BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, vs. U S WEST COMMUNICATIONS, INC., Respondent.	)	DOCKET NO. UT-950200 VOLUME 22 Pages 2273 - 2539

A hearing in the above matter was held at 9:00 a.m. on January 16, 1996, at 1300 South Evergreen Park Drive Southwest, Olympia, Washington before Chairman SHARON L. NELSON, Commissioners RICHARD HEMSTAD, WILLIAM R. GILLIS and Administrative Law Judge C. ROBERT WALLIS.

The parties were present as follows:

U S WEST COMMUNICATIONS, by EDWARD SHAW and DOUGLAS OWENS, Attorneys at Law, 1600 Bell Plaza, Seattle, Washington 98191 and JAMES VAN NOSTRAND, Attorney at Law, 411 - 108th Avenue Northeast, Bellevue, Washington 98004.

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION STAFF, by STEVEN W. SMITH and GREGORY TRAUTMAN, Assistant Attorneys General, 1400 South Evergreen Park Drive Southwest, Olympia, Washington 98504.

FOR THE PUBLIC, DONALD TROTTER, Assistant Attorney General, and JAMES CUNNINGHAM, Special Assistant Attorney General, 900 Fourth Avenue, Suite 2000, Seattle, Washington 98164.

Cheryl Macdonald, Court Reporter

APPEARANCES (CONT.)

AT&T, by DANIEL WAGGONER, Attorney at Law, 1501 Fourth Avenue, Suite 2600, Seattle, Washington 98101 and SUSAN PROCTOR, Attorney at Law, 1875 Lawrence Street, Denver, Colorado 80202.

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I N D E X

P R O C E E D I N G S

JUDGE WALLIS: Let's be on the record, please, for our January 16, 1996 session in the matter of docket UT-950200, U S WEST Communications.

Before beginning this morning we've discussed several procedural and administrative matters. We have asked the court reporter to redo the index to show for exhibit marking the page on which the exhibit is described for identification. We have reached a convention regarding confidential exhibits. Those exhibits will be split into two parts. The part without the C designation would be available for public information and distribution. Any confidential information will be segregated into an attachment or an associated exhibit marked with that number and the designation C. Because some of the documents that have been introduced appear to have confidential elements that may not be so designated and because there are some documents that have that designation but actually are not confidential, the parties have consented to go through the record and as to their own proprietary information designate that material which is confidential in conjunction with the record setter and produce a revised exhibit list, and we will make that available to all parties.

It would be helpful in doing that if any confidential information, truly confidential, is designated with a colored stamp or red stamp or something of that sort so that those copied pages that the company or companies no longer consider confidential, that decision can be ignored unless it's in red.

The company has distributed late-filed Exhibit 208 which is a representation of a chart which was drawn at the hearing by witness Haack, and that document is received in evidence.

(Admitted Exhibit 208.)

JUDGE WALLIS: Company has also provided Exhibit 172 and 172C separating the confidential items from the exhibit which was introduced through witness Wright. Ms. Wright's Exhibit 22 was offered and admitted but in fact should be designated withdrawn and is now so designated. The Commission staff and public counsel will be indicating when Mr. Farrow returns the portions of the Farrow deposition, Exhibit 345 for identification, that will be offered.

(Withdrawn Exhibit 22.)

JUDGE WALLIS: Is there anything else that we touched on that we need to state for the record? It appears not. The material we have scheduled today is

to hear evidence from public counsel witnesses. Public counsel has called Michael L. Brosch to the stand.
Whereupon,
MICHAEL BROSCH,
having been first duly sworn, was called as a witness herein and was examined and testified as follows:
JUDGE WALLIS: In conjunction with Mr. Brosch's appearance we are marking as Exhibit 390TC his direct testimony, 391 is a document designated MLB-1. 392 is MLB-2 Activities Received by U S WEST. 393 is MLB-3. 394C is MLB-4. 395C is MLB-5 Bellcore '93 budget. 396C is MLB-6. 397C is SCC/MLB1 accounting schedules, and the company has distributed a document which is designated as Exhibit 398 for identification entitled Exhibit X4 Executive Compensation.
(Marked Exhibits 390TC, 391, 392, 393, 394C, 395C, 396C, 397C and 398.)

DIRECT EXAMINATION
BY MR. TROTTER:
Q. Mr. Brosch, would you please state your name and spell your last name for the record?
A. Michael L. Brosch, B R O S C H.
Q. By whom are you employed?

A. By Utilitech Incorporated.

Q. What is your business address?

A. 740 North Blue Parkway, Suite 204, Lee's Summit, Missouri, 64086.

Q. And is Utilitech a consulting firm that was retained by public counsel and TRACER to appear in this proceeding?

A. Yes.

Q. In that capacity did you have cause to be prepared Exhibit 390T, your direct testimony?

A. Yes, I did.

Q. Is that document true and correct to the best of your knowledge?

A. It is.

Q. If I asked you the questions that appeared there, would you give the answers that appeared there?

A. Yes, I would.

Q. In the course of that testimony you refer to Exhibits 391 through 393 and Exhibit 394C, 395C, 396C and 397C; is that correct?

A. Yes.

Q. And were those exhibits prepared by you or under your direction or are they documents which have been supplied to you upon which you are relying?

A. Yes.

MR. TROTTER: Your Honor, move for the admission of Exhibit 390T and 391 through 393 as well as the confidential designated Exhibits 394 through 397.

JUDGE WALLIS: Is there objection?

MR. OWENS: No, Your Honor.

JUDGE WALLIS: Let the record show there is no objection and those documents are received.

(Admitted Exhibits 390TC, 391, 392, 393, 394C, 395C, 396C and 397C.)

MR. TROTTER: Note for the record that his cross-rebuttal testimony has already been admitted as 126T.

JUDGE WALLIS: Yes.

MR. TROTTER: With that understanding the witness is available for cross.

CROSS-EXAMINATION

BY MR. OWENS:

Q. Morning, Mr. Brosch, I'm Doug Owens representing U S WEST.

A. Good morning.

Q. Directing your attention to page 7 of your direct testimony, Exhibit 390T, at the bottom of the page there you talk about utilities having significant transactions with affiliates introduced what you call new complexity and responsibility into the regulatory process. Would you agree with me that, first of all, it's not uncommon at least today for utilities to have transactions with affiliates across the country?

A. It is not uncommon, and by reference to new here I meant to convey incremental complexity relative to utilities that do not have affiliate transactions.

Q. And in fact as far as U S WEST Communications is concerned would you also agree with me that its predecessor company had significant transactions with affiliates, essentially since regulation existed in this state?

A. I believe your reference is to pre divestiture AT&T.

Q. Yes.

A. And the subsidiary companies, and yes, there were affiliate transactions and affiliate issues prior to divestiture.

Q. And regulation dealt with those during that period of time, am I correct?

A. Yes, as best it could.

Q. And would it surprise you to learn that there was a Supreme Court case in this state that indicated that the affiliate relationship between this company's predecessor and the Bell system was a benefit to ratepayers?

A. I'm not aware of any such decision, but I am rarely surprised by such things.

Q. You've proposed a number of disallowances of expenses from U S WEST Inc. that have been allocated to U S WEST Communications; is that correct?

A. Yes. There are adjustments that I propose set out in some detail on accounting Schedule C8 within Exhibit 397.

Q. And just so the record is clear, would it be correct that the numbers that you have proposed under the total disallowance adjustment column represent the entirety of the amounts that were billed to U S WEST in these various categories -- billed to U S WEST Communications, that is?

A. That's not completely accurate. Within column C on Schedule C8 you will find the amounts directly billed to U S WEST Communications from the parent company in these responsibility centers that are listed. In column D are amounts that I call it circular billed, amounts that are billed by the parent to other affiliates and then rebilled by those affiliates to U S WEST Communications.

Q. I think we're saying the same thing. All

I'm trying to get to, Mr. Brosch, is that whatever the route by which the billing reached U S WEST Communications your intent and you believe the effect of your adjustment is to remove the entire amount in these categories of expenses generated at U S WEST Inc.; is that correct?

A. That is correct, for these RC's listed on lines 1 through 11 the disallowance is a full disallowance.

Q. Would you agree with me that federal tax policy affects U S WEST Communications?

A. Yes.

Q. And would you also agree with me that the U S WEST Communications public policy organization does not itself address federal tax policy?

A. Which organization?

Q. The U S WEST Communications public policy organization.

A. I don't know whether they do or not.

Q. You also discuss Mr. McDonald's testimony about safeguards and beginning at page 11 of your direct Exhibit 390T you talk about the fact that the FCC rules pursuant to parts 64 are procedural in nature governing how costs are accumulated and how transfer prices are determined. Would you agree with me that those rules are directed at insuring that deregulated are not subsidized by regulated operations?

A. I believe that is a stated purpose of those rules.

Q. And you're aware that the Federal Communications Commission audits U S WEST for compliance with the part 64 rules; is that correct?

A. I believe it does, yes, as well as other regulated telephone companies under its jurisdiction.

Q. And you say at page 13 that, to use your phrase, notably U S WEST Communications proposes no rate case adjustments from these audits, and you indicate Mr. McDonald admits that the FCC made no significant adjustments; is that right?

A. I'm sorry. Where are you at?

Q. Bottom of page 13.

A. Yes. I see that reference.

Q. Now, by the way you phrased that, Mr. Brosch, in terms of saying that it's notable that U S WEST doesn't propose itself any rate case adjustments and saying that Mr. McDonald admits that the FCC made no significant adjustments, are you intending to convey that you believe that those FCC audits for compliance with the part 64 rules are ineffective for their stated purpose?

A. No. I'm intending to convey that the existence of those rules and the compliance auditing related to those rules are inadequate safeguards. One can be in complete compliance with part 62 and part 32 rules and still seek recovery of unreasonable affiliate charges such as those proposed for this disallowance by me and by the Commission staff in this case.

Q. Well, now, sir, I asked you my question whether you were intending to convey your opinion that the audit was ineffective to insure compliance with the part 64 rules, which you earlier agreed with me were directed at preventing cross subsidy of nonregulated operations by regulated operations, like to ask you to focus on that. Are you intending to suggest by the way you phrased that statement that the compliance audits are ineffective as a safeguard to insure against cross subsidy of nonregulated by regulated operations?

A. You asked me what I intended to convey and that was what I just explained to you. The audits, as I understand the process, are to investigate whether or not there is compliance with the rules. I think the audits do that. Beyond that, I think the rules are insufficient to fully protect ratepayers from cross subsidization, so you can be in compliance with rules that are inadequate, and the audit attest function will certify some degree of compliance with those rules, but that doesn't answer all of the regulatory concerns.

Q. What specific expense that was treated in accordance with part 64 do you believe in fact results in a cross subsidy of unregulated by regulated operations?

A. The expenses that I've proposed to eliminate.

Q. All of them?

A. Yes. Because the rules don't address in any detail the nature of the activities performed within a parent organization, for example, but instead require that thereby an allocation of those costs at cost with a return reasonably related to the cost of capital. The nature of the activities generating those costs, though, are not subject to or critiqued by those rules.

Q. Well, is it your understanding, for example, that the president and CEO expense on Schedule C8 that you propose to disallow has not already been the subject of an allocation between regulated and nonregulated operations pursuant to part

64?

A. The amounts set forth on C8, line 1, are the result of an allocation, yes, sir.

Q. So it's your testimony that you know that notwithstanding that allocation that there's some portion or I guess, to use your testimony, all of this $478,000 was exclusively directed to the support of nonregulated operations; is that correct?

A. I explain in my testimony in some detail the rationale for that disallowance and it is primarily that I believe the president --

Q. Can you answer yes or no to my question?

A. I'm trying to. It is a complete --

MR. TROTTER: Your Honor, I think the witness has been responsive.

JUDGE WALLIS: I would ask if the question can be answered by yes or no to state that and then explain the answer. Do you have the question in mind?

THE WITNESS: May I have the question again.

Q. Is it your testimony that all of the $478,000 on Schedule C8 for the president/CEO is exclusively directed to the support of nonregulated operations?

A. Yes, either that or the support of parent company operations.

Q. Did you interview the president of U S WEST Inc. to make that determination?

A. No, I did not. I relied on the materials referenced in my testimony.

Q. Exclusively?

A. Yes.

Q. And would the same be true for the other positions as chief financial officer, executive vice-president, chief planning officer, corporate strategy department and VP public policy, that's your statement?

A. Well, I relied upon materials referenced in my testimony, and other materials produced by the company in response to discovery in this case, as well as my familiarity with the roles of these responsibility centers from previous U S WEST Communications rate cases in other jurisdictions.

Q. Now, of the amount, let's say the 478,000 for president/CEO your answer to my prior question was either that those expenses were exclusively devoted to the support of nonregulated operations or they were parent operations. Which part of the 478 represents exclusively nonregulated operations support?

A. I have not partitioned the 478 figure.

Q. So is the answer you don't know?

A. I have not done the work to answer the question. I don't know.

Q. Do you know that any of it supports nonregulated operations? Do you know that for a fact?

A. The job descriptions I reference in my testimony explain that the activities of the president and CEO are supportive of overall corporate operations and overall corporate operation would certainly include nonregulated businesses.

Q. But you indicated earlier you agreed with me that the numbers that you're proposing to disallow represent the result of a prior allocation designed to separate regulated from nonregulated costs. Did you not agree with me on that?

A. The prior allocation that I was agreeing with you about was the allocation of those costs across the various U S WEST Inc. subsidiaries. Some are regulated and some are not.

Q. Let me just be clear. Is it your testimony that you believe that there has not been a part 64 allocation the results of which are reflected in the dollars that you're proposing to disallow, that is, that there is another group of dollars that has already been identified and not charged in U S WEST's cost of service representing nonregulated functions of the president and CEO?

A. I don't think I understood all your question.

Q. Let me rephrase it. Is it your testimony that you believe that there has not been and does not exist another group of dollars representing functions of the president and CEO for the support of nonregulated operations that have been excluded from U S WEST cost of service?

A. I'm still confused by your reference to another group of dollars. What dollars are you asking.

Q. The dollars that would represent the result of the part 64 allocation representing the nonregulated side of that allocation?

A. Let me try to respond this way. There has been an allocation, and part of the costs of the president/CEO responsibility center at U S WEST Inc. have been charged to subsidiaries of the parent that are nonregulated. The amount that you see on line 1 is after that allocation has occurred.

Q. And so it's your testimony that notwithstanding there are some dollars in the totals on line 1 that represent dollars that should have been allocated to the nonregulated subsidiaries? Is that what your testimony is?

A. Either regulated elsewhere or absorbed by the company, the parent company and not allocated, and the parent company does choose to absorb certain of its costs and not allocate those costs to subsidiaries.

Q. And so then would it be a fair statement that the FCC attestation audit failed to detect the dollars that you believe are embedded in line 1 -- well, actually lines 1 through 5 that you believe should have been allocated to the nonregulated subsidiaries?

A. I don't think that's a fair statement, no, sir.

Q. Page 121, you discuss Mr. McDonald's testimony regarding a different safeguard involving the calculated return included in affiliate billings, and you say it's a mechanism to insure that affiliates billing their costs to U S WEST Communications recover a full return on the investment they employ. You're not saying by that that U S WEST Communications is guaranteed by the state that it will in fact recover revenues sufficient to insure a return on either its investment or any affiliate's investment, are you?

A. I don't believe there is a guarantee. I think you used the word guarantee in your question. I believe there is an opportunity for the company to earn a return on all reasonably incurred investment included in the ratemaking process by the Commission and an opportunity to recover all of those expenses found reasonable by the Commission including expenses charged to Communications by affiliates.

Q. Now, with regard to the parent expenses have you presented evidence that U S WEST has acted in bad faith in regards to the expenses that it has proposed for allocation from U S WEST Inc. to U S WEST Communications?

A. I guess I don't appreciate the question acted in bad faith. I believe the company has made its own judgments about how to allocate costs, and I disagree with some of those judgments.

Q. You say you don't appreciate the question. Do you not understand the concept of bad faith?

A. I'm not by my testimony accusing the company of misrepresenting the nature of its allocations or intentionally or fraudulently allocating costs or anything of that nature.

Q. I think that covers it. The expenses that we're talking about on C8, I just want to see if I can understand and establish for the record the precise basis of your actions. One basis that you state in your testimony is that these expenses are duplicative of expenses incurred at the U S WEST Communications level. Is that correct?

A. They are duplicative in the sense that with respect to some of the RCs listed on Schedule C8 there is a comparable function contained within Communications. For example, Communications has a chief executive officer, and the parent company has a chief executive officer. I'm not stating that the scope of responsibilities of those individuals are identical. In fact I explain in my testimony that they are quite different, but nevertheless there is a chief executive officer within each company.

Q. Now, you say that's as to some functions. As to the other ones what's the rationale?

A. The bottom half of Schedule C8 where under the heading public relations image advertising, the adjustments contained in the bottom half are more aligned with concerns about the nature of the costs incurred and whether they would be recoverable even if incurred directly by Communications. For example, if Communications chose to sponsor an international golf tournament and those costs were contained solely on Communications' books it's my judgment those costs should be excluded. They're excluded here because of the fact that they were incurred on the parent company's books and allocated to Communication.

