Exhibit ____(CTI-RT)

**BEFORE THE**
**WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

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| In the Matter of the | ) | |
| | ) | |
| Merger of the Parent Corporations of | ) | Docket No. UT-991358 |
| Qwest Communications Corporation, | ) | |
| LCI International Telecom Corp., | ) | |
| USLD Communications, Inc., | ) | |
| and U S WEST Communications, Inc. | ) | |

# REBUTTAL TESTIMONY OF

# CARL INOUYE

**Lead Director – Financial Advocacy**

**U S WEST COMMUNICATIONS, INC.**

**February 22, 2000**

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

A. Carl Inouye, 1600 Bell Plaza, Room 3006, Seattle, Washington 98191.

**Q. ARE YOU THE SAME CARL INOUYE THAT PROVIDE REBUTTAL TESTIMONY IN THIS DOCKET?**

A. Yes, I am.

**Q WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?**

A. My testimony makes the following points:

**Merger Synergies.** Staff uses a flawed analysis of merger synergies as the basis for its proposed 7-year moratorium on rate increases. Staff's "analysis" fails, among other things, to recognize the uncertainty associated with capturing merger synergies, and the costs that will be incurred to achieve such synergies. It is therefore unreasonable to place any reliance upon Staff's estimate of Washington intrastate synergies.

**7-Year Moratorium on Rate Increases.** Staff proposal for a 7-year moratorium on rate increases is unsupported by any analysis showing that the Company will have an opportunity to earn a reasonable return over that period. The cost of the merger conditions proposed by Staff far exceeds any merger synergies that can be expected to be achieved, thereby denying the Company any ability to earn a fair profit over the 7-year period.

**Investment Requirements.** Staff bases its proposal regarding investment requirements on the flawed assumption, without any supporting analysis, that the Company's Washington intrastate regulated operations generates "huge" cash flow that can be diverted. My testimony demonstrates that this is not the case and, in any event it is the role of management to determine how to deploy investor capital.

**Creation of an Advanced Services Subsidiary.** Parties proposing this requirement as a condition of merger approval fail to address necessary issues regarding the formation of an advanced services subsidiary. If such a requirement is imposed, the formation should be accomplished in a manner that does not competitively disadvantage Joint Applicants.

**Regulatory Oversight.** The transaction will neither increase the complexity of regulation, nor affect the Company's compliance with existing Commission requirements, which provide adequate regulatory oversight over transactions with affiliates.

**Yellow Pages Imputation.** Public Counsel's proposed condition requiring the continued imputation of yellow pages revenue is inappropriate in this proceeding, and is unsupported by any evidence in this docket.

**Sales of Rural Exchanges.** AT&T's proposed condition regarding future sales of rural exchanges is based upon inaccurate statements and, in any event, is unnecessary given the regulatory oversight already in place with respect to such transactions.

**Public Counsel Accounting Requirements.** Public Counsel's proposal for below the line accounting of service costs is an attempt to achieve a ratemaking result in this docket without a full presentation of the facts. It will not eliminate a contentious issue and is best left for the next rate case.

## I.MERGER SYNERGIES

**Q. WHAT IS THE IMPORTANCE OF STAFF'S ESTIMATE OF MERGER SYNERGIES IN THIS DOCKET?**

A. Staff's estimate of merger synergies provides a basis for its proposed seven year moratorium on tariff changes and for it proposed investment conditions. Staff asks the Commission to prohibit

U S WEST from eliminating or restricting any service, or increasing rates for tariffed services, for a period of seven years. Staff justifies its proposal by claiming customers should be protected from harm while the Joint Applicants should have the opportunity to capture synergy benefits. Staff claims Washington regulated operations will experience $233 million of expense savings.[1] Staff claims its estimate is "reasonable" and "conservative" and that it has determined that for the seven year period U S WEST's will have "a reasonable opportunity to recover its costs and earn a fair profit."[2]

**Q. IS STAFF'S CALCULATION OF THE WASHINGTON INTRASTATE REGULATED EXPENSE SAVINGS REASONABLE?**

A. No. Staff's calculation is a series of allocation factors applied to the merged company's estimate of expense synergies. Staff calculates its allocation factors from pre-merger Qwest and U S WEST, Inc. financial projections and the 1998 ratio of Washington regulated intrastate to U S WEST total company. When requested to state its justification for employing such "allocation factors," Staff responded that "it is the only information provided to Staff…" and that "it is the only method that would provide me with the percentage of the Washington Intrastate EBITDA as a percentage of the total merged company EBITDA based on the historical allocations of 1998 and the projections of 2000 through 2005."[3]

**Q. DID STAFF MAKE ANY ATTEMPT TO EVALUATE WHETHER A CALCULATION BASED ON ALLOCATION FACTORS WOULD RESULT IN A REASONABLE**

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[1] It should be noted that Staff's $233 million is not a reduction of current Washington expenses, but a reduction as compared to future levels of expenses, which will be higher.

[2] Blackmon Direct, p. 16, 20; Twitchell Direct, p. 8.

[3] Staff responses to U S WEST Data Requests 01-082 and 01-087, attached as Exhibit __ (CTI-2).

