attribute the poor
14 service to the entrant. Thus, maintaining an active service quality monitoring function
15 and access to service quality information is even more critical to regulatory
16 effectiveness than before. As the FCC noted in its Final Order in the SBC-Ameritech
17 merger, access to information is a critical state regulatory tool. The FCC found that
18 the merger, left unconditioned, would impair comparative benchmarking as a
19 regulatory tool.¹⁰ The merger, in reducing the information available to regulators for
20 comparative analysis of performance and benchmarking eliminates valuable
21 "observations" from the set of available information.

22
23 ***The Significance of State Regulatory Effectiveness in Assuring Nondiscriminatory***
24 ***Treatment of Unaffiliated Entrants In Achieving the Local Competition Goals of***
25 ***TA96***
26

1 ⁹ 47 U.S.C. § 253(b).

1 ¹⁰ See FCC 99-279 Final Order at ¶ 179 and ¶s180-190, generally.

1 **Q. WHAT PLACE DOES STATE COMMISSION ASSURANCE OF**
2 **NONDISCRIMINATORY ILEC SERVICE PROVISION HAVE IN THE**
3 **TRANSITION TO LOCAL EXCHANGE COMPETITION?**

4 A. In TA96, state regulators play a central role in achieving the benefits envisioned from
5 robust local exchange competition. The Act requires State regulators to prohibit
6 discrimination by the ILEC against unaffiliated entrants and implement
7 interconnection and unbundling agreements that assure competitive neutrality. These
8 substantial tasks have required State regulators to improve their access to new areas of
9 critical regulatory information. Information-intensive areas include identifying the
10 efficient cost of unbundled elements, assessing the technical and economic feasibility
11 of interconnection requests by entrants seeking to provide advanced services, and
12 mastering the technical details of operational support systems and other methods and
13 procedures ILECs use to deliver services to CLECs. To obtain the necessary
14 information at least cost and to speed decisions, state regulators have increasingly
15 relied on workshops, task forces, technical conferences, collaborative processes,
16 arbitration and mediation. Regulators are expanding their complaint handling and
17 market monitoring infrastructures in an attempt to gather and disseminate information
18 needed by consumers and market participants.¹¹

19
20 *The Increased Difficulties State Regulators Will Encounter In Assuring ILEC*
21 *Service Quality and Nondiscriminatory Treatment Post-Merger*

22
23 **Q. GENERALLY SPEAKING, HOW HAVE U S WEST AND QWEST WITNESSES**
24 **CHARACTERIZED THE EFFECTS OF MERGER ON THE REGULATORY**
25 **EFFECTIVENESS OF THE WASHINGTON UTC?**

26 A. I have reviewed the direct testimonies of Ms. Jensen, Mr. Inouye and Mr. Gallant on

1 ¹¹ See for example, National Regulatory Research Institute, 1999 Summaries, 99-15, New Models of Regulatory
2 Commission Performance: The Diversity Imperative.

1 behalf of the Applicants. Other than Mr. Inouye's admission that U S West's cost of
2 capital may be affected adversely, these witnesses suggest little or no effect of the
3 merger on regulatory process or regulatory outcomes in Washington.

4
5 **Q. DO YOU AGREE THAT THE MERGER WILL NOT ADVERSELY AFFECT**
6 **THE ABILITY OF THE WUTC TO REGULATE IN THE PUBLIC INTEREST?**

7 A. No I do not. Applicants' witnesses neglect to discuss the effects of merger on the cost
8 and quality of state regulation of ILEC services. This neglect is inconsistent with
9 Applicants' admissions that (1) significant vertical integration through merger is
10 expected to occur, (2) governance at the top will change, (3) significant product
11 compliments and substitutes exist between the two merging companies, and (4) capital
12 and individuals will be significantly re-deployed.

13

1 **Q. PLEASE DESCRIBE WHY THE FOUR FACTORS YOU LIST ABOVE**
2 **IMPLICATE REGULATORY EFFECTIVENESS POST-MERGER.**

3 A. First and foremost, each of these factors suggest a more tightly integrated firm, which
4 will organize and reorganize its regulated and unregulated affiliate operations and
5 production processes as profit conditions affecting the merged firm warrant. Of
6 course, this is not economically objectionable, *per se*, but the expansion and marriage
7 of in-state regulated operations with extensive complimentary (and possibly substitute)
8 processes should raise concerns about an increased ability and incentive for the
9 regulated ILEC to circumvent regulatory requirements for costing, pricing,
10 unbundling, interconnection and service delivery in ways that benefit newly-affiliated
11 operations.

12
13 Corporate reorganizations make the tracing of dollars and personnel more difficult.
14 Violations in Codes of Conduct or violation of other regulatory prohibitions are more
15 difficult for competitors and regulators to detect. As Dr. Mitchell explains, merger
16 expands the possibilities and attractiveness of regulatory circumvention right along
17 with the expansion of affiliate relationships under unitary corporate control. This
18 aspect of merger directly affects the returns from discrimination directed at unaffiliated
19 rival entrants.