Q.   Let me see if I understand your testimony then. As to the upper part of the page, lines 1 through 5, would the Commission correctly understand that you intend to convey by that answer that all five of those categories are duplicated and the reason for the exclusion is the duplication?

A.   Not entirely, no. There are other reasons explained in my testimony, including a very fundamental need or a lack of need for services provided by those functions at the parent, particularly given the existence of some departmental functions within C representing C's own unique interests and concerns on those matters. For example, public policy, within C there is a large public policy organization directly responsible for representation of C's interests in public forums.

Q.   But we already established, I believe, that at least one function performed by the U S WEST Inc. public policy organization, that is, of analyzing and acting with regard to federal tax policy is not duplicated at the Communications level, at least you don't know that it is; is that correct?

A. I said that I don't know if there is federal tax policy responsibility or functionality within C's public policy organization.

Q. Or any other organization within C?

A. I believe that there is within the finance controller's functionality an understanding and capability with respect to federal income taxation.

Q. Well, that's a broad statement. When you say an understanding and capability, would you agree with me that preparing the company's income tax returns may be a different function from analyzing and advocating change in federal tax policy?

A. Yes. Those could be different functions.

Q. Do you know that the latter function is included within U S WEST Communications finance organization?

A. I don't know one way or the other.

Q. So you said that one reason for the exclusion of the five items on the upper part of the page is that they are duplicated and another reason is that there is a lack of need for services at Communications. Is there any overlap between those in your mind, that is, the existence of duplication and the lack of need, are they the same thing?

A. They're not the same thing but in many instances they are related. For example, the existence of a president within U S WEST Communications suggests that there is a role in costs associated with executive oversight and management of that entity, costs which appear to be duplicated when one looks at the parent and observes that there is a similarly situated position responsible for overall governance of the entire consolidated entity.

Q.   I asked you whether you had interviewed the president of U S Inc. Just to round it out, did you interview the president of U S WEST Communications in making your judgment that there was duplication between those functions?

A.   No, I saw no need to do that. I relied on the written materials provided by the company in response to discovery and expect that if I did impose on those individuals for an interview they would understand the reasons for my questions and explain their responsibilities in a manner consistent with the explanations provided by the company in written discovery anyway.

Q.   And just so that the record is clear, did you interview anyone at either U S WEST Inc. or U S WEST Communications with regard to the other four areas of disallowance on lines 2 through 5 to form your conclusions about the existence of duplication or the lack of need?

A. I have spoken with individuals at U S WEST Inc. about the nature of responsibilities within these functions in this case and prior cases, but I have not interviewed personnel within these organizations. My contacts were regulatory contacts.

Q. It's correct, isn't it, that the regulatory impact review specifically found that there wasn't any duplication between the activities of U S WEST Communications and U S WEST Inc.

A. Finding Roman IV-F8 of the regulatory impact review says, "despite little documentation to help prevent the occurrence of duplication and overlap, no instances of overlap and duplication were noted by the RIR auditor during the RIR field work." To me that indicates something of a negative assurance. We found none based on what we looked at, and despite the existence of little documentation to help prevent --

Q. It's true, isn't it, that the RIR audit did conduct extensive interviews with personnel at both U S WEST Communications and U S WEST Inc. as part of the audit?

A. There were a series of interviews. I asked to participate and oversee the conduct of those interviews and was denied access to them.

Q. What capacity was it that you asked for the authority to supervise those interviews?

MR. TROTTER: Excuse me, Your Honor. The witness did not say he wanted authority to supervise. He just wanted to participate.

Q. What capacity was it that you asked for the authority to participate?

A. My firm was under contract with the staff of the Arizona Corporation Commission, one of the three states overseeing the conduct of that audit, and I was providing technical assistance to the staff and attending some of the meetings that took place and some of the planning work associated with both of the regulatory impact reviews, one directed at U S WEST Inc. and the one directed at U S WEST Advanced Technologies.

Q. As far as you know, did the regulatory impact review auditors interview people in the responsibility codes on Exhibit C8, lines 1 through 5?

A. I don't have recall of what individuals they interviewed. There was an extensive interview list and the scope of their report, as I understand the report, is intended to be all encompassing of functionality within the parent company.

Q. And it's correct, isn't it, that you've made an issue in this case of the question of whether there is duplication of activity between U S WEST Inc. and U S WEST Communications?

A. I point out that there are parallel positions and a concern that there is lack of need for services provided by Inc. in these RCs in part because Communications has its own president and CEO.

Q. Maybe my question wasn't clear. You've made a ratemaking issue of the question of whether there's duplication of activities between U S WEST Inc. and U S WEST Communications; is that right?

A. Maybe my answer wasn't clear. There are duplicate functions. There are duplicate titles and responsibilities, but they aren't duplicate in the sense that the roles are identical. The roles at the parent company for the president and CEO are much broader and aligned with the overall corporate interests of U S WEST Inc., as they should be. There is a president and CEO at Communications responsible for overall --

MR. OWENS: Can the witness be directed to answer my question which is simply has he made a ratemaking issue out of that question in this case.

JUDGE WALLIS: Can the witness respond to that question?

A. The answer is yes, with all of the explanation I gave you earlier, I'm trying to give you again now. I want to be clear. There are duplicate positions and titles for positions but the responsibilities within those are different. The scope of responsibilities are different.

Q. The Arizona Corporation Commission as opposed to the staff of that agency filed exceptions to the portion of the regulatory impact review that you quoted finding IV-F8?

A. There were extensive informal comments and exceptions noted during the audit itself. I don't know whether they filed formal exceptions or not.

Q. Now you've mentioned a couple of times that the titles of some of these positions are the same, but the responsibilities are different. Would you agree with me, for example, that U S WEST Communications has no board of directors in the sense that a corporation normally understands and uses that entity?

A. I believe that Communications has a board of directors, but I believe that board has no external directors.

Q. That board is essentially advisory; is that correct?

A. I'm not sure I understand your term advisory. They have the responsibilities of a corporate board because U S WEST Communications is a corporate entity but clearly having no external directors and having parallel responsibilities in fact, in some cases involvement on the parent company's board. Overall corporate governance occurs at the U S WEST Inc. board of directors level.

Q. One of the normal functions of a corporate board is to elect and remove officers; is that correct?

A. Yes.

Q. Is it your testimony you understand that U S WEST Communications board has that authority?

A. I don't know one way or the other.

Q. It's correct, isn't it, that U S WEST Communications represents about two thirds of the assets of all of the U S WEST Inc. operations?

A. I believe there's some information in my testimony that may get to that. You want the assets?

Q. Yes. Assets and an approximate relationship.

A. As of December 31, 1994, Communications --

do you want Communications group or Communications Inc.? I think they're roughly comparable.
Q. Communications Inc. will be fine.
A. I wish you had given me the other answer.
Q. If it's easier to do Communications group that would also suffice. I'm just asking for an overall magnitude. Maybe it would be easier to ask you to accept it subject to check.
A. Don't do that now. I'm almost done. Communications group is approximately 16 billion in total assets. Media group is approximately 7.4 billion at December 31, 1994.
Q. A little over two-thirds then, would you say?
A. At that point in time, yes.
Q. And just so that the record is clear, it's your testimony that you know that the president and CEO of U S WEST Inc. spends no time dealing with issues relating to U S WEST Communications which represents approximately two-thirds of the assets of the combined organization?
A. No, I didn't say that.
Q. So, are you then saying that you do recognize that the president and CEO of U S WEST Inc. does spend some time dealing with issues relating to

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U S WEST Communications?

A. I would assume in the role of responsibilities described for the president/CEO of U S WEST Inc. that there is some time spent and considerable responsibility dealing with issues involving C as part of the overall corporate portfolio of businesses. However, there is that same responsibility with respect to C in the president and CEO of C.

Q. And just so the record is clear, when you give that answer, the only information on which you base it, the latter part, are the descriptions in writing that have been admitted I think as Exhibits 272 and 273.

A. I don't know what that is.

Q. Responses to your data requests 214 and 215 where you asked for each executive officer of the two companies current written detailed position description?

A. No. There was more information than that relied upon.

Q. And what additional information was there that you relied on?

A. Well, if you look at the totality of my testimony in this area you will see reference to a number of other responses to discovery in this case, and as I explained earlier I was involved in the RIR audit exercise. There was certainly audit information produced there. I had discussions involving the responsibilities of the parent and C with those auditors and in the other states representatives involved in that process testified on this subject many times in the past and had the benefit of company information produced in those prior regulatory cases.

Q. Just so we understand, it's your testimony that every decision that the U S WEST Inc. president and CEO makes has to be ratified or approved by the U S WEST Communications president?

A. I don't think so. It's a well compensated and highly responsible position, as I understand it.

Q. Well, then if the decisions of the U S WEST Inc. president and CEO don't have to be ratified by the U S WEST Communications president, isn't it true that those functions would not necessarily be duplicative?

A. I don't think I understood your question. You have C executives ratifying Inc. decisions now?

Q. Well, that was the question I asked you previously.

A. Perhaps I misunderstood that one as well then.

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Q. Is it your testimony that the decisions -- each decision that U S WEST Inc. president and CEO makes is duplicated exactly by a decision at the U S WEST C level?

A. No.

Q. Is it your testimony that the U S WEST Inc. CEO defines how the U S WEST Communications CEO will achieve objectives set forth by U S WEST Inc.?

A. At a certain level objectives are defined corporate wide by Inc. personnel subject to the approval of the CEO. I believe it is up to management, including the president and CEO of Communications to find ways to develop and implement objectives, strategies and policies that conform to the overall corporate objectives but at the same time are tailored to the specific needs of Communications.

Q. Do you see those as different functions, that is, the setting of objectives on the one hand and the development of strategies for the implementation of those objectives in a particular way as you've described it on the other hand?

A. I see those objectives as being different in scope where one set of executive management is directly responsible for defining -- developing and defining strategic objectives and strategies for the

Communications and another set has a more global overall corporate set of objectives in mind, and the two don't necessarily agree in all instances.

Q. Is it true that included within the category of expense that you would exclude is share owner services?

A. I don't believe so. No, sir.

Q. I would like to talk now about your testimony with regard to directory imputation. At page 2 you describe the excessive earnings of U S WEST Direct in Washington. Is it correct that you haven't submitted any evidence in your testimony about the level of earnings of any other directory publisher in the state of Washington?

A. That's correct. I don't view that as relevant.

Q. The answer is that's correct, you haven't submitted it?

MR. TROTTER: Asked and answered.

MR. OWENS: Well, I'm trying to get an answer without the embroidery.

JUDGE WALLIS: I think the witness did answer your question, Mr. Owens.

Q. Like to ask you a few little foundation questions. It's correct, isn't it, that U S WEST

Direct has contracted with its advertisers?
A. Yes.
Q. And U S WEST Communications is not a party to these contracts, is it?
A. Well, I believe that there are instances where U S WEST Communications buys advertising from U S WEST Direct, so in those instances they are parties, but in the broader context, no, they aren't.
Q. And the contract essentially involves an agreement by U S WEST Direct to prepare a display ad and to print that and compile it into a book and publish that book and to deliver that to consumers in a particular geographic area. Would that essentially be U S WEST Direct's part of the contract?
A. I would have to assume that. I have not reviewed advertising contracts with U S WEST Direct customers. I know they exist.
Q. And on the other side, the advertiser's obligation is to pay the contracted price. Would that be a fair statement?
A. I would expect so, yes.
Q. And as far as you know the existence of the books in people's homes and businesses represents evidence that U S WEST Direct has performed its part of the contract?

A. I would think so.

Q. And then the advertisers in turn pay their -- perform their side of the contract by paying their contract price to U S WEST Direct. Would that be fair?

A. Most do, yes.

Q. And those payments appear on the books of U S WEST Direct not U S WEST Communications; is that correct?

A. I think those payments appear on both books in instances where U S WEST Communications provides billing and collection service for U S WEST Direct.

Q. They don't appear as revenue on U S WEST Communications books in that instance; is that correct?

A. That's true.

MR. TROTTER: I was asking for clarification of the question whether he means currently or in prior times.

Q. I'm talking about during the test year.

A. Yes. I would state all that I stated in the test year.

Q. And you're aware that there are other publishers of comparable directories, that is, the same type of a publication that U S WEST Direct publishes that operate in the state of Washington, aren't you?

A. I don't think they are very comparable,

but, yes, there are competing publishers.
Q. Well, when you say they're not very comparable, have you looked at their products?
A. Probably but I don't specifically recall any of their products.
Q. In any case you haven't attempted to impute any of their earnings to either U S WEST's operations or those of any other company; is that correct?
A. I have not. In fact I don't know that they have earnings.
Q. Do you know that they don't have earnings?
A. I believe I told you before that I didn't view any of that as relevant, made no inquiries in that area.
Q. So is the answer you don't know?
A. I don't know.
Q. Would you agree with me that what we've discussed is U S WEST Direct's performance of its contracts; namely, the publication and delivery of a printed book is not the same thing as the transmission of information over wire or optical media by electromagnetic or similar means?
A. Well, I never really thought about it but I suppose it's different, yes.
Q. You cite at page 17 of your direct

testimony and you quote from the secretary's supplemental order in this Commission's cause U-86-56 regarding the publishing agreement. It's correct, isn't it, that at the current time and during the test period U S WEST Direct was not making any payments as such to U S WEST Communications other than for things like publishing lists and billing and collect services?
A. Yes. By a letter dated December 12, 1988 Mr. Okamoto agreed to cease the payment of a publishing fee from U S WEST Direct to U S WEST Communications.
Q. Would you agree with me that in U S WEST's relationship, U S WEST Communications relationship with U S WEST Direct, U S WEST Communications is not making payments to U S WEST Direct that appear on U S WEST Communications books as either expense or capital?
A. That's not correct.
Q. What payments is U S WEST Communications making to U S WEST Direct that appear on its books as expense or capital?
A. As I indicated before, it's my understanding that U S WEST Communications buys advertising from U S WEST Direct. It would appear as an expense. It's also my understanding that U S WEST Communications provides certain reverse services, administrative services, on occasion to U S WEST Direct that would

result in Communications realizing and recording revenues.

Q. Well, that isn't what I asked you. I asked you about expense or capital and you've answered with regard to the purchase by U S WEST Communications of advertising expense in the U S WEST Direct books -- excuse me -- purchase of ads in the U S WEST Direct books that result in an expense. Other than that, are there any expenses that you're aware of that appear on U S WEST Communications books?

A. I am not certain in all instances whether reverse services, services provided by C to U S WEST Direct, are recorded as revenues or as negative expenses. I think they're recorded as revenues and if they're recorded as revenues then the answer to your question would be yes, I am aware of no other expenses.

Q. Now, you say at page 18 that U S WEST Direct has contracted with U S WEST Communications for the exclusive right to use the telephone company's name and the Bell logo; is that right?

A. I say trademark logo but that's what I mean, yes.

Q. It's correct, isn't it, that the telephone company's name doesn't appear on the U S WEST directories; is that right?

A. Well, the U S WEST part does.

Q. Well, the telephone company's name is U S WEST Communications Inc.; is that correct?

A. That's correct, and the U S WEST is the common part of the name within the corporate family. The full name does not appear, that's correct.

Q. And it's correct, isn't it, that U S WEST Direct began using U S WEST name approximately six years before the Communications company did; is that correct?

A. I don't recall the specific timing but there was a difference. For a period of time there was use of both the Pacific Northwest Bell name and the U S WEST Communications name somewhat interchangeably and different ways for different purposes, but the corporate consolidation of the three operating companies into U S WEST Communications and the promotion of the public education of that merger took place sometime later for Communications than U S WEST Direct.

Q. Well, let me ask a different question then. U S WEST Direct began using the U S WEST name at or shortly after divestiture; is that correct?

A. I believe so, yes.

Q. And isn't it true that there were a number of years before the U S WEST Communications name began to be used in conjunction with or in association with the Pacific Northwest Bell name, by the Communications company?

A. I believe that there was joint use of the names shortly after or coincident with divestiture. I recall seeing operating company names in bold large print with reference to a U S WEST company or a similar tag line that went to the operating company, to the U S WEST name, shortly after divestiture.

Q. When exactly?

A. I can't remember that far back.

Q. So it might have been as long as a year?

A. Perhaps. I don't recall specifically. I know that there was a period of time, as I stated earlier, when there was mixed usage of U S WEST identifiers and Pacific Northwest or Mountain or Northwestern Bell identifiers, in correspondence and in certain public communications.

Q. But you can't say for sure when that began?

A. I've made no study of the timing of the display of corporate names.

Q. Would it be fair that directing your attention to your Exhibit 393, which is the display advertising, the examples, there isn't a single one of those in which the Bell logo appears? Just answer it subject to check. We can do it?

A. All right. It is what it is certainly.

Q. I've handed you a book and just ask if you can accept or recognize that as a publication by a company called Local Touch Directory.