**ESTIMATE OF EXPENSE SAVINGS?**

A. No. In response to a U S WEST data request to provide all analyses or audits of the reasonableness of its calculation, Staff responded with a description of its method of calculation.[4]

**Q. WHAT IS THE BASIS FOR STAFF'S CLAIM THAT ITS ESTIMATE IS CONSERVATIVE?**

A. Staff claims its estimate is conservative because it does not include revenue and capital synergies. Expense synergies are only 35% of the total synergies.[5]

**Q. IS IT CORRECT THAT STAFF'S ESTIMATE IS CONSERVATIVE?**

A. No. Staff claims that the exclusion of revenue and capital synergies makes its estimate "conservative," yet at the same time Staff has independent reasons for excluding these types of synergies. With respect to revenue synergies -- the avoidance of future loss of existing local revenue to competitors -- Staff testifies "I do not believe that this type of synergy would be appropriate to measure because the increase in revenues merely offsets the projected loss of revenues caused by competition."[6] As for capital synergies -- the avoidance of future capital expenditures -- Staff testifies "I do not believe that this type of synergy would be appropriate to measure because the benefit will flow to the calculation of the rate of return in any regulatory review. I am unable at this time to measure the impact this will have on capital structure and the cost of debt and equity."[7] It is incongruous for Staff to testify that it is inappropriate to include

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4 Staff response to U S WEST Data Request 01-084, attached as Exhibit __ (CTI-2).

5 Twitchell Direct, p. 8, Blackmon Direct, p. 20. By contrast, Mr. Brosch testifies that "most of the anticipated synergies…would occur outside of regulated operations." Brosch Direct, p. 5.

6 Twitchell Direct, p. 6.

7 Id.

certain synergies, and then turn around and claim that the exclusion of those synergies makes its estimate of Washington intrastate synergy "conservative."

**Q WILL EXPENSE SAVINGS BE "ALLOCATED" TO WASHINGTON INTRASTATE REGULATED OPERATIONS IN THE MANNER ESTIMATED BY STAFF?**

A. Absolutely not.

**Q. HOW WILL EXPENSE SYNERGIES AFFECT WASHINGTON INTRASTATE REGULATED OPERATIONS?**

A. Whether expense synergies occur in the regulated or unregulated operations of the Joint Applicants depends upon where savings actually materialize. Thus, expense savings will be reflected on the financial books and accounts of the Washington intrastate regulated operations to the degree the savings are achieved in this operation. Other than a few headquarter type-expenses, expense savings will not be allocated.

**Q. HAS STAFF REASONABLY REFLECTED REGULATED AND UNREGULATED OPERATIONS IN ITS EXPENSE SYNERGIES ESTIMATE?**

A. No, it has not. Staff's allocation method holds constant the relative share of Washington intrastate regulated operations to total U S WEST. Such an assumption is inconsistent with Dr. Blackmon's testimony that "[W]ith this merger, we are likely to see major changes in U S WEST's management approach, operations, strategies, and business plan."[8] It is inconsistent with Ms. Folsom's testimony that "…we recognize that Qwest could be even more driven toward new

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[8] Blackmon Direct, pp.15-16.

ventures and acquisitions and less willing to invest in the core telephone network."[9] It is inconsistent with the existing U S WEST goal to grow its unregulated businesses by obtaining 271 relief and entering the interLATA long distance market. It is inconsistent with Staff's proposed requirement to structurally separate advanced services from regulated operations.

**Q. HAS STAFF INCLUDED THE COST OF ACHIEVING THE EXPENSE SYNERGIES?**

A. No. Logically, Staff should include such costs since it attempts to draw conclusions about whether U S WEST will have an opportunity to earn a reasonable rate of return over the next seven years. Without taking into account the costs to achieve these synergies, it is impossible for Staff to reach any conclusion about the Company's ability to earn a reasonable rate of return.

**Q. DOES STAFF GIVE ANY CONSIDERATION TO THE RISK AND UNCERTAINTY OF ACHIEVING EXPENSE SYNERGIES?**

A. No. There is no mention anywhere in Staff's testimony that achievement of the synergies depends in part upon the successful and timely integration of the Qwest and U S WEST businesses.[10] No assurance can be given that Qwest and U S WEST will succeed in integrating their operations in a timely manner without encountering significant difficulties.[11] On this point, Public Counsel testimony states that combining the businesses "is an extraordinarily challenging endeavor."[12] Public Counsel takes the position that synergies are "speculative" and "are based upon highly uncertain assumptions and could be ultimately be significantly different." As illustration, Public

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[9] Folsom Direct, pp. 13.

[10] In U S WEST Data Request 01-090, attached as Exhibit __ (CTI-2), Staff was requested to describe its investigation of the probability that its estimate of Washington intrastate synergies would occur. Staff failed to provide any meaningful investigation.

[11] Joint Proxy, page I-8, attached as Exhibit ___ (CTI-3).

[12] Brosch Direct, p. 20.

Counsel states that there is no assurance Section 271 relief will be granted by year-end 2001, one of the assumptions underlying the synergy estimate.[13]

**Q. HAS STAFF FACTORED INTO ITS ESTIMATE OF EXPENSE SYNERGIES THE EFFECT OF ITS PROPOSED MERGER CONDITIONS?**

A. No, it has not. Synergies are premised upon the ability of Joint Applicants to integrate their operations in compliance with existing Federal and State regulatory requirements. Staff's proposed merger conditions regarding the creation of an advanced services subsidiary and the required separation of wholesale and retail operations would prevent the achievement of at least some of the merger synergies. Nevertheless, Staff fails to consider or quantify the impacts that such conditions, if implemented, would have on the ability of the combined company to achieve merger synergies.

**Q. DOES STAFF CLAIM ITS PROPOSED MERGER CONDITIONS WILL NOT AFFECT EXPENSE SYNERGIES?**

A. Yes. In responses to U S WEST Data Requests 01-094 and 01-095, attached as Exhibit __ (CTI-2), Staff admits to having not analyzed the effect of its proposed conditions on expense synergies but nevertheless claims without benefit of analysis that each of its merger conditions "will increase the synergies." These responses are an obvious contradiction to Ms. Folsom's testimony that "[W]hile 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…"[14]

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1 [13] Id.
1 [14] Folsom Direct, pp. 9.