20
21 Also, the information disadvantage experienced by regulators increases in this
22 environment as do the costs of regulatory policing meant to keep regulatory
23 effectiveness at its pre-merger level. Below, I provide more details for my reasoning
24 that the four factors will lead to a more integrated and a more organizationally
25 dynamic company within which regulated ILEC operations will be embedded and
26 thereby increase costs associated with regulatory information gathering, monitoring
27 and oversight activities. Expanded profit opportunities from regulatory circumvention

1 also imply that economic penalties must be increased to counter the economic benefit
2 of conscious violation.¹²
3

4 **Q. PLEASE PROVIDE YOUR REASONS FOR EXPECTING REGULATED ILEC**
5 **OPERATIONS TO BE MORE FIRMLY INTEGRATED WITH AFFILIATED**
6 **PROCESSES IN THE NEW FIRM.**

7 A. First among the four factors is Applicants' claim the merger will produce otherwise
8 unavailable economies of scale and scope.¹³ If the merger creates significant
9 economies of scale and scope as Applicants claim, economic theory explains that these
10 efficiencies are gained precisely because productive processes are reorganized to
11 exploit the advantage of being all "under one roof." However, the details of this
12 productive reorganization are not described. Moreover, "[a]t this time, the merger
13 will not require any change in the rates, terms or conditions for the provision of any
14 telecommunications services provided in Washington."¹⁴ And, finally, "There are no
15 plans to reduce the level of investment in Washington as a result of the merger."¹⁵ I
16 accept that these statements are facially correct until the merger is consummated
17 and/or profit opportunities are reassessed. I do not accept these statements as blanket
18 promises of an enduring nature.
19

20 Second, governance will change with the expanding focus of the merged firm. Under
21 the merger agreement, the separate corporate existence of U S WEST, Inc. will cease.

22 The Office of the Chairman of the merged firm will be occupied by Messrs. Anschutz,

1 ¹² In a similar vein, SBC recently received the support of the Texas PUC in seeking 271 relief from the FCC.
2 The support was forthcoming only after SBC agreed to almost double the \$225 million cap on how much it can
3 be fined for failing to meet performance measures in dealing with orders from local competitors. *Austin*
4 *American Statesman*, Dec. 17, 1999 at A7.

1 ¹³ See Joint Application at 11.

1 ¹⁴ Direct Testimony of Theresa Jensen at 16 (emphasis added).

1 ¹⁵ Direct Testimony of Carl Inouye at 9.

1 Nacchio and Trujillo and will operate by majority vote. Mr. Anschutz controls
2 approximately 39% of the stock of Qwest Inc., where he is currently chairman of the
3 Board. Operating as his own agent and being a significant shareholder, one would
4 expect Mr. Anschutz to have considerable say in the direction of the merged Company.
5 The Office of the Chairman has exclusive power and final authority with respect to
6 acquisitions and depositions, allocation of capital resources, and the setting of general
7 corporate strategy among other powers.¹⁶ This change in governance is consistent with
8 the merged firm's focus on profitable national and international market expansions --
9 "target market areas" -- of Quest's farflung operations, some of which may be urban
10 centers in U S WEST's regulated service territories.

11
12 Third, significant product and operational interrelationships, *i.e.*, compliments and
13 substitutes, exist. In an attempt to comply with TA96, the merged firm will divest
14 itself of interLATA services Qwest Inc. currently offers in the U S WEST, Inc. region.
15 We are told that this service represents approximately 8% of revenues to parent,
16 Qwest, Inc. (projected for fiscal year 2000). However, to my knowledge, Qwest has
17 not divulged the current and expected future profitability of these operations. As Dr.
18 Mitchell indicates, the strength of any incentive created by this divestiture toward
19 Section 271 compliance by U S WEST depends, among other things, on the relative
20 profitability of this particular activity vis-à-vis alternatives competing for corporate
21 resources (at the time assessments and reassessments are made). The merging
22 companies possess complimentary core capacities with respect to the accelerated
23 deployment of local broadband connectivity. Combining these complimentary
24 resources, it is claimed, will enable "... the merged company to provide a broad array
25 of services with maximum efficiency..."¹⁷ These kinds of statements, in my view,

1 ¹⁶ See Joint Application at 8.

1 ¹⁷ Joint Application at 13.

1 presuppose significant reorganization, immediately or as changes in market
2 circumstances and opportunities dictate.

3
4 Fourth, Applicants report in their SEC disclosure an ability to redeploy capital in the
5 years 2000 through 2005 in the aggregate amount of \$7.5 billion toward new
6 investment in Internet applications and hosting, out-of-region facilities-based
7 competitive local exchange service, out-of-region broadband access, Internet services,
8 etc. This redeployment will be financed with dividend savings and \$2.2 billion of
9 savings from “capital expenditure synergies.”¹⁸ However, in the Risk Factors section
10 of the disclosure, Applicants explain that achieving the benefits of the merger such as
11 operating efficiencies, cost savings and synergies will depend in part on “integration of
12 the businesses of Qwest and U S WEST in an efficient manner, which we believe will
13 require considerable effort. In addition, the consolidation of operations will require
14 substantial attention from management.”¹⁹ These statements suggest that investment
15 and organizational changes will be effected to secure these synergies and that effective
16 regulation, for example, such as the ability to identify and assure competitively neutral
17 cost allocations in future pricing and unbundling cases, will become more complex
18 and demanding of Washington UTC resources.

19
20 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

21 **A. Yes, it does.**

1 ¹⁸ SEC filing at 33 of 270.

1 ¹⁹ SEC filing at 22 of 270.