A. It says at the bottom of the front cover copyright Local Touch Publishing Company, an affiliate of U S WEST. At the top it says a U S WEST directory.

Q. Is that for the Wallingford, Fremont, University District area in Seattle?

A. And Laurelhurst it says, yes.

Q. And what's the time, the date?

A. 1995/1996 is on the cover. I don't know when the directory is actually distributed.

Q. The date you gave me is sufficient for my purposes. It's correct that the Bell logo doesn't appear anywhere on that directory?

A. You mean on the cover?

Q. Well, I will ask you to accept that it doesn't appear inside either but just on the cover you don't see it?

A. I don't see it on the cover. I see the common corporate U S WEST name.

Q. Have you committed with your testimony any studies indicating or supporting the proposition that consumers view the advertising in the U S WEST Direct directories as valuable to them because of the association that directory has with U S WEST Communications?

A. I think the first of your question was have I conducted any studies.

Q. No. Have you included in your testimony any such studies?

A. No, I have not.

Q. And at page 25 of your testimony you talk about shared information and coordinated planning available to U S WEST Direct by virtue of its relationship with U S WEST Communications. What specific information are you talking about there?

A. What I had in mind in writing this was something that we spoke of earlier, the overall corporate strategic planning through common management at the parent company, an awareness of market opportunities, capital needs, capital availability, the full gamut of planning that falls within the strategic management of the parent company's portfolio of businesses, one of which is MRG and U S WEST Direct.

Q. You see there on line 4 I refer to common ownership by U S WEST Inc.

Q. At page 27 you state that the states of Arizona, Iowa, Utah, Montana and Washington impute directory revenues based upon the achieved profits of U S WEST Direct, and you attribute that to a U S WEST Communications response. It's correct, isn't it, that there has not been a rate case in this jurisdiction since divestiture in which the issue of imputation of directory profits has actually been litigated?

A. I believe that's right, and the decisions in the other states vary with respect to timing.

Q. Would you agree with me that you're not aware that there is any affirmative legal requirement on U S WEST Communications to publish a Yellow Page directory?

A. I have heard others state that and testify to that and have assumed that to be true, but I have not researched that.

Q. I was asking you if you're aware of the existence of an affirmative requirement. Would the answer be that you're not aware of it?

A. I am not aware of an affirmative requirement for the telephone company to publish Yellow Pages though it's generally anticipated that telephone companies do that.

Q. Are you aware of the existence of any

telephone companies in this state that do not themselves publish a Yellow Page directory?
A. I'm not sure what you mean by themselves. Can you explain that?
Q. Either directly or through an affiliate.
A. I have not made a specific study of the entities involved in the publication of directories for other telephone companies in the state.
Q. So you don't know that in fact all of them do publish a Yellow Page directory?
A. That's true, I don't know.
Q. And you're aware that there are publishers of Yellow Page directories who do not also provide local exchange telephone service?
A. Yes, there are.
Q. In Washington?
A. I believe that Ms. Koehler-Christensen identifies some in her testimony.
Q. You have no reason to disagree with that testimony?
A. That's true, I have no reason to disagree.
Q. The objective as far as you're concerned of imputing directory revenue to U S WEST is to enable the rates for residence service to be lower than they would be without the imputation; is that correct?

A. Well, my responsibilities stop with determining the revenue requirement for the company. I don't have any rate design objectives in mind beyond quantifying an overall reasonable revenue requirement for the company.

Q. Well, all right, let me make it more general then. The process of setting the revenue requirement is translated into specific rates as part of the rate case process; is that right?

A. Yes, it is generally translated.

Q. And so the objective from your standpoint of imputing the directory revenues is to enable a situation in which rates for telephone service of some description would be lower than they would be without the imputation; is that correct?

A. That's correct in that the revenue requirement in the case is lower with imputation than without.

Q. And would it be fair that as the revenue requirement is defined in terms of the sum of prudently incurred operating expenses plus return on the used and useful rate base plus taxes that the revenue requirement with the imputation is further away from cost defined in that fashion than without it?

A. When you say revenue requirement I'm not entirely clear as to whether you mean the incremental revenue requirement or change proposed in a particular case or the total amount of revenues required by the company.

Q. The latter.

A. The total amount of revenues required by the company is less when the revenues associated with imputation are recognized.

Q. And to the extent that in a regulatory context you would equate revenue requirement with cost of service, would you agree with me that a revenue requirement with imputation is further away from cost than one without it?

A. Well, it depends on how you add and subtract costs, I suppose, and what you consider a cost. In a certain sense the cost of service could be impacted by an imputation of directory results as a reduction to expense. It doesn't much matter whether you call it a revenue imputation or a negative expense imputation. The important concept is should we recognize the results of publishing Yellow Pages directories in setting rates.

Q. I understand your point of view. I am simply trying to ask you, if you define costs from the regulatory standpoint as the sum of operating expense plus return and taxes, would you agree with me that you move further away from costs as you add imputed directory revenues as part of that calculation?

A. I suppose within that narrow construct and if we assume that the Yellow Pages imputation is a revenue adjustment then the answer would be yes.

Q. Now, you referred at some length to the decision of the divestiture court at the time of the Tonney Act proceedings in support of your imputation recommendation; is that right?

A. I believe there's passing reference somewhere in here. Do you have a point in my testimony in mind?

Q. I see on page 26 at about line 8 a reference to U S versus AT&T. Is that what you have in mind?

A. Yes.

Q. It's not your testimony that Judge Green ordered or could order any such perpetual extraction in that case as you describe at line 7; is that correct?

A. Well, I don't see any reference in my testimony to perpetual extraction, and I don't fully understand the extent or limitations of any jurisdiction Judge Green might have had then or has now, but my statement is at the time of divestiture when USWD was organized that was the intent.

Q. Isn't it true that to a very large extent Judge Green acted on the assumption that for the foreseeable future local exchange service would continue to be a monopoly in all of its respects?

MR. TROTTER: I will object to the question unless that assumption is directly stated in the judge's opinion. This witness has no basis for reading the judge's mind.

MR. OWENS: Well, he's purporting to draw conclusions from what was stated in the opinion. It seems to me it's reasonable cross to ask whether circumstances have changed.

MR. TROTTER: That's a different question.

MR. OWENS: No, it isn't. It's a foundation question.

JUDGE WALLIS: The witness may respond.

A. I do not know what was in the Judge's mind in terms of the potential future changes and relative competitiveness or market conditions at the time the decision was written.

Q. Did he express concerns repeatedly throughout that opinion in terms of deciding in favor of divestiture as opposed to other remedies available to him in the context of an antitrust case about the possibility of the use of the local exchange monopoly to disadvantage competitors in one or other lines of business? Do you recall that?

A. There were certainly references to that effect in the decision.

Q. And it's correct, isn't it, that if you view, for example, basic exchange service in Washington as potentially competitive that the use of imputed profits from another line of business to depress the price could have an effect of deterring entry by an otherwise willing competitor?

A. I suppose it is possible that if one could link the revenue requirement imputation of Yellow Pages to the pricing of a particular product and demonstrate that there is a subsidization taking place, that might be a concern, yes.

Q. And is that a similar type of disadvantaging competitors that Judge Green described in his opinion in other contexts?

A. Only in a very general sense is it similar.

Q. I think you've delivered yourself of the view that another competitive entrant that had some similar source of other revenues could use those revenues to absorb startup cost and then you tend to

minimize the significance from a competitive standpoint of the imputation; is that correct?
A. Yes. I make reference in my testimony to the fact that in a consolidated business like U S WEST if imputation were ceased the corporation would still have the benefit of the Yellow Page revenue and profit stream and could, for example, choose to use that revenue and profit stream to subsidize its own entrance into new businesses.
Q. It's true, isn't it, that not every potential entrant in the local exchange business would be fortunate enough to have another profitable affiliate or associated business that it could use to absorb those startup costs; is that correct?
A. It is true that some may not be affiliated with other profitable businesses, yes.
Q. And it's true, isn't it, that at least as far as your recommendation the proposal is to continue the imputation of directory revenues indefinitely into U S WEST's Washington intrastate operations?
A. Well, I certainly in my testimony have not suggested any rate increase in future years to remove the imputation.
Q. So a potential competitor in that situation wouldn't just be facing startup costs in terms of

needing an additional revenue source; is that correct?
A. I don't understand your question.
Q. In order to be able to under the hypothetical that we've been talking about that you could identify the imputation to the pricing of a particular service, the competitor would have to have the ability to itself cross subsidize for an indefinite period in order to be able to compete; is that correct?
A. Not necessarily, no. I think part of your question is do you know specifically where the Yellow Page imputation in the revenue requirement calculation causes specific rate amounts for specific services to come out the back end of the ratemaking process, and I don't know that it follows that all of the Yellow Pages revenue imputation makes its way into the price of a particular service or particular services that a given competitor might choose to offer in competition with U S WEST Communications. There's a link in the process that's not altogether clear to me with your questions.
Q. You agreed with me earlier by definition that the rates that will be set as a result of this process would be lower by the amount of the imputed directory income than they would be without that imputation, than they would be in aggregate?

A. Yes, that's the important part. Rates in aggregate are what I'm concerned with in quantifying the revenue requirement. Said another way all of the rates for all of the company's regulated products and services will be designed to produce in total an amount of revenue sufficient to meet the company's revenue requirement.

Q. Doesn't that necessarily mean that at least some services will be priced at levels lower than they would be without the imputation?

A. Presumably, yes, but which ones I don't think I can say.

Q. And you're not aware that there's any legal impediment to a competitor coming in and competing for any service that U S WEST provides in Washington today; is that correct?

A. I don't know whether there are or not.

Q. You haven't produced any evidence in your testimony that any rates in Washington would be unaffordable if imputation is not ordered by the Commission in this case; is that correct?

A. That's correct.

Q. Did you respond to U S WEST data request No. 31 to the effect that you had no studies to support the statement at page 20 of your testimony that U S WEST

Communications' provision of billing and collection services to U S WEST Direct is a unique and valuable business advantage to U S WEST Direct?
A. My response was no such documents are in the possession of me.
Q. Do you have any evidence to show that U S WEST Communications charges for billing and collection services provided to U S WEST Direct are less than it costs other publishers to provide that function for themselves?
A. We're talking about billing and collection?
Q. Yes.
A. It's my understanding that billing and collection is not provided to any competing publishers.
Q. Maybe you didn't understand my question. Do you have any evidence to show that the charges that U S WEST Communications makes or bills to U S WEST Direct for the provision of billing and collection are less than it would cost or does cost other Yellow Page publishers operating in Washington to perform that function for themselves?
A. I have no information one way or the other in that regard.
Q. You talked in your cross rebuttal testimony

at I believe it's page 11 of the -- you support the staff's proposal to impute test period revenues for service provided to customers who had held orders during the test period. That is an imputation, isn't it?

A. You're on page 11 with the cross rebuttal?

Q. Yes.

A. It is an imputation in the sense that it recognizes -- that adjustment would recognize revenues that would exist if not for the held order situation.

Q. And you characterize that as a reasonable penalty for noncompliance with the Commission's rules; is that correct?

A. Yes.

Q. Is the Yellow Page imputation a penalty for noncompliance with the Commission's rules?

A. No. I've characterized the Yellow Page imputation as being an adjustment that restates the accounting for the Yellow Page business as if it had not been extracted from the telephone company at divestiture, basically putting back what was removed.

Q. So one imputation is a penalty but the other one isn't, is that it?

A. That's correct. In fact in the Yellow Page instance there are very real revenues and profits being realized by the company whereas in the held order situation there are revenues lost because of the inability to satisfy those held orders.

Q. Like to move now to your discussion of advertising on your proposed disallowance of certain of the company's advertising expenses during the test year. You aren't an expert in the field of advertising, are you, Mr. Brosch?

A. I have considerable experience in evaluating the ratemaking treatment of advertising, but if you mean by your question am I in the business of designing and placing advertising, the answer is no.

Q. And have you ever been in that business?

A. No, sir.

Q. Have you ever taken any courses in the subject of advertising the objectives and methods by which those objectives are achieved?

A. Yes.

Q. Where? What were they?

A. University of Missouri in Kansas City as part of my business degree curriculum there were marketing courses dealing with advertising issues.

Q. Did they indicate to you in those courses that one of the objectives of advertising is to create demand for a product or stimulate a purchase decision?

A. Yes. That could be an objective and often is an objective.

Q. In terms of advertising by a commercial firm, isn't it almost always the case that the objective to stimulate a purchase decision is involved in the decision to place an ad?

A. Not necessarily. Some ads by a commercial firm are promoting a specific product or a purchase decision related to a specific product or service. Other advertising may be to position the reputation of the business favorably, in a more general sense, a nonproduct specific sense.

Q. Is it your testimony that there's a difference between what you call a nonproduct sense and the desire to stimulate a purchase decision even if it's at some future time and for a product that isn't specified in the ad?

A. I'm not sure I understand your question.

Q. Let me ask it this way. Isn't it true that you can have as an objective of advertising the stimulation of a purchase decision even if you don't specify a particular product in the ad?

A. You might have in mind generating a positive public perception of your company, so that at a later time or at another selling opportunity you have the benefit of that public perception as well as the specific promotional message that you might later choose to offer on a product specific basis.

Q. And the benefit that you mentioned in that answer would be some small additional inducement on the positive side to stimulate the purchase decision at that later time?

A. Hopefully it would be that. It may be little more than a warm and fuzzy feeling about a good corporate citizen that one has in the back of their mind.

Q. But from the standpoint of a commercial profit maximizing firm, isn't it true that it is the hope or expectation that there would be that incremental stimulus to the purchase decision at a future point in time that motivates the decision to place the ad?

A. That could be one of many motivating factors.

Q. Let me ask you another question. U S WEST Communications and U S WEST Inc. are both profit maximizing firms, would you agree with that?

A. Yes.

Q. And so a dollar of advertising expense is a dollar of reduced profit if it doesn't produce some incremental increase in sales that would generate an offsetting profit; is that correct?

A. Not necessarily. A public policy or a positive public perception of the firm might manifest itself in better results with regulators or better results at the legislature or at Congress. This imagery, this positive public perception concept behind positioning advertising can result in many benefits. It's the reason for example that many commissions disallow image advertising and charitable contributions and other kinds of public perception influencing activities of public utilities.

Q. But you agreed with me earlier that what you characterize as image advertising could also have as its objective the stimulation of purchase decisions by customers at a future point in time?

A. It is possible that it would have a positive influence, yes, albeit indirect.

Q. And would you agree with me that to the extent the purchase decisions result in increased sales of services that contain contributions, the remaining ratepayers are better off, at least under a revenue requirement rate of return regulatory environment?

A. Well, only if the additional sales are regulated products and services. When there is public positioning of U S WEST as a good corporate citizen one might expect the benefits to go as well to cellular and other nonregulated retail business functions. In fact if one believes that the majority of regulated products and services are offered in a monopoly environment or a relatively noncompetitive environment you have to question the need for any advertising to stimulate, for example, the sale of basic residence and business access line service.

Q. That's an interesting point. Is it your testimony that when U S WEST stimulates the sale, for example, of an additional business line that the other ratepayers are not better off than they are if that additional business line isn't sold?

A. One would expect to see the sale of an additional line creating additional revenue and margin. My point was that when the customer makes the decision to acquire that additional line there's not much of a decision about who to order it from, so there is demand stimulation in some areas of Communications regulated business while in other areas U S WEST Communications is mostly an order taker, an only provider.

Q. But you do acknowledge, at least in some areas, there is a benefit which you call increased margin. That does translate, does it not, into benefit for other ratepayers whose rates are set residually; is that correct?

A. There would be a benefit, and in fact that is why my testimony does not challenge the much larger amount of product specific advertising that the company incurred in the test period.

Q. Isn't it true that a number of the ads that you have proposed to disallow specifically mention additional lines as a part of the advertising message? I will just ask you to accept it subject to check.

A. I wanted to look at -- I will accept that subject to check but I wanted to note for you and the record that Exhibit 393 indicates in the written response on page 1 that the attachment that I've included contains copies of ads run in Washington which were coordinated by USWI but that a special study would be required to identify the direct and indirect costs associated with each ad, and then there's reference to several RCs. And given the company's inability to define the costs and individual RCs associated with each ad, it's not possible to draw a very firm conclusion about which ads represent the majority of the cost or which ads relate to specific RCs at issue.

Q. But your proposal is to exclude all of these costs; is that correct?

A. I've excluded the costs that originate at Inc. for advertising that the company classifies as image rather than product advertising in applying the FCC rules you appeared to favor earlier in our dialogue.

Q. Well, regardless of your interpretation of my questions you're not suggesting to the Commission that an FCC classification controls what this Commission does for regulation or ratemaking in Washington; is that correct?

A. No, it certainly doesn't control it. In fact, many of the adjustments proposed in public counsel and TRACER's case and in the staff's case indicate that it's not a very adequate control in many instances for ratemaking purposes, but my reference to it was to indicate that the company's own classification scheme recognizes that the costs I would disallow are image advertising. It was the company's judgment that applied those rules to costs in question.