**Q. DOES STAFF'S TESTIMONY REGARDING MERGER SYNERGIES PROVIDE A BASIS UPON WHICH TO MAKE A FINDING THAT U S WEST WILL HAVE AN OPPORTUNITY TO EARN A REASONABLE RATE OF RETURN OVER THE SEVEN YEAR MORATORIUM PERIOD?**

A. No. As noted above, Staff's "analysis" of merger synergies (1) is not "conservative," (2) fails to recognize the uncertainty associated with capturing merger synergies, (3) fails to adequately distinguish between regulated and unregulated operations, (4) does not take into account the significant costs the combined company will incur to achieve expense synergies, and (5) fails to reflect the impact that Staff's proposed merger conditions, if adopted, would have on the level of synergies that could be achieved. It is therefore unreasonable to place any reliance upon Staff's estimate of Washington intrastate synergies.

## II.STAFF'S PROPOSED 7-YEAR MORATORIUM ON RATE INCREASES

**Q. WHAT EVIDENCE DOES STAFF PRESENT TO JUSTIFY ITS PROPOSAL FOR A SEVEN YEAR MORATORIUM?**

A. Staff's justification appears to be its testimony that at the current rates U S WEST will have "a reasonable opportunity to recover its costs and earn a fair profit" over the next seven years given Staff's estimate of merger synergies and the financial effects of other Staff proposed merger conditions.[15]

**Q. HAS STAFF PERFORMED AN ANALYSIS THAT SUPPORTS SUCH TESTIMONY?**

A. No, it has not. U S WEST requested Staff's analysis of projected revenues and expenses over the next seven years to verify that the analysis indeed indicated that the Company would have "a reasonable opportunity to cover its costs and earn a fair profit." Staff admits to having performed no such analysis.[16]

**Q. HAS STAFF FACTORED INTO ITS ANALYSIS THE COST OF ITS PROPOSED MERGER CONDITIONS?**

A. No, it has not. As discussed in Section I above, Staff has not quantified the effect on earnings of any of its proposals regarding investment requirements. Without such an evaluation, it would be impossible to conclude that U S WEST would have an opportunity to earn a reasonable rate of

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15 Blackmon Direct, p. 20.

16 Staff response to U S WEST Data Request 01-073, attached as Exhibit __ (CTI-2).

return over the seven year moratorium. Similarly, Staff has not quantified the effect on earnings of its proposal to require the creation of an advanced service subsidiary or of its proposal to require the structural separation of wholesale and retail operations.

**Q. DOES STAFF ADMIT THAT THE COST OF ITS PROPOSED MERGER CONDITIONS EXCEEDS ITS ESTIMATE OF SYNERGIES?**

A. Yes. Staff admits the total cost of its investment conditions alone would exceed Staff's estimates of merger synergies.[17] Staff attempts to justify the situation by alluding to unquantified expectations of offsetting revenues, but provides no evidence that such an offset would be sufficient during the seven year rate moratorium proposed by Staff to allow U S WEST any reasonable opportunity to earn a "fair profit."[18]

**Q. STAFF CLAIMS A SEVEN YEAR MORATORIUM ON RATE INCREASES WOULD BE "SIMILAR TREATMENT"[19] TO THE COMMISSION'S TREATMENT OF RESTRUCTURING CHARGES IN DOCKET NO. UT-950200. IS THIS CLAIM CORRECT?**

A. No, it is not. Nowhere in the Commission's treatment of restructuring in Docket No. UT-950200 did the Commission order a seven year moratorium on future rate increases by U S WEST. Furthermore, the rate reduction in Docket No. UT-950200 was quickly followed by a rate increase in Docket No. UT-970766.[20]

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[17] Folsom Direct, p. 9. Staff also admits to having made no attempt to estimate the related network expense that would be incurred along with the required $500 million of capital, nor the related depreciation expense. See Staff response to U S WEST Data Request 01-131, attached as Exhibit __ (CTI-2).

[18] See Staff response to U S WEST Data Request 01-132, attached as Exhibit __ (CTI-2).

[19] Blackmon Direct, p. 17.

[20] The Order in Docket No. UT-950200 is dated April 1996. In April 1997, U S WEST made its first presentation of revenue requirements to Staff under the so-called "make whole" rate case concept that became Docket No. UT-

97066. The Company sought an expedited review of its earnings. U S WEST was granted a $59 million rate increase in January 1998.

**Q. WHAT ABOUT THE THREE EXCEPTIONS TO THE RATE INCREASE MORATORIUM WHICH STAFF IS PROPOSING?**

A. Staff purports to offer three exceptions to the moratorium under which changes would be allowed.[21] However, it is unclear that any of the exceptions would be allowed to operate in the manner proposed by Staff. Given the prohibition against single-issue rate cases, if the operation of any of the three exceptions would result in a net increase of revenues there would likely be an issue as to whether an increase is permissible without a general review of all regulated revenues and costs.

**Q. DOES STAFF PROPOSED EXCEPTION INVOLVING TSLRIC ENSURE A REASONABLE OPPORTUNITY TO EARN A FAIR RATE OF RETURN?**

A. No, it does not. Staff mixes two concepts that do not relate to each other. A fair rate of return relates solely to the company’s earnings measured by total revenues and costs reflected on its books of accounts. TSLRIC reflects incremental costs on a forward looking basis. In order to bridge the gap, U S WEST request that Staff provide its analysis that rate increases based on TSLRIC would reasonably relate to the opportunity to earn a fair rate of return based on booked costs. Staff admits it performed no such analysis.[22] Therefore, there is no evidence Staff’s proposal would do as is claims.

**Q. WOULD IT BE REASONABLE FOR THE COMMISSION TO ADOPT STAFF’S PROPOSED CONDITION IMPOSING A SEVEN YEAR MORATORIUM ON RATE INCREASES?**

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[21] Blackmon Direct, pp. 17-19.

[22] See Staff response to U S WEST Data Request 01-74, attached as Exhibit __, (CTI-2).

A. Absolutely not. As demonstrated in the above testimony, Staff offers no credible evidence that such a moratorium afford U S WEST an opportunity to earn a reasonable rate of return over the seven year period.

# III.INVESTMENT REQUIREMENTS

**Q. PLEASE SUMMARIZE STAFF'S TESTIMONY ON INVESTMENT REQUIREMENTS AND THE U S WEST CASH FLOW GENERATED FROM WASHINGTON INTRASTATE REGULATED OPERATIONS.**

A. Staff claims that Qwest should not be allowed "…simply to leverage the cash flow generated by U S WEST's customers to finance Qwest's next corporate deal." According to Staff testimony, "[T]he 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…," and "…Staff believes that the Commission must consider and guard against…the opportunity to redirect USWC's cash flow elsewhere."[23]

**Q. DOES THE COMMISSION REGULATE U S WEST'S CASH FLOW?**

A. No. The Commission regulates the Company's rate of return indirectly through the ratemaking process. I know of no direct or indirect regulation of the Company's cash flow other than the requirement that the Company deploy sufficient resources to enable it to provide adequate service.

**Q. IS THE PRESUMPTION OF STAFF'S TESTIMONY THAT HUGE CASH FLOWS EXIST THAT CAN BE DIVERTED?**

A. Yes, I believe so.

**Q. DOES STAFF SUPPORT ITS TESTIMONY WITH ANALYSES AND**

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[23] Blackmon Direct, pp. 15, Folsom Direct, pp. 14. Intervenors make similar arguments. For instance, see Moya Direct, pp. 7-8 and Ward Direct, pp. 57-58.

**QUANTIFICATIONS TO VERIFY THAT SUCH A SITUATION EXISTS?**

A. No. Staff admits to having performed no such analyses.[24]

**Q. HAVE YOU MADE SUCH AN ANALYSIS?**

A. Yes, I have. The following is the 1999 annualized revenues generated from Washington intrastate regulated customers. Subtracted from that amount are the operating expenses, taxes, and interest expense of the Company. Also subtracted are capital expenditures. I estimated the intrastate portion of capital expenditures by multiplying by 70%. The end result is that cash flow is a negative $104 million. In other words, the cash flow from regulated intrastate customers is not sufficient to pay for the expenses and new capital investment. Staff and intervenor testimony that the Commission should be concerned about cash flow is not on point.

Washington Intrastate Regulated Operations ($M)

| | |
|---|---|
| Revenues from regulated customers: | 1,030 |
| Less: Operating expenses, taxes, interest: | 742 |
| Less: Capital Expenditures: | 392 |
| Cash Flow: | -104 |

**Q. DOES THE ABOVE CASH FLOW CALCULATION INCLUDE THE EFFECT OF STAFF'S PROPOSED INVESTMENT REQUIREMENTS?**

A. No, it does not. Staff's proposed $100 million annual investment requirement would make the Washington intrastate cash flow more negative.

**Q. IS IT REASONABLE THAT U S WEST SHOULD DETERMINE HOW IT INVESTS**

24 See Staff responses to U S WEST Data Requests 01-068, 01-135, 01-136, and 01-137, attached as Exhibit __ (CTI-2).

**CASH FLOW?**

A. Yes, it is. Cash flow represents return **of** capital through the recognition of depreciation of previously invested capital and the return **on** capital that remains invested in regulated operations. In each case, the cash flow is investor supplied capital. It is the role of management to determine how investor supplied capital is deployed to fulfill the Company's obligation to provide service to Washington customers.

## IV.CREATION OF AN ADVANCED SERVICE SUBSIDIARY

**Q. PLEASE DESCRIBE YOUR TESTIMONY AS IT RELATES TO THE PROPOSED REQUIREMENT TO CREATE AN ADVANCED SERVICE SUBSIDARY.**

A. My testimony addresses the planning, financial, and accounting issues associated with such a requirement. Ms. LaFave addresses the reasonableness of this proposed requirement.

**Q. WHAT JUSTIFICATIONS DOES STAFF OFFER IN SUPPORT OF ITS PROPOSAL TO REQUIRE THE CREATION OF AN ADVANCED SERVICE SUBSIDIARY?**

A. Staff claims that "many alternative providers…operate at a disadvantage relative to U S WEST" and that "this problem" will increase as a result of the merger "because Qwest will be under even more pressure from the market to deliver revenue and earnings growth." Staff asserts "harm to the public interest" if Joint Applicants are "permitted to monopolize the advanced services market…"[25]

[25] Blackmon Direct, pp. 6-7.

**Q. WHAT EVIDENCE DOES STAFF RELY UPON TO SUPPORT ITS CLAIM THAT SOME ALTERNATIVE PROVIDERS OPERATE AT A "DISADVANTAGE" RELATIVE TO U S WEST AND THAT SUCH "DISADVANTAGE" IS UNREASONABLE?**

A. None. U S WEST requested that Staff identify each alleged advantage it claims. Staff responded that "[I]t is not possible to identify each instance in which U S WEST has an advantage; if it were, a separate affiliate might well be unnecessary."[26] Staff's claim that it is impossible to identify how some alternative providers operate at a disadvantage and its admission that, if such identification could be made, the advanced service subsidiary might be unnecessary, demonstrates that its separate subsidiary proposal is unfounded and ill-advised.

**Q. DOES STAFF CLAIM THAT ALL ALTERNATIVE PROVIDERS OPERATE AT A DISADVANTAGE?**

A. No, it does not. Staff's testimony is only that "many" alternative providers operate at a disadvantage. Staff makes no attempt to quantify "many" and whether the alternative providers that are not disadvantaged are significant players in the market such that structurally separation would unfairly disadvantage Joint Applications.