Q. If the company claims that an expense is reasonable and you think that it's unreasonable that doesn't stop you from pointing out that it's unreasonable; is that correct?

A. No, sir.

Q. And you haven't introduced any evidence, have you, that the amount of dollars spent on advertising that you would propose to disallow are unreasonably high; is that correct?

A. I don't quite know how to respond. The adjustment that I propose implicitly is saying that the company's expenditures in this area for image advertising are too high.

Q. Well, let me ask you this. If the company had spent one dollar on image advertising, would that be excludable in your view?

A. Probably, yes.

Q. So your proposal is completely independent of the level or amount of dollars that the company has spent. It's based on your chacterization of the purposes of that purposes of that advertising. Would that be a fair statement?

A. In part, yes, but you used the word completely independent, and I have to say my adjustment was proposed with knowledge that the company has spent a considerable amount on product specific advertising that I am not challenging.

Q. Well, let me ask you this. Is there any amount of advertising in what you have characterized as the category you will disallow or propose for disallowance because it is what you call image advertising that would be reasonable for the company to spend in order for it to be included in rates?

MR. TROTTER: I will object to the question. The witness has already testified that it was the company that characterized this as image advertising.

MR. OWENS: Well, he's also characterized it that way.

MR. TROTTER: Well, I thought the question was suggesting that it was exclusively that Mr. Brosch so classified and I was objecting on that basis.

MR. OWENS: The company hasn't treated this as Mr. Brosch has treated it and so my purpose in this question is simply to pin down under applicable legal standards whether there's any challenge to the reasonableness of the amounts involved as opposed to the witness's characterization of them.

JUDGE WALLIS: Witness may respond.

A. I hate to ask, but may I have the question?

Q. Is there any amount of dollars that the company would spend in the category you've indicated as image advertising that you believe would be reasonable for inclusion in regulated results of operations?

A. If the company did not have considerable product specific advertising expenditures, and if the message contained in the corporate ads coordinated by Inc. was aimed at specific products and services of Communications as a primary message then there is an amount that I would judge to be allowable. I don't have a preconceived notion of what that amount is but I would be receptive to rate recovery of some reasonable amount. However, given facts to the contrary in this case, specifically the message, the primary message of these ads, the existence of significant U S WEST Communications product specific advertising in the test period, it's my judgment that these costs should be excluded.

Q. I think you've perhaps assumed something that I didn't include in my question, namely, that the substance of the ads would change. Let me ask you, did you assume that in your answer? That is, when you said that if the primary message of the ads here in question were different than you perceived that it is

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did you assume that the ads would change?

A. I understood your question would be a general question as to whether there is any amount of image advertising that might be available.

Q. Let me separate it then. As to these specific ads, am I to understand that there is no amount of these ads that you would consider reasonable in amount, that is, dollars spent on them, the ones that are in your exhibit?

A. I believe these ads are primarily image advertising, that that's the principal message, and I would disallow their costs.

Q. And the answer to my question is, there's no amount of this type of ad that would be reasonable in your opinion?

A. That's true.

Q. Now, changing to the other question, which is you assumed a hypothetical that the company did not have substantial product advertising and that the ads here would be changed so that their primary message was product related. Would that not convert them to product advertising as you've used the term?

A. It might. I'm using that term as the company has used it in classifying costs. There is an FCC account that provides for the recording of expenses for product specific advertising and in fact the company might change its classification of the costs of ads if the primary message became more product specific.

Q. Is it your testimony that it's an objectively determinable fact on which all reasonable people would agree whether the primary message of a particular ad is, as you call it, product oriented or, as you call it, image oriented?

A. No. It involves judgment. Clearly ours differ.

Q. So under the hypothetical that you mentioned earlier that the company would not have substantial product advertising and the ads would be -- at issue here would be changed so that they would not have what you characterize as their primary message being image, what is the dollar amount that you would consider to be reasonable?

A. I think I said before I don't have any preconceived motion of an amount that is reasonable. I believe with respect to its product specific advertising the company has responded to some discovery indicating a payback or a cost benefit type of analysis for those ads suggesting that there is revenue stimulation of an amount associated with advertising expenditures to promote a specific service of some other amount, and that's a reasonable way to look, first of all, whether a particular ad is a product specific message, and secondly, whether it is a cost justified expenditure to do that advertising.

Q. It's true, isn't it, that businesses who buy display ads in the U S WEST Direct Yellow Pages sometimes purchase ads that you would characterize as image oriented?

A. Yes. I've seen ads that do little more than display a company's name to keep it in the front of the mind and thinking of the public.

Q. Would you say that those businesses expect by virtue of putting the ad in the Yellow Pages at some point in time to stimulate the purchase of goods or services that they provide?

A. That may be one of their objectives, yes.

Q. Do you know whether or not U S WEST has competitors for the provision of local exchange service in the state of Washington?

A. I have not specifically studied the degree or existence of competition. It's my understanding that there is some amount of emerging competition.

Q. Do you know whether one of those emerging competitors is Electric Lightwave Inc.?

A. I have heard of that company. I am not familiar with their offerings. One might view cellular service at some level as being a competitor. I've heard arguments to that effect.

JUDGE WALLIS: Mr. Owens, can I interject with a brief question and that is, how are you doing on your examination?

MR. OWENS: Well, I have a number of other questions. I'm not nearly done I guess if that's the question you were asking me.

JUDGE WALLIS: Let's take a 10-minute recess at this time then.

(Recess.)

JUDGE WALLIS: Let's be back on the record, please, after a morning recess.

MR. OWENS: Thank you, Your Honor.

Q. I've handed you the April '94 to '95 Seattle Yellow Pages, have I not, Mr. Brosch?

A. Yes, the one with the Bell logo on the front.

Q. I figured you'd mention that. And it's correct at page 1635 of that publication, isn't it, that there's a display ad for Electric Lightwave under the classification telephone companies?

A. Yes, there is.

Q. And that display ad has the company name logo and mention of a couple of products; is that correct?

A. Yes. It says world class provider of communication and information services and then two bullet points. One says local, regional and national networks and the other says voice data and video.

Q. Would you say that at least in some respects that that would represent an image type ad?

A. Yes. Certainly the characterization of Electric Lightwave and its logo is being indicative of a world class provider of services involves a certain amount of imagery.

Q. Thank you. You mentioned the case of Jewell versus Washington Utilities and Transportation Commission, that is, the advertising connection, and you state that you're not talking about it as a lawyer. Did Jewell have advertising expense?

A. I believe that it dealt with charitable contributions, nonessential expenditures.

Q. And are charitable contributions and advertising expense booked in the same account?

A. In some instances they may be in the same account, but there are other accounts provided for contributions that are more normally used.

Q. Are you aware of any contributions in any of U S WEST Communications advertising accounts that you seek to disallow in this case?

A. No.

Q. Are you aware of a prior case of the Washington Supreme Court in which the court upheld the Commission's approval of a promotional rate discount for natural gas?

A. That does not ring any bells with me, no, sir.

Q. Let's move to your discussion of research and development. You propose to exclude at least for purposes of this case a number of or certain amount of expense related to a number of projects directed toward research and development; is that correct?

A. Yes. On schedules C6 and C7 are listings of the projects that I would propose be disallowed. They are relatively small proportion of the population of projects charged to Communications.

Q. And it's correct, isn't it, that you specifically state that you're not challenging whether it was prudent for the company to spend the money to do this research; is that correct?

A. That's correct.

Q. It's correct, isn't it, that the

telecommunications business is a technology intensive business?

A. Yes, it is.

Q. Relative to some other businesses like the electric power industry, there are physical limitations that govern, for example, how much electricity can be extracted from a given amount of fuel. Would that be true?

A. Well, there are a number of technology issues facing the electric power industry and significant expenditures on research and development in that industry, in particular through the Electric Power Research Institute in California, but in terms of percentages of revenues I would characterize that industry as not being as technology driven as the telecommunications industry.

Q. Let's take a more historical perspective. Would you agree with me that the telecommunications industry is substantially different today than it was, let's say, in the 1920s?

A. Absolutely, yes.

Q. And is it fair to say that a substantial if not governing factor in that difference has been research and development directed toward improving the technology?

A. Certainly technological change has driven much of the evolution of the network and CPE and new products and services over the years. Some of that research and development has been funded by the telephone utilities over the years. Some of it has been funded by vendors of equipment and CPE, so, yes, there is a definite technology push.

Q. Well, during the years of the existence of the Bell system at least for Bell companies the vendors were a part of the system, weren't they?

A. If you're referring to the Western Electric Company that was a part of the AT&T pre-divestiture Bell system, yes. Is that your reference?

Q. Yes. And so the research and development that was done that resulted in the improvements was done and funded through a license contract. Would that be correct?

A. I don't want to leave you with the impression that only Western Electric and Bell Labs were doing telecommunications research, but certainly there was a considerable amount of research over the years funded through the license contract and ultimately by Bell Telephone Company ratepayers to the extent those expenditures were not disallowed in rate cases.

Q. To that extent would you agree with me that today's ratepayers enjoy the benefits of research and development that was included in results of operations that resulted in rates paid by previous generations of ratepayers?

A. Yes. I would certainly hope so, and I think that they are, and in addition there are beneficiaries outside the regulated telephone company domain.

Q. And would you agree with me that ratepayers of regulated services today are better off in terms of their ability to use new services and also in terms of the real costs of those services than they would have been if that research and development hadn't been done?

A. I would hope so, yes.

Q. Is it true that in prior cases where license contract expenses were reviewed, specifically including research and development, there wasn't any required demonstration that there was a tangible benefit from a particular project to a particular current ratepayer group that was relied on to support the inclusion of those expenses in rates?

A. Where and by whom do you mean?

Q. Let's say in Washington.

A. I'm not familiar with what criteria might have been employed by this Commission prior to divestiture to evaluate Bell system license contract charges. I can tell you from personal experience that I was making adjustments back then to Bell labs license contract R and D charges in other jurisdictions.

Q. And U S WEST has not had a contested rate case in Washington since divestiture; is that correct?

A. I believe the last contested case was within a year or two of divestiture. I don't recall the specific dates.

Q. It was before divestiture, wasn't it, 1982?

A. I'm not certain. I think that's right.

Q. Would you agree with me that it's likely that most people who are U S WEST Communications ratepayers today will also be U S WEST Communications ratepayers two years from now?

A. I expect that many will be. There is certain mobility in our society that causes people to move to other areas that might cause them to be subscribers of another telephone company.

Q. At page 70 you state one of your reasons for your proposed disallowance that your evaluation of U S WEST's stated goals leads you to think that the agenda for technology efforts extends far beyond serving the traditional telephony needs of the current businesses of U S WEST Communications. Is that a fair statement?

A. Yes. You're at the top of page 70?

Q. Yes.

A. Uh-huh.

Q. Would you agree that it's likely that the needs of U S WEST Communications regulated customers in the future will be different from what you call the traditional telephony needs of the current businesses of U S WEST Communications?

A. Some will be different. Many people continue to need and want basic telephone service.

Q. But it's likely that at least some will be different, is that your statement?

A. I would think so.

Q. Now, of the projects that you propose to exclude for ratemaking on schedules 6, C 6 and C 7, can you state each one that you are certain that will not relate to the needs of U S WEST's future regulated customers?

A. The issue here, I think, is that no one can state much with certainty about future needs and beneficiaries of this work. I can't and I don't think

the company can. The company has asserted the appropriateness of rate recovery of all of these costs and many other project costs, and I am challenging the cost recovery of these in large part because of that uncertainty.
Q. Is it your testimony that the company has acted in bad faith in proposing to recover the costs of these projects?
A. I have not used the words bad faith. I think the company has exercised considerable judgment, which is unavoidable given the nature of these costs in terms of deciding first which U S WEST Inc. subsidiaries to allocate costs to, and secondly what proportion of the costs allocated to C are to be treated as regulated, and given those judgments mine are somewhat different with respect to the projects listed here and the comments that I just made refer to Schedule C7, the EAT projects. The Schedule C6 projects are the Bellcore projects.
Q. I'm not sure you answered my question. Are you saying that you don't allege the company has acted in bad faith in attempting or proposing recovery here?
A. I have not alleged that.
Q. Would it be correct that the exclusive basis on which you propose that these projects be

excluded from ratemaking is your perception that they relate to the future needs of some customers as opposed to the traditional telephony needs of the current businesses of U S WEST?
A. In your questions you continue to use exclusive reason and such absolute terms. There's considerable testimony explaining the basis of my investment. Certainly a central theme in that testimony is that the benefits associated with these projects are likely to fall outside the needs of current ratepayers, and it's probable that beneficiaries will be other than those to which the company chooses to charge these costs.
Q. Are you aware that other than services that have been preemptively deregulated all of U S WEST Communications services are regulated, or other than any that are deregulated by statute such as wireless communications, cellular? Is that correct?
A. It's my understanding that in general Communications products and services are regulated, that wireless is not, but that there is a classification procedure by which regulation can be relaxed for competitive services of Communications.
Q. Classification process leads to relaxed regulation, not deregulation, is that your

understanding?

A. It's my understanding that the classification system results in deregulation of specific prices for specific services. If you have in mind a legal framework for the word deregulation perhaps you could define it for me and we could talk about it.

Q. Is the investment still in the rate base after the service has been classified competitive?

A. It might be unless someone effectively adjusts it out and that adjustment is approved by the Commission.

Q. Does the Commission have the authority under the competitive classification statute to reclassify a service competitive if circumstances change?

MR. TROTTER: You mean reclassify as noncompetitive.

Q. Reclassify them as noncompetitive if circumstances change?

A. I'm not clear. You're positing first that a classification of service is competitive and then you're asking if it can be reclassified as noncompetitive?

Q. By the Commission, yes.

A. I don't know.
Q. Let me ask this. I'm going to ask you to assume for the purposes of this question that the law in Washington is that a public utility has an obligation to plan and make reasonable provision for the continuing availability of its services in the future. Do you have that in mind?
A. All right.
Q. Which of these projects that you're proposing to disallow are inconsistent with the performance of that obligation if one exists?
A. You're on C6?
Q. Actually both C6 and C7.
A. With that assumed obligation in mind, one cannot predict whether the specific benefits of these particular projects first will even be offered by Communications and be Communications products and services in the future.
Q. That wasn't what I asked you. I asked you which of these projects is inconsistent with the performance of the obligation I asked you to assume for purpose of my question.
A. I can't say. I don't know.
Q. I would like to ask you a little about your proposal for the actual treatment of these costs.

Your proposal -- let me ask just as a preliminary question. Are you proposing what you call the deferral for only the AT costs or for both the AT and the Bellcore costs?

A. Well, first I'm not proposing a deferral in the traditional accounting sense. I'm not recommending that the company be directed to account for these costs in a deferred account. Instead, I'm recommending first the costs not be charged to ratepayers today in this case, and secondly, that the company be afforded an opportunity to prove me wrong in the future when information is available that might allow the company to do that much in the sense that the company now employs its fair compensation process to make retrospective adjustments to its own judgments about who to charge for projects like these at the inception of the work.

Q. With that clarification, is that treatment intended to apply to both the Bellcore and the AT projects or just one?

A. To both.

Q. And the only way that the company could in fact make this demonstration and achieve the objective of the recovery which would be not granted at this time would be, I take it, for the company to file another rate case at sometime in the future; is that right?

A. Well, that would be a way that that could be done. It's conceivable that the company's financial performance in the future would suggest that a rate case is not necessary in that revenue growth or other changes have created earnings sufficient to continue to absorb those costs even though the company might be able to make that showing at a specific date in the future. For example, it wouldn't be in the company's profit maximizing interests, as you referred to it earlier, to file a rate case and prove up these research and development disallowances three years from now if otherwise the company would be found to be earning an excess return and subject itself to possible rate reductions.

Q. Well, certainly the overearning is the other side of the coin of the underearning, I will grant you that, but let me ask it differently. Whether a rate case is initiated by the company or by another party in the forum of a complaint, would it be correct, then, that the only forum in which the issue of the belated recognition for ratemaking purposes of the costs that you would exclude in this rate case would be in the form of a rate case at sometime in the future?

A. Well, that is the forum in issues like this, issues of amounts to be allowed for ratemaking purposes are considered. My point earlier was just to observe that you can't say next year what costs are being collected or not collected through rates because everything changes subsequent to the test period. You can observe in a next case that these projects perhaps were disallowed and now information suggests that that was inappropriate and at that point assert the right to collect monies foregone.

Q. And so the way this would work, let's say we have a test year in this case which spans two calendar years but it's largely 1994?

A. Yes.

Q. And let's say we had a rate case that was filed in 1997, for example, that would use, let's say a 1996 test year. Do you have the hypothetical in mind?

A. Okay.

Q. Regardless of whether it's filed because the company believes it's underearning or whether it's filed as a complaint because another party believes it's underearning, let's say the issue was presented on the introduction of a new service that was sought --

against which it was sought to have recovered a project that had been disallowed in this case. Do you have that in mind?

A. All right.

Q. So is it your view that U S WEST, assuming it was the proponent of this recovery, would be able to enjoy a dollar for dollar inclusion in revenue requirement of the expenses that will be disallowed in this case by proving, for example, that there was a new service that benefited from that research that was then during the test year or shortly thereafter being provided in the future case?

A. Yes, and in fact one could do an accounting for the costs thought to have not been allowed by reviewing the Commission's order and the record behind that order in the period that new rates were in effect and then provide information to the Commission that in fact that technology did find its way into a new service and that new service has been reflected in the case and revenues and expenses related to it are reflected in the case, but this adjustment is required to amortize and charge to ratepayers this previously disallowed cost.

Q. Now, would you assume that that would be a process where there would be no controversy about the linkage between the previously incurred expense of three or so years before and the particular project and revenues from that project during the test year?

A. Well, it's difficult to envision how controversial a nonspecific future proposal might prove to be, but the fair compensation review process that the company relies pretty heavily on in this area is just that, an after the fact judgment of whether previous charges for research and development were fair or not and adjustments where they weren't.

Q. What I'm trying to get to is, are you stating that, for example, public counsel will simply take the company's word for it that the linkage exists between one or more prior projects and one or more current or immediately future services?

A. Well, my recommendation to public counsel would be to review all the information the company offered and draw appropriate conclusions from that information and where more was desired in terms of support is the discovery process of, as I said, additional information.

Q. Let's make a hypothetical just a little more complicated and assume that the company were to file a rate case in 1996 and would there potentially be another layer of projects that would be excluded from current recovery and subject to this potential future recovery process as a result of that case?

A. It's possible that the same or different projects could be scrutinized and challenged by parties to the next case, yes.

Q. And public counsel under this scenario would not suggest that in that future rate case that the attempt to recover dollar for dollar these expenses amounted to some form of retroactive ratemaking?

A. Well, I would recommend that the public counsel consider the Commission's decision in this case with respect to these projects as inviting reasonable reconsideration of these costs, essentially reserving final judgment on the allowability of these costs until the time when the company might present additional information much in the way the fair compensation process is retrospective in its review of previous cost allocations.

Q. In your testimony you criticized the allocation of corporate funded R and D's in the allocator's relative size; is that correct? And I think you said in response to a data response you said this was because you thought relative size was a relatively poor predictor of the distribution of ultimate beneficiaries of particular projects. That was data request 47.

A. Yes. I state that that's my opinion and that the RIR auditor recommended a reduced reliance upon relative size based allocators for corporate research.

Q. Did you in your testimony produce any allocator that is a better predictor of that variable?

A. I believe I have. I believe I've looked at the specific projects and suggested that revised allocation for those projects away from C, but in a general sense I have not. If I did it would produce a much larger adjustment than the one that I've recommended.

Q. Well, you're essentially -- strike that. You haven't introduced any specific testimony on the specific beneficiaries of specific projects that you're proposing to disallow, is that correct, who they are?

A. My testimony talks about the projects that I list and propose to disallow but explain fairly generally that it's my judgment those projects are not currently producing benefits to ratepayers of regulated services and that there's a significant likelihood that the beneficiaries will be other than

C-regulated ratepayers; but no, project by project I have not attempted to predict exactly where the parent company might choose to deploy technologies that might result from that particular project and who the ultimate beneficiaries could be.

Q. You testify at page 94 about the fair compensation process, and in this connection you criticize the fair compensation process because of what you characterize as a miniscule percentage of corrections to the initial assignments of cost; is that right?

A. Yes. I believe you're referring to line 5 on page 94.

Q. Yes.

A. And the numbers that precede that?

Q. Yes. At any time is it true that the fair compensation review process is also effective if it prevents the uncompensated use of the technology that would otherwise be used by a nonfunding entity?

A. It's effective in this miniscule amount, yes, sir.

Q. Well, I'm sorry, I don't think you understood my question. You're viewing this in terms of the actual compensation paid for transactions where the nonfunding entity found it to be economical to pay

the compensation in order to obtain the technology, correct?
A. Yes. I'm looking at the quantitative results of fair compensation, that's correct.
Q. But in terms of preventing cross subsidy of nonregulated by regulated operations, wouldn't you agree that if the fair compensation process prevents the use of the technology on the basis that the nonfunding entity determines not to use the technology rather than pay the fair compensation price that that also is an effective prevention of cross subsidy?
A. Yes, it could be.
Q. Did you examine whether or not there had been any cases where fair compensation review had occurred and ultimately it was decided not to proceed with the technology transfer because the nonfunding entity chose not to pay the price?
A. Yes. There are some cases with that result.
Q. Would you say that as between the case of an abandoned electric power generating plant that has never produced electricity and the projects that you propose to exclude here the latter are more likely to result in benefits to regulated ratepayers than the formerer?

MR. TROTTER: Your Honor, I didn't get that question, could we either read it back or ask another question.

MR. OWENS: I will ask a foundation question.

Q. Are you aware that there's a case in this jurisdiction in which the Commission's decision to include in operating expenses the costs of abandoned generating plant that had never generated electricity was upheld by the Supreme Court?

A. I believe I've heard of that case.

Q. So as between those expenses and the expenses that you're proposing to disallow here, would you agree with me that the expenses you're proposing to disallow here are more likely to result in benefits to regulated ratepayers than the abandoned nuclear power plant construction expenses?

A. I would hope so. I think they are more likely to, although I am not so familiar with the abandoned power plant case to know if ratepayers have entitlement to reuse of the plan site or other benefits or whether that decision was driven by the financial condition and survival of the company rather than the perceived benefits or lack thereof of cancelled plan amortization costs.

Q. I am simply asking you in terms of benefit to ratepayers, which is your standard, isn't it?
A. That is a standard that I talk about in my testimony, yes, and it is I will agree with you, difficult to imagine significant benefits from a cancelled plant to ratepayers unless there are other indirect benefits such as financial survival of the utility or reuse of the plant site or other factors to consider, and I am not familiar enough with the case to know if there are or are not.
Q. And you haven't in your testimony addressed any interest of future ratepayers of regulated services who would be faced with not having the service they want because the research necessary to produce that hasn't been done; is that correct?
A. I have not researched that, that's correct.
Q. I would like to now talk about your annualization of revenue adjustment. It's correct, isn't it, that this Commission has not in the past made such growth adjustments as you're proposing in this regard?
A. I have not researched that and can't say in any comprehensive sense that they have not proved such an adjustment but it is my understanding that the convention typically employed is one of average

volumes within a given test year.

Q. Is it correct that the company's test year results of operations did include growth in revenue due to actually experienced growth in access lines during the test year?

A. Not completely, no.

Q. But it did include it to some extent; is that correct?

A. Yes. For example, if an access line was added in the last month of the test period, then one twelfth of the ongoing revenues from that line in theory would be included in the revenues at present rates.

Q. You didn't make any comparable adjustment that is based on the same theory of annualizing the last quarter for toll and access revenue; is that correct?

A. I accepted a series of company adjustments that restate the volumes of business and revenues in those areas for consideration such as primary toll carrier changes. The methodology employed in those company adjustments was different than the methodology I used to quantify local revenues, the last quarter times four calculation.

Q. Well, did you satisfy yourself that there

was no systemic reduction in toll revenues in addition to the effect of primary toll carrier in making a decision not to annualize toll the way you annualized access revenue?
A. Yes, I did.
Q. And what was the basis of that?
A. The spreadsheeting and graphing analysis that was done in evaluating revenue volumes and trends that was produced for the company in response to discovery.
Q. And you make an observation in your cross rebuttal that it's not appropriate to adjust, or I don't believe you answered the question whether it's appropriate to adjust the rate base to a year end value. You simply observed that if the rate base were adjusted to a year end value you believe that the reduction in revenue requirement would be greater simply because U S WEST's rate base is smaller at the end of the year than the average; is that right?
A. That sounds familiar. Can you give me a page reference? I may have found it page 9 at the bottom. Yes, I see that.
Q. If it were the case that U S WEST year end rate base were higher than the average should that adjustment be made?

A. Yes, I would think so.

Q. That would represent a significant departure from this Commission's prior practice in that regard; is that correct, use of a year end rate base?

A. Could be, yes, sir.

Q. And that should be a generally applicable principle for rate cases going forward; is that right?

A. Well, I think the Commission should do what in its judgment is most reflective of reasonable, ongoing costs and revenues and in this case the company has made a number of adjustments that move to and beyond test year end to make a quantification of some of those cost items. And I am representing to the Commission in my testimony that it would be equitable to also consider in this case the significant volume growth in the local revenue area that has more than offset the local rate reductions that were implemented near the front end of the test period, and that if consideration were given to year ending or annualizing of the rate base further down adjustment would result, and I have not made that adjustment in this case in the interest of conservatism.

Q. Well, the adjustments that you mentioned that go beyond the test period don't relate to the

rate reduction that you mentioned; isn't that correct?
A. That's correct. I was thinking of wage rate increases with that statement.
Q. So, is it your testimony that if the company had not made an adjustment to reduce the revenues on account of the rate reduction that actually occurred on a proforma basis that you would still recommend annualizing revenues as you have done?
A. Probably, although the amount of that adjustment would be much different and the need for that adjustment less compelling, again, with the interest in quantifying a reasonable ongoing level of revenues and expenses that are matched as to timing. I don't think it's in the interests of the parties here to mismatch prices and volumes at different point in time in determining revenue requirements.
Q. In your other annualization adjustment for wages -- and that's your adjustment; is that right?
A. I don't think so.
Q. Or is that Mr. Carver's adjustment?
A. Mr. Carver can help you. There's an index on the front of the accounting schedules indicating which of us did what adjustments.
Q. Directing your attention to what's been marked as Exhibit 398.

A. I have it.

Q. Do you recognize this as a page from the regulatory review of U S WEST Inc.

A. Yes, the regulatory impact review we spoke of earlier, it is.

Q. And directing your attention to the box where the checkmark is under total compensation. Do you see that?

A. I do.

Q. Does that reflect a determination by the auditor that total compensation for the three corporate entities listed above was approximately 31 percent below market?

A. I see that number there. I don't recall precisely how the auditor characterized the results they captured here. I recall a distinction between the variable and base and language to the effect that base salaries were somewhat higher than peer groups or other comparables but that in this year under study which, by the heading, is 1990 data the short and long-term variable or incentive compensation was quite low and if you look at the differentials you can see that those variable or incentive amounts or what is pulling the total down considerably.

Q. Well, but do you not agree that under the total compensation the conclusion the auditor grew was that you compare the market with the three companies that the total compensation available to their employees was approximately 31 percent below market?

A. In this year with the experienced level of incentive payouts that was the apparent result. Again, I think it would be fairer to them to look at their characterizations of the results and I don't recall how they determined the market or comparable group.

Q. It's correct, isn't it, that the reasonableness of compensation is an issue in rate proceedings?

A. It can be, certainly.

Q. A number of the projects that you propose to exclude for advanced technologies have to do with wireless, wireless standards, PCS infrastructure and bolder infrastructure test bed; is that correct?

A. Five of them do, three of which I understand the company has conceded.

Q. As to those the company has not conceded, would you agree that there are included the ones that I mentioned?

A. On line 5 of Schedule C7 there is a $46,000 adjustment for PCS standards and data services, and there is an $11,000 adjustment for PCS -- typo -- it should be infrastructure.

Q. Do you know whether or not those projects relate at least in substantial part to the company's gaining the ability to interconnect with providers of PCS service and terminate their traffic?

A. I believe the standards work has to do with that, but standards by definition would be applicable both to the company's in region network and to other networks where such standards might be employed such as the Atlanta cable TV/telephony at the time work at some point in the future or the Time Warner full service network.

Q. And you've proposed to exclude it all?

A. I have at this point primarily because the standards would be beneficial to both the retail side of the PCS business and the wholesale side, the access interconnect side, and at this point in time none of those benefits are included in this case. There are no PCS access revenues for example in this case.

Q. Is that your standard that there have to be revenues in the test period in order for a project to be included in results of operations?

A. It's not an absolute standard but it's something that I considered. I mean, it's conceivable, for example, that at some point in the future video dial tone revenues might be considered jurisdictional and included for ratemaking purposes, but with that consideration in mind I've observed that the company has decided to exclude video dial tone research costs.

Q. So from the standpoint of your application of your standard, under what circumstances where there are no test period revenues in the case would you nonetheless recommend that the expense be included in results of operations?

A. At the point when it's reasonably certain that the beneficiary is Communications and that the allocation to Communications reflects that relative to charges to other U S WEST corporate entities, and those benefits are reasonably certain in the near rather than distant future.

Q. What's the near future?

A. I don't have an absolute time frame in mind but I guess my thinking is within one or two years.

Q. Is another group of projects that you're proposing for exclusion the compass and advanced communications services from AT?

A. That's correct.

Q. Do you have any reason to think that the services that those projects make possible would be attractive to customers in other states but not in Washington?

A. I think their attractiveness is likely to be comparable amongst states including Washington.

Q. Is cell relay service one of the service that's made possible by these projects?

A. Project 2321 CD, the ACS projects item, refers in Exhibit 396 to asynchronous transfer mode cell relay service.

Q. Do you know or would you accept that U S WEST has a customer for that cell relay service in Minnesota at the remote health care type deployment, and there's also a customer at the university of Oregon in the state of Oregon for the same service?

A. It doesn't surprise me to have you suggest that there are isolated customers interested in cell relay and ATM provision services. Other companies have begun to deploy overlay networks with ATM switching to provision such services.

Q. Would you agree with me that cell relay service is actually a step up in terms of transmission speed and capacity from frame relay service?

A. Yes. It's intended to be an evolution of high speed data services.

JUDGE WALLIS: Mr. Owens, I wonder if we could check in and see in light of the time what your estimate is for cross.

MR. OWENS: I suppose another five minutes or so.

JUDGE WALLIS: Mr. Trotter.

MR. TROTTER: We prefer to redirect him after lunch. We just had three hours of cross.

MR. OWENS: Not quite but close.

JUDGE WALLIS: Very well. Let's continue then.

Q. Another project you propose to exclude is the feasibility analysis project from AT; is that right?

A. Yes.

Q. And was it correct that the regulatory impact review recommended that AT do more rigorous analysis to prioritize its projects?

A. I believe it said something like that with respect to the corporate projects which this is one of. I don't recall the context of the statements.

Q. Would you agree that feasibility analysis is directed toward, in effect, the winnowing projects that it's capable to determine at an early stage are not feasible and then using the resources on those that remain?

A. Well, in a general sense, yes. Again referring to the exhibit attached to my testimony, Exhibit 396, there's reference for this project to supporting global venture multimedia applications, engineering and architecture evaluations, building service prototypes to promote video standard support and the like. So I think it's a little more specific than AT-wide feasibility studies which your question seemed to suggest.

Q. Would assessing feasibility be a reasonable way in prioritizing work?

A. Yes, in a general sense you would engage in that.

Q. Another project you propose to disallow is fixed wireless loop project; is that right?

A. I think so.

Q. Although I don't see it.

A. Could you help me with a reference?

Q. No. 1095 BC.

A. No, you probably need to talk to the staff about that one.

Q. Directing your attention now to your Exhibit 395C, page 80.

A. All right.

Q. Is this one of the projects that you proposed to disallow?
A. Yes.
Q. And what's the basis of the disallowance of this project?
A. If you turn back two pages I have highlighted the information I relied most heavily upon in determining for each project the basis of disallowance by the vertical bars in the right-hand margin, and in this instance I believe I had in mind the introduction of broadband service referenced about five lines deep in the first paragraph before the specific goals for the project are stated.
Q. As far as you know, will broadband services involve the transmission of information over optical or metallic facilities by electromagnetic or similar means?
A. Possibly. When I think of broadband the emphasis in technology is more typically on optical rather than electromechanical transmission.
Q. Electromagnetic or similar means?
A. Okay.
Q. What does electromagnetic mean to you?
A. I'm sorry. Metallic transmission media as opposed to optical.

Q. Did you understand me to say over metallic or optical media?

A. I thought you said similar and I didn't understand what similar meant.

Q. Let me rephrase the question. As far as you know, would broadband involve the transmission of information, number one, over metallic or optical facilities, number two, by electromagnetic or similar means, number three?

A. Yes, if photonic is similar.

MR. OWENS: That's all I have. Thank you. I would offer Exhibit 398.

JUDGE WALLIS: Is there objection? There being no objection 398 is received.

(Admitted Exhibit 398.)

JUDGE WALLIS: Let's take our noon recess and be back at 1:30, please.

(Lunch recess taken at 12:10 p.m.)

AFTERNOON SESSION

1:38 p.m.

JUDGE WALLIS: Let's be back on the record, please, following our noon recess. The company has concluded its cross-examination of Mr. Brosch and we verified that there are no other parties that have cross-examination. Now it's time for commissioner questions.

CHAIRMAN NELSON: Thank you.

EXAMINATION

BY CHAIRMAN NELSON:

Q. Good afternoon.

A. Good afternoon.

Q. I would just like to ask you a question about how you are paid, not what you are paid, but it's interesting TRACER and public counsel cosponsoring a witness. Do they pay you 50/50 or what are the payment arrangements?