**Q. DOES STAFF DEMONSTRATE THAT THE ADVANTAGES JOINT APPLICANTS POSSESS ARE INAPPROPRIATE?**

A. No, it does not. Staff ignores that all competitors in the market have advantages and disadvantages in relation to each other and that such is neither unusual nor inappropriate. For instance, it is not atypical that U S WEST's competitors rely upon non-union workers at lower pay scales. That

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[26] Staff responses to U S WEST Data Requests 01-023, 01-042, and 01-043, attached as Exhibit ___ (CTI-2).

U S WEST possess advantages versus competitors is not per se inappropriate. When requested to provide evidence that any U S WEST advantage was inappropriate, Staff provided no response.[27]

**Q. WHAT EVIDENCE DOES STAFF RELY UPON FOR ITS CLAIM THAT JOINT APPLICANTS CAN "MONOPOLIZE THE ADVANCED SERVICES MARKET"?**

A. U S WEST requested that Staff provide all evidence which support or relate to the ability and the likelihood of Joint Applicants monopolizing the advanced services market. Staff provided no evidence and admitted that it has not performed such a study.[28]

**Q. WHAT EVIDENCE DOES STAFF RELY UPON TO SUPPORT ITS CLAIM THAT THE PUBLIC INTEREST WOULD BE HARMED?**

A. Staff claims "customers of monopoly services could end up bearing the risks of the company's ventures into advanced services."[29] When requested to provide evidence as to the likelihood and the ability or lack thereof of the Commission to prevent such from occurring, Staff admitted to having no evidence.[30]

**Q. HAVE THE PARTIES PROPOSING THE ESTABLISHMENT OF AN ADVANCED SERVICE SUBSIDIARY ADDRESSED HOW SUCH A SUBSIDIARY WOULD BEGIN OPERATION?**

A. No, they have not.

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27 Id.

28 Staff response to U S WEST Data Request 01-024. In addition, when requested to detail how Staff alleges Joint Applicants could leverage market power, Staff provided no evidence and admitted to having conduct no investigation. Staff responses to U S WEST Data Requests 01-48 and 01-49, attached as Exhibit __ (CTI-2).

29 Blackmon Direct, pp. 7.

30 Staff responses to U S WEST Data Requests 01-025 and 01-026, attached as Exhibit __ (CTI-2).

**Q. SHOULD THE COMMISSION BE CONCERNED WITH SUCH DETAILS?**

A. Yes, it should. Assuming such a requirement would be imposed, the process by which an advanced service subsidiary is created and begins operations must be fair to U S WEST and Qwest. Joint Applicants should not be disadvantaged by implementation of such a condition.

**Q. UNDER WHAT TERMS SHOULD U S WEST BE ALLOWED TO ESTABLISH AN ADVANCED SERVICES SUBSIDIARY, ASSUMING SUCH A REQUIREMENT EXISTED?**

A. U S WEST should be allowed, unencumbered by any further regulatory requirement, to transfer the existing intrastate customers[31] of U S WEST, including all customer contracts, business records, and employees necessary to continue the provision of service to those customers. I am advised by counsel that the Commission's approval is not required to transfer the above list of items.

**Q. WHY IS IT NECESSARY THAT U S WEST TRANSFER THE EXISTING CUSTOMER BASE AND THE ASSOCIATED CUSTOMER CONTRACTS, BUSINESS RECORDS, AND EMPLOYEES?**

A. Joint Applicants would be unable to comply with a regulatory requirement to separate the existing advanced services portion of the U S WEST operations without the ability to move existing customers and the necessary business records and employees to the subsidiary.

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[31] It is U S WEST's contention that the Commission has no jurisdiction over matters involving interstate and unregulated services. On the other hand, Staff's proposed requirement would "not apply only to services subject to the WUTC's jurisdiction." See Staff response to USWC Data Request 01-017, attached as Exhibit ___, (CTI-2).

**Q. UNDER WHAT TERMS SHOULD U S WEST BE ALLOWED TO TRANSFER REGULATED INTRASTATE TELEPHONE PLANT TO AN ADVANCED SERVICE SUBSIDIARY?**

A. U S WEST should be allowed to transfer the physical telephone plant used to provide advanced services to the advanced services subsidiary at the plant's net book value.

**Q. WHY SHOULD U S WEST BE ALLOWED TO TRANSFER REGULATED INTRASTATE TELEPHONE PLANT AT NET BOOK VALUE?**

A. Under normal circumstances, U S WEST would be required to obtain the Commission's prior approval to transfer assets to an affiliate. In this situation, however, the separation of advanced services operations would be required by the Commission. Furthermore, such a requirement would be premised, at least in part, upon the notion that the separation would prevent alleged subsidization of advanced services by regulated services. The telephone plant, therefore, can be presumed to be worth no more than net book value. Any valuation greater than net book value would result in an unsubstantiated payment, or subsidy, to regulated customers from advanced services.

**Q. IF U S WEST WERE REQUIRED TO SEEK SEPARATE AUTHORIZATION FROM THE COMMISSION TO TRANSFER ASSETS, WOULD THAT JEOPARDIZE THE START-UP OF THE ADVANCED SERVICE SUBSIDIARY?**

A. Yes, it would. A fair requirement to separate advance services would be one that would allow the advanced services subsidiary to quickly and efficiently accomplish the separation and begin operations immediately without creating confusion or uncertainty for its customers. If U S WEST is required to seek authorization from the Commission prior to transferring assets, the establishment and start-up of the subsidiary would be hampered to the competitive disadvantage of the merged company. Joint Applicants need certainty as to the specific requirements in order to proceed.