A. They are 50/50.

Q. At page 10 of your direct testimony it indicates that you're not going to deal at all with potential affiliate relations that might involve U S WEST C and its affiliates. Can you give me a flavor for how your patrons assigned you which

affiliation. Was there a criterion they used?
A. There was a suggestion on my part that my firm, and I in particular, had familiarity more with some affiliates than others, and there was consideration regarding what could be done within a reasonable budget and we proposed to address certain areas of the case at certain costs and selections were made by the firm's clients on that basis.
Q. When you say costs you mean the costs that are relevant to the ratepayers of U S WEST C?
A. No. The costs of the consulting effort involved.
Q. So some affiliate transactions are less expensive to examine than others?
A. Yes. And some are more familiar than others. Some involve more detailed discovery than others, and all of those entered into the considerations of what we felt like we could do properly within a given budget and scope of work.
Q. Thank you. At page 47 of your direct you at the top 15 lines quote apparently U S WEST spokesman in Investor's Bulletin on the more advanced services that are being deployed outside U S WEST's territory. Can you update me or do you know if the plans to build the broadband network announced in this July 20, 1993

Investor's Bulletin, how progress has been coming on any of that?

A. The information that I have seen is in the press magazines, newspaper accounts, and the most recent that I recall with respect to the Orlando full service network was that the last group of customers had either just been connected or their connection was imminent and that the market trial phase of that project was under way.

As far as the Omaha trials I have not seen any very recent information on that. There was an announced redirection, a change in approach to the network architecture to be employed midstream or thereabouts in that project, and I don't know if that change of technology direction has influenced progress or not.

Q. Very well. Thank you very much. That's all I have.

JUDGE WALLIS: Mr. Trotter.

REDIRECT EXAMINATION

BY MR. TROTTER:

Q. Just couple of items. Mr. Brosch, are you a witness on issues of competition by new entrants in telecommunications markets in Washington?

A. No, I'm not.

Q. You were handed a directory by Mr. Owens covering the Wallingford university and Laurelhurst neighborhoods. Did you recall that?

A. Yes.

Q. And that directory apparently did not have a Bell logo as far as you saw?

A. That's correct.

Q. Is it your understanding that those are three neighborhoods within the city limits of Seattle?

A. Yes, it is.

Q. Would it be fair to assume that these neighborhoods would be covered in the larger Seattle telephone book and Seattle Yellow Pages directories?

A. I believe that's a reasonable assumption, yes.

Q. During the lunch hour, did you have a chance to examine the Yellow Pages directories in the Commission's branch of the state library?

A. Yes, I did.

Q. Did you look at the Seattle Yellow Pages directory?

A. Yes.

Q. Does it bear a Bell logo?

A. Yes, it does.

Q. Did you examine the directory for the greater east side?
A. I did.
Q. Spokane?
A. Yes.
Q. Tacoma?
A. Yes.
Q. Vancouver?
A. Yes.
Q. Did all of those Yellow Pages directories bear the Bell logo?
A. They did.
Q. How many other directories for U S WEST did you find in that library?
A. 19 others.
Q. And did they each bear the Bell logo?
A. They did.
MR. TROTTER: Nothing further.
JUDGE WALLIS: Is there anything further of the witness.
MR. OWENS: Nothing.
JUDGE WALLIS: Very well. Mr. Brosch, thank you very much for appearing today. You're excused from the stand. Mr. Carver will be your next witness.

MR. TROTTER: Yes.

JUDGE WALLIS: Will you step forward, please.

Whereupon,

STEVEN CARVER

having been first duly sworn, was called as a witness herein and was examined and testified as follows:

JUDGE WALLIS: In conjunction with Mr. Carver's appearance his direct testimony is marketed as Exhibit 400 TC. His Exhibit SCC 1 is marked as Exhibit 401 and his cross-rebuttal testimony is marked as Exhibit 402 T for identification.

(Marked ExhibitS 400TC, 401 and 402T.)

DIRECT EXAMINATION

BY MR. TROTTER:

Q. Will you please state your name and spell your last name for the record.

A. Steven C. Carver, C A R V E R.

Q. And by whom are you employed?

A. Utilitech incorporated.

Q. And what's your business address?

A. 740 North Blue Parkway, Suite 204, Lee's Summit, Missouri 64086.

Q. And you're in the same firm as the previous witness, Mr. Brosch?

A. Yes, that's correct.

Q. And were you retained by public counsel and TRACER to present testimony and exhibits in this proceeding?

A. Yes.

Q. Referring you to Exhibit 400T, is that your direct testimony?

A. Yes, it is.

Q. If I asked the questions that appear there, would you give the answers that appear there?

A. Yes, I would.

Q. In the course of that testimony you refer to Exhibit 401 and Exhibit 397 which have previously been admitted through Mr. Brosch; is that right?

A. Yes. That's the joint accounting schedules.

Q. And to the extent of your responsibility in Exhibit 397, is that exhibit true and correct to the best of your knowledge?

A. Yes, it is.

Q. With respect to Exhibit 401, is that a document that you relied on in your testimony?

A. Yes.

Q. With reference to Exhibit 402T, is that your

cross rebuttal testimony?
A. Yes, it is.
Q. And is it true and accurate to the best of your knowledge?
A. Yes.
Q. If I asked you the questions that appear there would you give the answers that appear?
A. Yes, I would.
MR. TROTTER: I would move for admission of Exhibit 400, 401 -- 400T, 401 and 402T.
JUDGE WALLIS: Is there objection?
MR. VAN NOSTRAND: No, Your Honor.
JUDGE WALLIS: Exhibits 400, 401 and 402 as designated are received in evidence.
(Admitted ExhibitS 400TC, 401 and 402T.)
MR. TROTTER: Witness is available for cross.

CROSS-EXAMINATION

BY MR. VAN NOSTRAND:
Q. Thank you. Mr. Carver, I'm James Van Nostrand representing U S WEST Communications in this proceeding.
A. Good afternoon.
Q. With respect to the impact of restructuring

are you aware the company is no longer proposing a proforma adjustment to reflect 1995 levels of expense related to restructuring?
A. Yes, that's my understanding.
Q. And this has the effect of reducing the requested revenue requirement in this case by about $13.7 million; is that correct?
A. Yes, approximately true.
JUDGE WALLIS: Excuse me. Let's be off the record.
(Discussion off the record.)
Q. Instead of this proforma adjustment to reflect 1995 levels the company proposes to calculate rates on the basis of the restructuring expenses actually incurred during the test period. Is that my understanding?
A. Yes, based upon my review of Ms. Wright's transcript.
Q. And you propose an adjustment that would eliminate the test period amount as well; is that correct?
A. Yes, I did.
Q. And this would reduce the revenue requirement by about $20.3 million?
A. Yes, that's true.

Q. And one of the reasons you cite for your adjustment is that because these costs were included in the company's 1994 results of operations, the purposes of the 1994 AFOR plan year, the company's ratepayers will have effectively funded these costs. Is that your testimony?

A. Yes, it is.

Q. Weren't all 1994 operating expenses included in the 1994 sharing calculation?

A. Yes, and the distinction with the restructuring costs concerns the question of their ongoing nature and whether the test year expenditure levels represent ongoing cost levels. It's my opinion that they do not. Other test year expenses have either been adjusted or normalized or eliminated in some fashion to the extent that they are out of period or not appropriately reflected in test year costs for ratemaking purposes.

Q. And is that a distinction which appears on the face of the AFOR orders?

A. Excuse me?

Q. Is that a distinction which appears on the face in the text of the AFOR orders? In other words, that expenses which are found to be nonrecurring and occur during a sharing period they should be excluded from test period results of operations in determining a rate year revenue requirement?

A. I do recall that the AFOR settlement provides for specific adjustments. I don't recall as to whether the language addresses the ongoing nature of the costs. My earlier reference was to the appropriateness of the ratemaking recognition of expenses incurred during the test year and there is -- given the different purposes of the AFOR calculations versus ratemaking treatments of costs in determining overall revenue requirement it's very possible and should be expected that adjustments deemed to be necessary and appropriate for ratemaking are not recognized or adjusted for within an AFOR type calculation.

Q. So it can only be determined later which costs were essentially funded during the 1994 plan calculation. That won't appear from the calculation for the AFOR purposes itself?

A. It's my understanding that the AFOR review and analysis is more limited in scope and purpose than occurs for typical ratemaking and setting permanent prospective rates. As a consequence, I would expect that items would be identified and become known through the rate case audits in terms of what was embedded within that historic period that would not be known or maybe even knowable during the more limited AFOR review period.

Q. If these particular expenses are determined to be recurring in nature, would that alter your analysis as to whether or not they were funded during the 1994 AFOR sharing calculation?

A. I'm sorry. Could you repeat the question?

Q. If these expenses are determined to be recurring in nature, would that change your analysis as to whether or not they were funded under the AFOR calculation?

A. I think it's possible. No, not necessarily because I think it's possible that there may be certain costs embedded within the AFOR calculations that were not adjusted that could be found for ratemaking application purposes to not be recurring in nature. I believe there are two different focuses, two different sets of standards that are applied between those two types of proceedings.

Q. Well, can you make the same argument with respect to every other type of operating expense incurred by the company during 1994 that it was funded under the AFOR?

A. Unless it was eliminated it was funded under the AFOR. However, treatment under the AFOR and funding does not necessarily provide an indicator as to whether that particular cost is appropriately recognized for prospective rate setting purposes.

Q. Would you agree with Ms. Wright's testimony that about 40 percent of the costs identified with the restructuring program relate to system and system-related improvements? Do you recall that from her testimony?

A. No, I do not.

Q. Would you accept subject to check that that's what she testified when she was on the stand last week?

A. Systems related?

Q. Yes.

A. Yes. That appears to be approximately 40 percent or in that ballpark.

Q. And would you agree that about 26 percent of the costs identified with restructuring relate to severance payments and benefits paid to employees who exit the business?

A. I don't have those numbers in front of me.

Q. Would you accept subject to check that that's what Ms. Wright testified last week?

A. Yes.

Q. And if we focus on the work force reduction component of the restructuring adjustment. Is it your testimony that the costs related to work force reduction should be disallowed because they are imprudent?

A. None of my adjustments for restructuring proposes an elimination because the costs were imprudent. Whether it's due to costs related to employee separations or system development or any other category of costs, my recommended disallowance in part is based on whether or not those costs are ongoing in nature and will be continued to be incurred at those same cost levels in the future.

Q. You would agree that the company has had work force reductions before, hasn't it?

A. Yes, but not of this magnitude or focus or purpose.

Q. In looking at Ms. Wright's rebuttal testimony which shows work force reductions of 4,135 employees in 1990, 2,085 employees in 1992, 2,949 employees in 1993, and 3,009 employees in 1994, it's clear the company has established a pattern of work force reductions over the last four years, hasn't it?

MR. TROTTER: I will object to the question. Those figures were not net of additions. I don't believe the proper foundation has been laid for that testimony.

A. I would like to see Ms. Wright's rebuttal testimony.

JUDGE WALLIS: Will the question be revised?

MR. VAN NOSTRAND: Yes.

A. Your question, please?

Q. Doesn't that testimony, which shows the network force of reductions in years 1990, '92, '93 and '94, the estimates for '95 establish a consistent pattern of work force reductions in recent years?

A. In recent years there have been some significant reductions in work force. However, the current restructuring program includes specific reductions anticipated of 8,000 employees U S WEST C-wise as a result of redesigning and reformatting the basic way the company does business. Certainly there have been changes in operations and procedures over the past period as the company evolves and tries to become more efficient and more effective, but in my view the current restructuring program goes far beyond what's been done historically.

Q. And it's simply because of the characterization that it's part of the restructuring program that makes these expenses disallowable as nonrecurring?

A. It's the magnitude of the expenses that are nonrecurring not that it's a different type of program, but it's the program that's driving the cost the company is incurring, and based upon the forecast information the company has supplied, in a very short period of time it expects and forecasts that the costs and resulting savings are going to change dramatically coupled with the existence of the AFOR program leads me to conclude that the costs should not be recognized for ratemaking purposes.

Q. You speak in terms of the magnitude of expenses. Are you saying that the work force reductions for 1994, which are part of the test period results, stand out in their magnitude above the other work force reductions shown on page 10 of Ms. Wright's testimony?

A. You're mixing two different components in your question. One, you're directing my attention to numbers of bodies or FTEs, full-time employees, and in the other you're trying to discuss costs incurred in a specific period. While there is a connection, an indirect connection, between FTE reductions and cost levels, it's not a straight cost per employee type arrangement, so that while there may be comparable numbers of employees being reduced the costs can be significantly different from year to year and program to program. I'm focusing on the costs of the restructuring program.

Q. In looking at Ms. Wright's testimony on page 10 she shows projected work force reductions of 3,500 in 1996 and 2170 in 1997. Do you have any reason to expect the company not to have work force reductions of this magnitude in the future?

A. I do not have reason to believe the company will not achieve these forecast employee reductions, but a significant portion of these employee reductions are attributable or at least I anticipate they're attributable to the restructuring program that we're talking about the costs of, and these employee counts do not track with the level of direct expenses net of savings the company is forecasting to realize or incur on this same forecast period, so the reductions in employee levels, while they're attributable to restructuring are not indicative of the net costs forecasted for restructuring during this same time frame.

Q. You mentioned the savings calculations. When you calculated your adjustment for restructuring you did not adjust the test year results to remove the savings resulting from work force reductions, did you?

A. No, because those savings are ongoing in nature.

Q. So the savings will recur but the expenses will not, is that your testimony?

A. That is my testimony, and that's borne out by company forecast documentation.

Q. As a policy matter do you think your proposed treatment of costs associated with work force reductions in this case which disallows the test year expenses yet includes in test year results the savings associated with the work force reduction discourages a company from ever reducing its work force?

A. No.

Q. Doesn't your proposed ratemaking treatment encourage utilities to continue on a business as usual approach?

A. No, it doesn't. When you look at the company's own forecast projections it's anticipating significant savings resulting from the restructuring program. Those savings allow the company to reduce their costs, to become a more efficient provider and to be more pricing competitive as their markets open up to more and more to competition, assuming that's

the path we're charted for. So I believe there are many incentives for the company to try to be the most efficient it can cost-wise and effective in delivering services the customers want beyond merely whether or not costs are allowed for recovery within the ratemaking process. The savings in the test year pale in comparison to the company's forecast annual savings just a couple of years beyond the test year, so, no, I don't believe that provides a company an incentive to maintain business as usual.
Q. Do you know whether the Commission as a matter of precedent has previously disallowed from rate recovery the cost of severance payments associated with the work force reduction?
A. I don't know.
Q. How about employee retraining costs, has the Commission previously disallowed rate recovery from rate recovery employee retraining costs?
A. I don't know.
Q. How about precedent regarding system costs associated with the utility restructuring?
A. Same answer, I don't know.
Q. Focusing on the systems portion of that cost identified in the restructuring adjustment, have you reviewed Ms. Wright's testimony regarding the

trend in system expenses in recent years on page 11 of her rebuttal testimony?

A. Yes.

Q. And is it your testimony that the company was imprudent when it incurred these system-related costs and system upgrades?

A. No. As I indicated previously, my proposed disallowance is not based upon the prudency but whether or not the total net program costs are ongoing in nature, which they're not.

Q. Doesn't the compilation on page 11 of Ms. Wright's testimony show an annual increase in system costs of about 9 percent per year for the last six years?

A. Yes. Simply focusing on this one component and ignoring cost savings, yes, it does. The focus again is on the restructuring program, its costs and its related savings. That's not reflected on this schedule.

Q. But doesn't this schedule establish that system upgrades to the tune of 9 percent a year are part of the ongoing operations of the company?

A. I don't know whether this is system upgrades or system maintenance or system rework. What I do know is that the restructuring program is changing a lot of those systems and evolving it to a new operational mode.

Q. And it's because of the characterization of this program as a restructuring that makes these system-related expenses subject to disallowances as nonrecurring; is that correct?

A. No. It's the company's characterization of this program as a significant change in its operation, its format, the basic way it does its business, and the fact that on a net basis the what appear to be net costs in the 1994 time frame decrease dramatically into net savings a couple of years later. It's the net costs that I'm focusing on and looking at whether or not the test year cost levels reasonably represent ongoing levels for the company.

Q. Would you agree that additional expenditures and system upgrades are necessary in order to obtain or improve productivity in the face of a declining number of employees?

A. I'm sorry. Repeat your question.

Q. Would you agree that additional expenditures and system upgrades are necessary to obtain or improve employee productivity in the face of declining numbers of employees?

A. Yes. I would expect that continuing

expenditures will be necessary. However, those continuing expenditures will be offset by reductions in other costs that are related to that improvement in employee productivity.

Q. Would you agree that by failing to make any allowance for restructuring costs in the revenue requirement in this case the entire risk of whether or not those savings occur fall on the shareholder?

A. No.

Q. With respect to the treatment of these restructuring costs in the other jurisdictions in which USWC operates, are you aware of any situations where these costs were disallowed from rate recovery?