**Q. WHAT WOULD BE THE EFFECT OF A REQUIREMENT THAT U S WEST SEEK COMMISSION APPROVAL BEFORE TRANSFERRING ASSETS?**

A. There would be likely be disagreement over legal and financial issues, which would have the effect of delaying or seriously disadvantaging the startup of an advanced service subsidiary. It is possible that the transfer of assets, if not the entire operation of the advanced service subsidiary, would be delayed for a year or longer while litigation before the Commission (and possibly in the courts) was pending. It would become impossible for Joint Applicants to comply with any Commission requirement to separate advanced services in a separate subsidiary while litigation is pending.[32]

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[32] It cannot be emphasized enough that if the Joint Applicants are required to structurally separate advanced services while at the same time required to seek Commission approval to implement such structural separation, Joint Applicants will be seriously disadvantaged financially and competitively. See Staff responses to U S WEST Data Requests 01-022 and 01-027, attached as Exhibit __ (CTI-2).

**Q. IF THE COMMISSION ORDERS THE CREATION OF AN ADVANCED SERVICE SUBSIDIARY, WHAT CONDITIONS SHOULD BE INCLUDED?**

A. As I have stated above, U S WEST should be authorized as part of such a requirement, and without further Commission proceedings, to transfer to the advanced services subsidiary (1) existing customers, (2) all customer records, business records, and employees that are necessary to comply with the requirement to separate advanced services, and (3) telephone assets at the then existing net book value.

## V.REGULATORY OVERSIGHT

**Q. IS YOUR TESTIMONY ON ISSUES REGARDING REGULATORY OVERSIGHT IN ADDITION TO THAT OFFERED BY MR. TAYLOR ON BEHALF OF JOINT APPLICANTS?**

A. Yes, it is. I will address existing affiliate requirements and safeguards of the Washington Commission.

**Q. PUBLIC COUNSEL CLAIMS THE PROPOSED MERGER WILL INCREASE REGULATORY COMPLEXITY.[33] DO YOU AGREE?**

A. No. Although there may be a greater number of affiliate relationships and thus affiliate transactions requiring regulatory oversight, this does not increase the "complexity" of regulation. To the extent regulatory complexity has increased, it is due to changes in the industry, which will continue to occur irrespective of the merger. Federal and state

[33] Brosch Direct, p. 23.

regulatory efforts to manage the transition from regulation to competition have increased regulatory complexity. If anything, merger conditions proposed by Staff and intervenors in this docket will increase regulatory complexity. Examples are the proposals to create an advanced service subsidiary and to structurally separate wholesale and retail operations.

**Q. DOES PUBLIC COUNSEL PROVIDE EVIDENCE TO SUPPORT ITS CLAIM THAT THE MERGER WILL INCREASE REGULATORY COMPLEXITY?**

A. No. U S WEST requested that Public Counsel identify the "more and different affiliate transactions" it claims will result from the merger. Public Counsel's response is that it cannot do so. U S WEST requested that Public Counsel identify of the "more and different affiliate transactions," which would be compensated via tariff versus some other manner. Public Counsel stated that these transactions cannot be determined. U S WEST requested that Public Counsel explain how new affiliate transactions and allocations among affiliates would be "more complex." Public Counsel was unable to state any specifics.[34] It is incongruous that Public Counsel offers testimony claiming the merger will make regulation more complex, but is unable to identify with any specificity the way in which regulation will be more complex.

**Q. WILL THE COMBINATION AND INTEGRATION OF QWEST AND U S WEST NECESSARILY INCREASE REGULATORY COMPLEXITY?**

A. No, it will not. The integration of regulated and unregulated operations is allowed and

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[34] Public Counsel responses to U S WEST Data Requests 01-029, 01-030, and 01-031, attached as Exhibit __, (CTI-4).

anticipated under existing regulatory requirements, including those governing joint marketing. Regardless of the merger, more affiliate transactions across a broader array of unregulated services and involving more affiliates are going to happen. The mere increase in the number of affiliate transactions or an increase in the number affiliates across which holding company costs are allocated does not make regulation more complex.

**Q. PLEASE RESPOND TO AT&T'S CLAIM THAT THE COMMISSION WILL BECOME CONFUSED BECAUSE U S WEST HAS NO PLANS IN PLACE TO COORDINATE AND TRACK AFFILIATE DEALINGS.**[35]

A. It simply is not true that U S WEST does not have plans to coordinate and track affiliate transactions. The Company does exactly that, day in and day out, and has done so consistently in compliance with the Commission's requirements. The Commission should make note of the absence of testimony from Staff that the merger threatens oversight of affiliate transactions. It is significant that the party primarily responsible for regulatory oversight does not mention this concern arising from the transaction.

**Q. ARE AT&T'S AND PUBLIC COUNSEL'S PROPOSED MERGER CONDITIONS RELATING TO AFFILIATE TRANSACTIONS AND REGULATORY OVERSIGHT NECESSARY?**

A. No. The Commission's existing affiliate requirements and safeguards are being ignored. The merged company will comply with the Commission's existing affiliate requirements, which are discussed below. There will be no changes in the Company's compliance with

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[35] Ward Direct, pp. 58-59.

existing requirements to file affiliate contracts, the accounting of affiliate transactions, or the reporting of affiliate matters to the Commission.

AT&T's proposed conditions confirms AT&T's lack of knowledge and its inaccurate presumption that no Commission oversight of affiliate transactions exists. AT&T recommends disclosure of affiliate transactions and terms and conditions. That is already done currently through the filing of affiliate contracts, as discussed below. AT&T further proposes that U S WEST be required to commit to comply with affiliate rules. This commitment is unnecessary, as U S WEST is already in compliance with the Commission's requirements and intends to stay in compliance. AT&T also claims that the proposed structural separation into wholesale and retail operations would enable the Commission to enforce affiliate transactions requirements. As discussed below, U S WEST has a history of complying of the Commission's affiliate requirements.

**Q. WHAT ARE THE COMMISSION'S REQUIREMENTS WITH RESPECT TO TRANSACTIONS BETWEEN AFFILIATES?**

A. U S WEST is required to file for the Commission's review the contracts with affiliates with which it does business. The contracts lay out all the transactions between U S WEST and the affiliate and specify the terms and conditions. U S WEST fully complies with this requirement.

Furthermore, transactions between U S WEST and its affiliates are governed by the Part 32 accounting rules, which the Commission has adopted. The affiliate portion of Part 32 rules requires that services U S WEST be transacted at tariffed rates, if such tariffs exist, and, if not, that services provided to affiliates be priced at the greater of the market price or fully distributed cost. Services affiliates provide to U S WEST must be priced at the lesser of market or fully distributed cost.

Pursuant to Part 64, U S WEST is required to maintain a cost allocation manual specifying how it apportions costs between regulated and unregulated operations of U S WEST. The cost allocation manual describes nonregulated operations and sets forth the basis by which USWC accounts for revenues and costs of unregulated services provided by U S WEST. An outside auditor annually audits transactions with affiliate to ensure compliance.

**Q. DOES U S WEST FILE A REPORT WITH THE COMMISSION DETAILING ITS TRANSACTIONS WITH AFFILIATES?**

A. Yes. Every June 1st, U S WEST files a report with the Commission that details its transactions with affiliates.

**Q. ARE ADDITIONAL AFFILIATE REQUIREMENTS SPECIFIED IN SECTION 272 OF THE TELECOMMUNICATIONS ACT OF 1996 (THE "ACT")?**

A. Yes. Section 272 of the Act provides that all transactions between U S WEST and its Section 272 affiliates must be conducted at arms' length, reduced to writing, and available for public inspection. The purpose of these requirements is to enable a determination that such transactions are conducted in compliance with the accounting rules. Pricing, or compensation, for services are to be documented in the form of work orders and task order, then posted on the website for public disclosure.

**Q. WHAT OTHER COMMISSION REQUIREMENTS APPLY TO AFFILIATE TRANSACTIONS?**

A. Transfers of assets between U S WEST and unregulated affiliates are governed by the asset transfer statute. Pursuant to the statute, transfers of assets are not allowed without prior approval of the Commission.

**Q. DOES THE MERGER AFFECT ANY OF THE ABOVE AFFILIATE REQUIREMENTS OF THE COMMISSION?**

A. No. All the Commission's affiliate requirements remain in place.

**Q. IF, AS A RESULT OF THE MERGER, MORE AFFILIATE RELATIONSHIPS ARE FORMED, WILL THE COMMISSION OVERSIGHT OF THOSE RELATIONSHIPS CONTINUE?**

A. Yes. If there are any new affiliate relationships involving U S WEST, the organization that I lead will file affiliate contracts for the Commission's review.

## VI.PUBLIC COUNSEL'S PROPOSED CONDITION REGARDING YELLOW PAGES

**Q. WHAT IS PUBLIC COUNSEL'S PROPOSED CONDITION REGARDING DIRECTORY IMPUTATION?**

A. Public Counsel proposes that the Commission, as a condition of the merger, require U S WEST to "continue to impute directory profits…"[36]

**Q. WHAT IS THE RELATIONSHIP BETWEEN THIS PROPOSED CONDITION AND THE MERGER TRANSACTION?**

A. There is none. Other than Mr. Brosch's testimony that his conditions "…address merger cost accounting to ensure that only reasonable costs become embedded in USWC's above-the-line expenses," there is absolutely no evidence justifying the inclusion of a requirement to impute directory profits as merger condition.

**Q. DOES DIRECTORY IMPUTATION HAVE ANYTHING TO DO WITH "MERGER COST ACCOUNTING"?**

[36] Brosch Direct, p. 9, 42.

A. No. Directory imputation is a revenue ratemaking adjustment upon which the merger has no effect.

**Q. DOES PUBLIC COUNSEL ATTEMPT TO PRE-EMPT THE PROCESS ALREADY UNDERWAY IN DOCKET NO. UT-980948?**

A. Yes. The reasonableness of continuing the imputation of directory revenues is a matter before the Commission in Docket No. UT-980948. There is no basis for Public Counsel to seek a finding in this proceeding that continuation of imputation is "reasonable." Such a finding is neither appropriate, given the scope of this proceeding, nor supported, given the scant testimony of Mr. Brosch. It should be noted that Staff, for its part, is recommending that the results from Docket No. UT-980948 be allowed to take effect irrespective of any moratorium on rate increases.[37]

## VII.AT&T'S PROPOSAL TO BAN RURAL EXCHANGE SALES

**Q. PLEASE DESCRIBE AT&T's PROPOSAL TO PROHIBIT THE SALES OF EXCHANGES.**

A. AT&T proposes that the Commission impose a moratorium on the sale of local telephone exchanges for at least three years following merger close and that in any future sale, the merged company be required to improve service quality before making a sale.[38] In the alternative, AT&T asks the Commission to prohibit U S WEST from marketing rural exchanges while the merger is pending. AT&T claims the merger will affect how and where the merged company provides service in Washington, that a moratorium would ensure investment in the rural areas of

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1 [37] Blackmon Direct, p. 19.
1 [38] Ward Direct, pp. 64-65.

Washington, and that the merged company should be prevented from reaping savings by declining to service high cost areas.

**Q. ARE SUCH PROPOSALS REASONABLE?**

A. No, they are not. Such conditions are unnecessary in light of the Commission's continuing authority to approve sales of telephone exchanges in Washington. AT&T ignores the public interest showing which must be established in order to obtain the required approval of such sales, and seeks to presumptively prohibit future sales before the facts are even known as to whether customers would be better served by another local carrier.