A. No, I'm not. I am not aware of any rate proceedings which have been resolved by final Commission order which have a test year that included any significant restructuring costs. The most recent Arizona case a minor amount of restructuring costs, if any, would have been related to the test year in that case. In fact I don't think any probably would have been.

Q. Isn't it true that in a recent order of a Utah Commission allowed recovery but amortized it over a five year period?

A. I haven't read the Utah order. I don't know what their considerations were, and to what credence the Commission gave the company's forecasted cost savings and whether those savings that were going to be similarly deferred and amortized for ratemaking purposes to the benefit of the ratepayer. In my opinion if you don't symmetrically treat costs and cost savings it provides only a one-sided imbalance mechanism with respect to allowing costs recovery for the company but not recognizing for ratepayers that there are savings that may not be captured within a particular test period that that very program will generate.

Q. And you would say that your proposal does not suffer from this same imbalance even though it captures the savings and disallows the expenses?

A. No, I do not. The 1994 costs were recognized within the AFOR calculation for '94 for which there was no sharing, and in '95, '96 and '97 the level of forecasted restructuring costs and cost savings changed dramatically. So, no, I don't agree.

Q. In the same treatment you propose for work force reductions extends to the OPEB curtailment loss; is that correct?

A. Yes, they're related.

Q. In other words the company is not allowed to recovery the OPEB curtailment loss associated with the 1994 work force reductions?

A. For the same reasons, yes.

Q. Is your testimony that the company did not actually incur a curtailment loss in 1994 under FAS 106?

A. No, that's not my testimony at all.

Q. The OPEB curtailment loss assumed that 2200 employees would be separated in 1994; is that correct?

A. Yes. That's in my testimony.

Q. And under FAS 106 as applied to this work force reduction the company was required to recognize an expense immediately certain costs related to employees separated during 1994?

A. Yes.

Q. And that was $7.7 million booked in 1994?

A. In '94 or the test year?

Q. '94. Can you accept that subject to check, $7 million booked in 1994?

A. Yes.

Q. Thank you. And the ratepayers will benefit in the future from these reduced expenses caused by the work force reductions; is that correct?

A. Yes, to the extent that those work force reductions are reflected in future rate cases. To the extent that the company realizes savings that are not captured in rate cases or occur between rate proceedings, those savings will be retained by the company in the absence of an AFOR sharing plan.

Q. And one of the reasons you give for excluding the curtailment loss is that this is a one time event for that particular group of employees; is that correct?

A. Yes.

Q. And it's your testimony that an event cannot be recurring for the sole reason that it is one time as to some employees?

A. No. The primary reason for recommending disallowance of the OPEB curtailment loss is that those costs are related to and driven by the restructuring program and employee reductions caused by that program in 1994 or the test year as is the focus of this case. But my testimony on the curtailment loss goes on to state that it is one time with regard to those particular employees.

Q. Doesn't the classification as recurring or nonrecurring depend upon whether the expense will occur again and does not focus on the impact on a particular group of employees?

A. Yes, I agree with that.

Q. And that's your understanding of the concept of recurring as it's applied in ratemaking?

A. Let me explain. The company has revenues that it records as non -- it identifies as nonrecurring revenues but there is a level of revenues that although they're called nonrecurring are recurring in nature, and the question becomes whether those revenues or in the case of expenses whether those expenses are expected to be recurring on an ongoing basis. And as I said before while my testimony on the curtailment loss identifies those specific dollars as being nonrecurring for those particular employees, the primary reason I propose to eliminate the test year OPEB curtailment loss is that it's coupled with the restructuring program.

Q. I'm trying to understand your testimony on page 38, lines 5 to 6. You say, "the recognition of a curtailment loss is a one time event for that particular group of separated employees." Which seems to suggest that it is disallowed for that reason alone. That doesn't seem to be what your testimony is now. Could you --

A. What page are you referring to?

Q. Page 38, lines 5 to 6. You say that the curtailment loss is improper for ratemaking purposes because it is a one time event for that particular group of separated employees. Is that your testimony?

A. Yes, that is my testimony, and if you refer to line 5 of page 38 the paragraph starts with the word "third." If you turn to the prior page on line 11 that paragraph starts with the word "second," and on -- so that's two of the three reasons I provide and discuss for disallowing the OPEB curtailment loss. Beginning at line 5 of page 37 is my primary reason, which couples this adjustment with the restructuring program. So, no, I haven't changed my testimony. I've indicated that this OPEB curtailment loss during the test year is a one time event for those particular employees or former employees.

Q. I understand as to your prior two points. My point is would this reason standing alone be justification for disallowing the OPEB curtailment loss, that it is a one time event for this particular group of employees?

A. Standing alone?

Q. Standing alone.

A. Standing alone if the following year and the year after that the company was not anticipating having OPEB curtailment loss then I would say it is nonrecurring and should be adjusted, standing alone.

If standing alone the company anticipated ongoing losses of that same magnitude for the next several years then I would say while it's nonrecurring for that group of employees it's going to be recurring on a near term basis and should be allowed, much like my earlier analogy to the treatment afforded nonrecurring revenues which are in fact recurring at some level on an annual basis.

Q. Focusing on the portion of your testimony that discusses the test year and ratemaking theory.

MR. TROTTER: Could we have a reference?

MR. VAN NOSTRAND: Beginning on page 14.

Q. Do you recall the following testimony from testimony you gave before the Arizona Corporation Commission on this issue? You stated as follows, "in order for a test year to provide reasonable results it is critical that the various components of a rate base, revenues and expense be as internally consistent as possible. While certain deviations from the test year periods selected may be unavoidable those deviations should be minimized to the extent possible."

A. Yes, I recall that.

Q. And the test period in this proceeding is the 12 months ended October 1994; is that correct?

A. Yes, this rate case proceeding. That proceeding was not.

Q. Right. And you would agree that it is important that rate base, revenues, expenses and rate of return be properly synchronized in order for the ratemaking equation to function properly?

A. Yes. I believe that's consistent with my testimony here.

Q. In other words it's important that the integrity of the test year be maintained through synchronizing revenues, expenses and investment?

A. Yes, as best as possible.

Q. And if these components are not properly synchronized a consequence may be that a utility would not have the opportunity to earn its allowed return; is that correct?

A. Yes. Or it may have the opportunity to over earn.

Q. And in considering whether the adjustments you propose reserve the integrity of the test year, it's true, isn't it, that you adjust employee levels to reflect the numbers as of the end of the year 1994?

A. Calendar year end 1994, that's correct.

Q. And calendar year end 1994 is outside of the test period in this proceeding; is that correct?

A. Yes, it is, as are the wage rate increases the company proposes to reach into 1995 for.

Q. And you propose to disallow those; is that correct?

A. Yes. I propose to synchronize wage rates and employee levels at year end 1994.

Q. And in comparing whether another adjustment of yours preserves the integrity of the test year, it's true that you propose a revenue adjustment that looks at price level and quantity of the end of 1994; is that correct?

A. I don't propose that adjustment. It's proposed by Mr. Brosch, but, yes, it also looks at year end 1994.

Q. Which is beyond the end of the test year in October 1994, correct?

A. Yes, it is with the same qualifier earlier.

Q. And these adjustments for revenue growth and the updating of employee count both have the effect of decreasing the revenue requirement?

A. In this case they do, yes.

Q. And you propose in the adjustments relying on out of test period data which would increase the revenue requirement?

A. There are a couple of company proforma adjustments that we did not propose to eliminate. Except for those proforma adjustments I am not aware of any others that go beyond year end 1994.

Q. And is your adjustment of wage and salary to reflect year end 1994 employee levels presume that those employee numbers are more reflective of ongoing conditions?

A. Yes.

Q. And would your recommendation be different if more recent information shows that monthly equivalent head counts has grown since December 1994?

A. Yes. If the equivalent head counts were prepared properly I would agree with that.

Q. And have you reviewed the response to bench request or public counsel data request No. 01921 which is now 324?

A. What's that again.

Q. Exhibit 324 which is response to public counsel data request 01-921.

A. Yes, I have reviewed that response.

Q. Doesn't that show the decline in employee head count is not continued at least during the December 1994 through December 1995 time period?

A. That exhibit shows that using a weighted payroll allocation method for determining equivalent head counts that head counts do increase during 1995. However, it's my opinion that use of employee -- let me back up. It's my opinion that use of employee salaries and wages to develop and allocate head counts is incorrect. What should be done is employee positions should be allocated based upon the allocation factor so that you remove salary and wage dollars from the equation. For example, if a full-time employee is located in Colorado, has 25 percent of their time attributable to work performed on behalf of U S WEST Washington operations, then 25 percent of that employee position should be allocated to Washington. It's my belief that use of wages and salaries does not achieve that goal and that the month to month fluctuations in wages and salaries can result in unintended changes in employee counts attributable to a given state that aren't reflective of true equivalent employees.

I have attempted to get equivalent employee information relative to the state of Arizona and have been unable to get that information because of the complexity of trying to develop the employee specific allocation of head counts, and that is something that the company was in agreement with me on in regard to the Arizona operations. So when I see these numbers, I

see what's happening but I cannot conclude that is representative of what is the equivalent employee trend is for the state of Washington.
Q. So you would deny that the monthly equivalent head count calculation shown on the last page of Exhibit 324, when that increases from 7287 in December '94 to 7699 in September '95, you would deny that that reflects any increase in actual monthly equivalent head count in Washington?
A. For the state of Washington that's true. I believe that the number is inappropriately calculated and if it agrees with the employee specific allocation I just described I would be extremely surprised.
Q. I would like to look for a moment on the revenue adjustment which I understand was described in more detail by Mr. Brosch but you nonetheless describe it as part of your adjustments which are necessary to properly synchronize and balance the test period?
A. Can you give me a testimony reference, please?
Q. Yes, page 24. Now, as I understand your testimony the adjustment would reflect the revenue growth through December of 1994 associated with increases in the number of access lines; is that right.
MR. TROTTER: Excuse me, Your Honor. I

think we may have the wrong witness. This adjustment is specifically sponsored by Mr. Brosch and he was examined on it extensively.
MR. VAN NOSTRAND: I understand. I understand the calculation was performed by Mr. Brosch. I wish to explore with Mr. Carver the propriety of out of test period adjustments and selective out of period adjustments.
MR. TROTTER: I didn't catch the last part. I would also object because the question assumes a December figure was used and it was clear that fourth quarter was used, but I thought it was pretty clear from the testimony who was sponsoring RSA 3.
JUDGE WALLIS: Do you want to rephrase the question?
Q. Yes. I would like to clarify that the adjustment which you're discussing on page 24 of your testimony reflects the revenue growth which occurred from October through December of 1994?
A. To clarify, I believe that what you're referring to is a sentence on page 24, line 4 of my direct testimony which says, "similarly, annualizing for rate reduction revenue impacts, for example, RSA No. 3, while ignoring revenue growth associated with access line gains, is also distortive of revenue

requirements and not reflective of ongoing conditions." Mr. Brosch sponsors an adjustment identified as Schedule C1 in Exhibit 397 and 397C which, as I understand it, annualizes certain components of local recurring revenues based upon a fourth quarter '94 times four methodology. That actual adjustment -- I'm sorry. The annualized level is compared to test year actuals to derive that adjustment. While I don't discuss that adjustment within the text of my testimony, the point I'm making is that in the company's case they propose a rate reduction revenue impact adjustment but fail to recognize that revenues also grow within the test year and offset that revenue reduction. That's the point of my testimony.

Q.   And in the case of local service revenues the adjustment is to look at the period outside the test period, October through December 1994, and make an adjustment which reflects that increase in quantity; is that correct?

A.   Yes. It looks at increase in quantity, as I understand it, and that use of fourth quarter of '94 in my opinion is consistent with my proposal to annualize both employee wages and head counts at year end '94 levels.

Q. Now, did the rate reduction which the company adjusted for also relate to toll rates as well?

A. I don't recall. You would have to ask that question of Mr. Brosch.

Q. In reflecting the impact of out of period rate reductions in revenue requirement calculations, has the Commission historically looked at the growth in quantity or the increase in volume as an offset?

A. It's my understanding that the Commission historically has looked at average test year volumes. However, in a prior Commission decision in U S WEST's last rate case the Commission did make a productivity adjustment that I address in my testimony.

Q. If you can turn next to your testimony on the sharing restatement adjustment beginning on page 49. Your testimony indicates that the concern about a tax code violation related to tax treatment of the sharing calculation may be moot and that any violation would have already occurred by failing to recognize the debit in the 1991 through 1994 sharing calculation. Is that your testimony?

A. Yes. Can you give me a page reference?

Q. Page 49 lines 4 through 7?

A. Yes, I recall that.

Q. Is it your testimony that these sharing calculations constitute final rate determinations for purposes of the tax code?

A. Yes. I believe it can be construed that way, and let me explain why. If it were not capable of being construed in that fashion then the following situation could arise. The Commission could, it would seem to me, set permanent rates recognizing full normalization as required under code section 167L, but then on an annual basis revisit the company's achieved earnings and actually quantify the impact of flowing through accelerated depreciation to ratepayers, and if the Commission were to implement an annual refund to ratepayers much like could occur in an AFOR type sharing calculation it seems to me that the IRS would look on that action with disfavor and contend that a regulatory body were attempting to circumvent the normalization requirements of the tax code. So, yes, I think it's possible that it could be construed in that fashion.

Q. And if the sharing calculations are not final rate determinations, isn't the door still open for the company to correct the calculation as it is proposing to do in this case?

A. The company is only proposing to correct that calculation on a prospective basis. There's no look back or recapture or attempt to make things right in the past four years. Once the code is violated it's been violated.

Q. Is it your understanding that the sharing calculations involve a full cost of service revenue requirement analysis?

A. As I indicated previously it does not -- its basis is not the same degree of detailed inquiry and review as a rate proceeding. It's more of a streamlined process, but nevertheless if the Commission were to flow through accelerated depreciation benefits to ratepayers I think the company would have severe problems with the IRS.

Q. You state on page 44, line 17 that based on your review of the Commission sharing orders you could not identify any reference or any indication that any party expressed any intent that the excess revenues credited to the depreciation reserve would be offset by deferred income tax reserves in future rate proceedings. Was there any reference in the sharing order that specifically stated that the company should not record deferred taxes associated with depreciation?

A. No, there was not explicit language to that effect. The Commission did spell out in its order the depreciation reserve accounts that the amounts should be credited to. I believe that if the Commission had intended to address deferred taxes it probably would have addressed that as well. Subsequent to writing this section of my testimony I spent some time with file documents in the AFOR sharing docket and identified some staff comments I believe in the June 1991 period in which the staff laid out a simplified example of why they thought dealings with the sharing credits in this fashion was a good thing for the company's ratepayers, and those calculations, while simplified, did not reflect any credit for accumulated deferred income tax reserve offsets. So I believe the staff, and I believe my client, maybe the Commission, anticipated that when the orders said for example $10 million would be credited to rate base to benefit ratepayers through reduced carrying costs, I think the expectation was that $10 million would be reduced from rate base.

Q. At least as indicated in the staff memorandum to which you referred?

A. Yes. And that's the only information that I've been able to locate. The company has been unable to provide any that would make me think otherwise.

MR. VAN NOSTRAND: I have no further questions, Your Honor.

JUDGE WALLIS: Other cross-examination? Commissioner questions.

CHAIRMAN NELSON: No.

COMMISSIONER HEMSTAD: I have none.

COMMISSIONER GILLIS: No.

JUDGE WALLIS: Mr. Carver, does the company or did it during the test period have unamortized investment tax credit on its books?

THE WITNESS: Yes.

JUDGE WALLIS: How is U S WEST's investment tax credit treated for ratemaking purposes?

THE WITNESS: I believe that the company has an -- is an option two company which means that the previously generated and utilized investment tax credits are amortized rateably as a credit to cost of service as a reduction to income tax expense.

JUDGE WALLIS: Are there federal income tax regulations regarding ITC and interest synchronization?

THE WITNESS: Yes. In code section 46F deals largely with interest synchronization. Back in the late 1970s and early 1980s I filed testimony in Missouri in a series of rate cases addressing the issue of interest synchronization and the industry's allegations that that methodology violated section 46F of the tax code.

In or about '82 or '83 after a series of state Commission decisions concluding that it did not violate the code and a series of FERC decisions that felt it did not violate the code using that methodology I believe it was a DC circuit decision that also indicated that it wasn't a problem with the code.

Subsequently the treasury came out with -- I don't want to call them regulations. Maybe they were regulations -- that said the use of interest synchronization in this method or the accumulated investment tax credits were essentially earning the overall rate of return, which is net of tax, does not violate the normalization requirements.

Since about 1983, I have not found it necessary to address that issue in detail in rate proceedings.

JUDGE WALLIS: Thank you very much. Mr. Trotter?

MR. TROTTER: No redirect.

JUDGE WALLIS: Anything further of the witness? It appears not. Mr. Carver, thank you for appearing today. You may be excused from the stand. Let's be off the record for a moment.

(Recess.)