**Q. WOULD SUCH PROPOSALS FINANCIALLY DISADVANTAGE JOINT APPLICANTS?**

A. Yes, it would. AT&T is a significant, if not primary, competitor of U S WEST in the State of Washington. It would be unreasonable to place conditions upon the merger that would disadvantage the Joint Applicants in relation to AT&T. AT&T has and is continuing to merge with other telecommunications providers. AT&T's cable division is known to have service problems. Rearranging service territory in order to reduce costs is common in the cable industry. AT&T's rural service territory can be presumed to also be high-cost areas. Nevertheless, when asked about its service commitment in rural Washington and its practices and safeguards, AT&T stated that its policies are not issue in this docket.[39] Quite to the contrary, whether the conditions recommended by AT&T would financially disadvantage the Joint Applicants in relation to AT&T is a reasonable issue to explore in this docket.

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[39] AT&T responses to U S WEST Data Requests 01-008, 01-009, 01-013, and 01-014, attached as Exhibit __ (CTI-5).

**Q. IS AT&T'S TESTIMONY BASED ON INACCURACIES?**

A. Yes. In support of its proposals, AT&T witness Ward gives testimony that is extremely inaccurate.[40] AT&T claims that rates have not been reset as a result of the sale of high costs telephone exchanges and that the Company has not re-invested money from the prior sale nor sought to reduce wholesale rates. In support of Mr. Ward's testimony, the only supporting evidence offered by AT&T is a news article available on the Internet.[41]

Incredibly, AT&T simply chooses to ignore the facts readily available in Washington in dockets before the Commission in which AT&T participated. The financial effect of the sale of telephone exchanges approved by the Commission in Docket No. UT-940700 was fully incorporated into the rates set in Docket No. UT-950200. AT&T ignores the settlement agreement in Docket No. UT-940700 whereby U S WEST agreed to re-invest capital to provide signaling system seven (SS7) and CLASS service capability in all its central offices.[42] AT&T ignores the Docket No. UT-940700 settlement agreement which obligated U S WEST to reduce switched carrier access charges by $1 million.[43] That reduction was effected in Docket No. UT-950200 when, as I stated above, all the financial effects of the sale were incorporated into rates.

**Q. PLEASE COMMENT ON AT&T'S TESTIMONY THAT U S WEST SHOULD BE PREVENTED FROM "SUBSIDIZING" ITS OTHER PROJECTS WITH MONEY FROM SALES OF RURAL EXCHANGES.[44]**

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[40] Ward Direct, pp. 61-63.
[41] AT&T responses to U S WEST Data Request 01-010 and 01-011, attached as Exhibit __ (CTI-5).
[42] Docket No. UT-940700, Settlement Agreement, p. 3-4.
[43] Id., p. 4.
[44] Ward Direct, p. 64-65.

A. This is a mischaracterization of the facts. The specific proceeds from all sales of telephone exchanges, net of the effect of settlement agreements such as that in Docket No. UT-940700, have retained by U S WEST and used to pay for the Company's capital investments.[45] With respect to the claim of "subsidy," it is management's right to direct investor-supplied capital as it sees fit. How the exercising of that right constitutes a "subsidy" is not explained by Mr. Ward.

**Q. AT&T CRITICIZES JOINT APPLICANTS' FAILURE TO BE EXPLICIT IN HOW THE MERGER WILL AFFECT FUTURE SALES OF EXCHANGES. PLEASE COMMENT.**

A. I believe that Joint Applicants' responses to AT&T's data requests have clearly indicated that the Company expects to continue to evaluate the situation post-merger just as U S WEST has done for many years. I do not see the merger affecting, one way or another, activity in this area. There is no basis for AT&T's claim that this is an area that will be affected by the merger and therefore requiring Commission-imposed conditions.

## VIII: PUBLIC COUNSEL ACCOUNTING REQUIREMENTS

**Q. PUBLIC COUNSEL PROPOSES BELOW THE LINE ACCOUNTING FOR THE COST OF PROVIDING CUSTOMER RELIEF FOR SERVICE FAILURES. DO YOU AGREE?**

A. I agree to the extent of tracking through the accounting system the cost U S WEST incurs to provide the cellular loaner program, service credits paid to customers, and other payments. The Company does this in the normal course of business and accounts for these cost consistent with

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[45] It is inefficient to ear-mark the proceeds from a Washington sale to pay for Washington capital investment because of the inability to accurately time the sale close with the expenditure of cash for future capital investment. Logically, U S WEST manages its cash at the company level.

Part 32 accounting rules. I disagree to the extent that Public Counsel desires the Commission to depart from Part 32 accounting rules and order different accounting rules for U S WEST.

**Q. WOULD PUBLIC COUNSEL'S PROPOSAL ELIMINATE A CONTENTIOUS ISSUE IN A FUTURE RATE CASE?**

A. No, it would not. As Public Counsel well knows, accounting does not determine ratemaking. If it did, rate cases would be simpler. Public Counsel's plea for an exception to existing accounting rules amounts to an attempt to achieve a ratemaking result without having a rate case. This issue is best left to where it belongs, i.e., for the next rate case when all the facts and circumstances can be heard by the Commission. In the meantime, U S WEST pledges to continue its existing tracking mechanisms.

**Q. IS IT CLEAR WHAT COSTS PUBLIC COUNSEL REFERS TO?**

A. No, it is not. Public Counsel has not detailed what costs of "providing customer relief for service failures" specifically refers to. When the Company has an out of service condition or service complaint, it dispatches employees to fix the problem. It is the Company's position that the cost the Company incurs to resolve service issues should never be disallowed. Doing so may create a disincentive to quickly restore service or resolve service complaints. Furthermore, anything relative to estimating foregone revenues would logically require estimation of expense and investment necessary to achieve the revenue.

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

A. Yes, it does.