JUDGE WALLIS: Let's be back on the record, please. The office of public counsel has called Steven G. Hill to the stand at this time.

Whereupon,

STEVEN HILL, PhD,

having been first duly sworn, was called as a witness herein and was examined and testified as follows:

JUDGE WALLIS: In conjunction with Mr. Hill's appearance today we have marked for identification his direct testimony as 405T for identification; an errata sheet as Exhibit 406 for identification; document SGH-1, his resume, is 407 for identification. SGH-2 cost of equity schedule is 408 for identification. SGH-3, DCF growth rate is 409 for identification. SGH-4, price earnings -- ratio 410 for identification. SGH-5 market to book ratio is 411 for identification. SGH-6 capital asset pricing model is 412 for identification. His rebuttal testimony is 413T for identification. And the company is proposing to introduce through his testimony Exhibit 414 for identification which is responses to data requests 12, 16, 57 and 66.

(Marked Exhibits 405T, 406, 407, 408, 409, 410, 411, 412, 413T and 414.)

DIRECT EXAMINATION

BY MR. CUNNINGHAM:

Q. Would you please state your name and business address for the record?

A. My name is Steven G. Hill, H I L L. My business address is P.O. Box 487, 4000 Benedict Road, Hurricane, West Virginia, 25526.

Q. Were you engaged as a consultant by the office of public counsel of the office of the attorney general to study the costs of capital in this proceeding?

A. Yes, I was.

Q. Do you have before you what's been marked for identification as Exhibit 405T and 406?

A. Yes, I do.

Q. 406 is an errata sheet, is it not, relating to your testimony?

A. Yes.

Q. If those changes reflected in Exhibit 406 were made to Exhibit 405T, would then 405T constitute your testimony in this proceeding?

A. Yes, it would. The answers would be the same. The only exception would be that I would note for the record that my equity return of recommendation is within a range of 11 to 11.5. I use 11.25 as the indicator or the midpoint of that range. I would note that this testimony is filed in August and capital costs have fallen since then so I would encourage the Commission to pay some attention to the lower end of that range at this time. With that change that would complete my testimony.

Q. Do you have before you what has been marked for identification as Exhibits 407 through 412?

A. Yes, I do.

Q. And are those exhibits to which you refer in your direct testimony?

A. Yes, they are. They amount to appendices which further define my direct testimony.

Q. Were those prepared by you or under your supervision?

A. They were all prepared by me.

Q. Are they true and correct to the best of your knowledge and belief?

A. Yes, sir.

Q. Do you have before you what's been marked for identification as Exhibit 413T?

A. Yes, I do.

Q. Does that constitute your rebuttal testimony in this proceeding?

A. Yes.

Q. If I were to ask you the questions contained in Exhibit 413T would your answers be as indicated?
A. Yes.
Q. Thank you.
MR. CUNNINGHAM: Thank you, Your Honor. The witness is tendered for cross-examination. I would offer Exhibits 405T through 413T.
MR. VAN NOSTRAND: No objection.
JUDGE WALLIS: There being no objection the exhibits are received.
(Admitted Exhibits 405T, 406, 407, 408, 409, 410, 411, 412 and 413T.)

CROSS-EXAMINATION

BY MR. VAN NOSTRAND:
Q. Good affternoon, Mr. Hill.
A. Good afternoon.
Q. I'm James Van Nostrand representing U S WEST Communications. Starting off with your recommendations regarding capital structure you recommend a 52 percent equity ratio as compared to the 56.6 percent equity ratio recommended by the company's witness Mr. Cummings; is that correct?
A. That's correct.

Q. And you agree that the 56.6 equity ratio proposed by Mr. Cummings represents the actual capital structure for regulatory reporting purposes?

A. Yes. It's a very different capital structure than he initially reported, but that is according to his testimony the actual capital structure I believe at June 30, 1995.

Q. And the effect of your recommendation is to substitute a lower cost debt for equity into the company's capital structure; is that correct?

A. My recommendation is to set rates for this company using a more cost-effective capital structure, one that is both safe and economical, yes.

Q. But the practical effect is to substitute the difference between 56.6 and 52 and treat that as if it were financed by debt rather than equity?

A. I think that's the arithmetic effect of it. I don't believe that fully describes the rationale or the rate rationale for it, let me say it that way.

Q. If we were to try to translate that into the impact on the revenue requirement, would you agree that it has the effect of reducing the revenue requirement by about $2.6 million? And I calculated that by looking at the increment of 3.5 percent, the difference between 11.25 percent that you recommend for the equity return and the 7.75 percent incremental debt rate? This is just for purposes of simplicity. Ignoring the tax effects and using a rate base of $1.6 billion and the 4.6 difference between 56.6 and 52? Would you accept subject to check that that's to a revenue requirement impact of about $2.6 million?

A. That's an after tax revenue requirement that did not adjust for tax effects?

Q. That's correct.

A. I will accept that subject to check. I would like to run through those numbers if I could. Can you give them to me again so I will have something to check.

Q. The 4.6 difference is just 56.6 minus 52. Assumed a rate base of $1.6 billion and comparing your recommended equity return of 11.25 to your new debt, your marginal cost debt rate of 7.75 percent.

A. The marginal cost debt rate?

Q. The rate for new debt that you calculated.

A. I can check that. And your figure is?

Q. Around 2.6 million.

Would you agree that your recommendation amounts to a disallowance of the company's actual capital costs?

A. I suppose you could characterize it that way. I prefer to look at it as making a ratemaking capital structure which more equitably balances financial strength and economics for the ratepayer.

Q. And if we could turn for a moment to the responses to data requests which have been marked as Exhibit 414. Your response to company data request No. 66 indicates that you are not testifying as to the prudence or imprudence of the company's capitalization; is that correct?

A. Yes. I haven't testified about prudence. That word doesn't appear in my testimony. My review of the Commission's past orders over the past 20 or 30 years in telephone cases is that I'm not aware of an instance where the Commission determined prudence. Their criteria were safety and economy, and those are the yardsticks I use to determine a ratemaking capital structure.

Q. Taking your testimony together it's true, isn't it, that you are proposing a disallowance of about $2.6 million without offering any testimony to suggest that the company's actions were imprudent?

A. A disallowance is your term. I just testified that I don't use the term imprudence. I don't believe that it's necessary. The Commission has often used a capital structure that's different than the actual booked capital structure for rate setting purposes.

Q. Suppose the company's actual equity ratio was 55 percent, and you were recommending 53 percent. Would you still recommend that the Commission substitute your capital structure for the actual capital structure?

A. If my analysis showed that the capital structure I recommended was both safe and economical it would be reasonable, in my view, to use the lower equity ratio.

Q. Is there some point at which your recommendation and the company's actual capital structure are close enough that you would not propose an adjustment?

A. Practically speaking, that's probably true. I don't have a number in mind at which that would occur. If the company were asking, for example, for 53 percent equity I might not suggest that the Commission go with 52. That's pretty close. But I don't know. I would have to look at the circumstances. In that situation I also might go to the bottom of the equity return range and make some other sort of adjustment, but practically speaking I think that would be true that there would be some range within which I would not make such an adjustment.

Q. Would you agree that the Commission has expressed a preference for using an actual capital structure versus a hypothetical capital structure?

A. That's my preference too. I would in most situations would rather use an actual capital structure than a hypothetical capital structure. Incorporates generally should be based on costs, and I think that's a pretty standard paradigm in ratemaking. However, if there is a mismatch between risk and return or the rate impact on ratepayers and the financial risk of a particular capital structure I believe that should be addressed. In situations in which the situation was reversed, where a company, for example, doesn't center enough equity I've recommended a higher equity ratio than the company actually has.

We spoke a moment ago. I'm going to Phoenix tomorrow to testify in a Tucson Electric Power case. Company has zero equity in the books. They have had some tremendous write-offs over the past few years and almost went bankrupt a couple of times. I'm recommending a 40 percent equity ratio in that case. There's some other subsequent adjustments I recommend to duplicate market pressure on the company, so it

works both ways. That's my point. I'm not in the business of just making downward adjustments to equity ratios. It works both ways.
Q. If you could turn to your response to data request 12 which is also included in the packet marked as Exhibit 414. Your response indicates, doesn't it that because U S WEST Washington operations are only about 12 percent of USWC's total operations you can effectively substitute a cheaper capital structure and have a relatively small impact?
A. Well, that's one part of a data request which responds to your question would a hypothetical capital structure containing 52 percent equity directly impact U S WEST Communications double A minus bond rating. That's one of the rationales I provide why it's likely that that would not be the case. There are other rationales provided.
Q. Well, you do make the statement that because Washington's operations are only 12 percent it would have a relatively small impact?
A. I think that's true, yes.
Q. And in a second paragraph of that response don't you also say that U S WEST need not necessarily issue debt in the market, that all you have to do is reallocate debt capital to Washington?

A. Yes. That can certainly happen. I believe Mr. Cummings's debt cost rate in his updated testimony is 6.84 percent which is higher than his original testimony, interestingly, but that's nearly a full 100 basis points below the marginal debt cost rate that I used, so the company actually -- the actual debt cost rate is below what I recommend in my testimony.

Q. But following the analysis that you don't really issue debt, you just reallocate debt capital, is it your testimony that Oregon or Wyoming ratepayers should pay for a more expensive capital structure so that Washington ratepayers can pay for a cheaper capital structure?

A. No, that's not my testimony, not my recommendation. The problem that I have that's sort of embodied in this question is that I have difficulty with what I call the tail wags the dog theory of regulation where the company says we have a bond rating we want to protect, what kind of coverage ratio can we generate from that. In this situation if we wanted to insure that U S WEST Communications maintained a double A bond rating we would have to go up to a coverage level of above 5.5 which would generate -- if you work backward through Mr. Cummings's recommended capital structure would generate a rate of return of 16 percent. Well, the obvious problem with that is that's not the cost of capital, not even close, and yet working backwards from the coverage ratio to the return on equity that's the kind of results you would get, and I have a problem with that sort of view of I think backwards view of regulation.

Q. If we follow the approach recommended in the second paragraph of your response to data request 12 and simply reallocate debt capital to Washington, isn't the effect of your adjustment to replace debt with equity in the other 13 jurisdictions in which U S WEST Communications operates?

A. No. That was not the intent of that paragraph. All I'm saying there is that I have, in determining my ratemaking debt cost, I have tried to account for that shift in debt cost by assuming that the company issues new debt to manufacture that shift. In actuality the company wouldn't have to do that but could reallocate debt and have a lower embedded debt cost than what I show. I'm not saying that one jurisdiction should subsidize another. It's my view that U S WEST Communications should be more highly leveraged, period, in all regulatory jurisdictions, not just this one.

Q. I would like to turn to the portion of your testimony where you refer to gas distribution companies as having similar risks to telephone companies.
A. What page are we on?
Q. I believe page 48 contains where you first begin to talk about reference to returns required by gas distributors.
A. I'm there.
Q. According to your testimony gas utilities face operational risks similar to telephone utilities; is that correct?
A. That's correct.
Q. And you developed a list of comparable gas distributors comprising 11 companies as market based indicators of capital costs for gas distributors; is that right?
A. Yes. And in answer to your previous question I said they were similar but I also say at the very top of page 48 "while gas distribution companies are generally considered to carry less investment risk than telephone utilities." That's my first sentence. I recognized that right off the bat. So my recommendation in this case brackets a cost of equity between gas distributors and telephone

companies, and also one of the data requests that you had in the packet that's identified as Exhibit 414, No. 57, is incomplete. It doesn't contain the attachment from Standard and Poor's, one sentence of which is, "Gas utilities which operate in a much more competitive market than electric or even telephone utilities are assessed with regard to competitive standing in the three major areas of demand residential, commercial, industrial, as well as components of the industrial classification."

My point by mentioning that is that there are indications that gas distributors have operational risks which is similar to and Standard and Poor's point out in some cases greater than telephone utilities.

Q.   And in terms of the relative risk involved, your DCF cost of equity capital for the gas distributors shows an average of 10.97 percent; is that correct?

A.   That's the DCF number, yes. All the other corroborative figures are lower so my estimate for gas distributors is about 10.75.

Q.   And this compares to the 11.78 percent which you computed as the DCF cost of equity capital for your comparable telephone companies?

A.   Right. And my estimate I believe for the telephone companies, the RBOCs, in August was 11.5 to 12, cost of equity estimate.

Q. And what weighting did you apply in comparing the results suggested for the gas distributors versus the results for the telephone company group in reaching your equity return recommendation for U S WEST Communications in this case?

A. No weighting. The range that I determined was reasonable was in between the two. As I discussed in my testimony, U S WEST Communications has lower risk than U S WEST because of U S WEST's unregulated operations, their investment in Time Warner, cable companies, et cetera, global communications. U S WEST Communications is largely still regulated operations, have lower operating risk. Some of the rating agency publications that the company provided in data responses confirmed that. So a proper cost of equity for U S WEST Communications would be lower than that for the RBOCs. So that's one measure, the RBOCs. I used gas distributors as something to tie down the low end of the range. My range for gas distributors was 10.5 to 11. My range for RBOCs was 11 and a half to 12. The midpoint of that difference is 11.25 but I didn't do a specific weighting of one or the other.

However, my recommendation was in the middle, and as I noted at the outset of my testimony here that that was in August and I believe capital costs are probably lower than that now and would recommend the Commission pay more attention to the lower end of the range.

Q. If we look at the 10.97 percent return shown for gas distributors on page 2 of your schedule 9 and compare that to the 11.78 for the telephone companies on page 1 of schedule 9, it's fair to say that inclusion of gas distribution companies in your analysis tends to reduce the suggested required return, isn't it?

A. Well, you could say that. You could characterize it that way, but I would, even if I didn't do a gas distributor analysis I would not recommend that the company's cost of capital be within the range established by the RBOCs. I think it's pretty clear that the regulated operations of USWC don't have the same kind of risk as U S WEST does with its entertainment investments, and all of the other companies had similar kinds of unregulated overseas investments as well as in this country. So the cost of equity should be below that determined for the RBOCs. I simply use the gas distributors to give me an anchor somewhere down below. How far below should

it be. I would say that the cost of equity for USWC is higher than a gas distributor. It's higher than electric and certainly higher than a water company so I think of those three gas distributors are probably the riskiest of electric, water or gas, so I basically picked that as a low end of the ballpark.
Q. You also testify in rate proceedings involving gas distribution companies?
A. Yes, I do.
Q. And in fact you testified before this Commission in Washington Natural Gas Company's last rate proceeding; is that correct?
A. That's correct.
Q. In reaching your recommendation of a 10.5 percent equity return for Washington Natural Gas Company in the 1992 rate proceeding, did you develop a list of telephone companies that you considered as having operational risks similar to gas distributors?
A. No, I didn't. It wasn't necessary. The companies that I picked for a similar sample group were similar in very many ways to Washington Natural Gas, and it's a very different situation than in the instant case. Here we're faced with trying to assess the equity capital costs of an entity that does not have a market traded equity and therefore we have to

use, in my view, it's necessary to use two groups of companies, one which is riskier, one which is less riskier, to find a range of returns which is reasonable for USWC.

Q. When you testify around the country in rate proceedings involving other gas distribution companies, do you typically develop a list of probable telephone companies which you take into account in developing your equity return recommendation?

A. No, sir, I don't. It's not necessary to do that.

Q. According to your testimony here the two industries have similar operating risks; is that correct?

A. Yes, but as I said, I began my discussion of similar operating risks by saying generally gas distributors are less risky.

Q. So if you use gas distributors to establish the low end of the range for a telephone company case, why wouldn't it be appropriate in analyzing the equity return for gas distribution companies to look at the required return for comparable telephone companies?

A. Because you can find the sample of gas distribution companies that have similar operating risks and within that range of returns described by that sample you can select a range of return for the applicant utility that's under analysis. That's not something you can do with a local exchange telephone operating company. USWC doesn't have traded equity capital. The RBOCs which are the nearest telecommunications operation that does have similar risk, they do have traded equity. But costs of equity capital for a local exchange telecommunications company is below that of the RBOCs, so that's a dilemma. And in order to try to better locate a reasonable cost of equity I used gas utilities which I believe are the energy companies, and the water companies, are the highest risk.

Q. If you did include analysis of comparable telephone companies in your testimony in proceedings involving gas distribution companies wouldn't it tend to increase your recommended equity return?

A. If I relied on the number and averaged them in some way, arithmetically that would be the result but that's not something I would do. As I said it's unnecessary.

Q. And your testimony does acknowledge that gas distribution utilities have a somewhat less risk than telephone utilities; is that correct?

A. I've had that a couple of times.

Q. If you look at the beta coefficient of the two industries gas distribution companies appear to be less risky than telephone companies?

A. Gas. Interestingly, gas distribution company betas are extremely low. They are below, as a matter of fact, electric companies and water companies. But what that underscores to me is that beta alone is not a very reliable measure of the risk. To directly answer your question, they are substantially below the betas of telephone utility companies.

Q. And in fact the figure is .55 for gas distribution companies and .76 for telephone companies?

A. That's correct, and I would note parenthetically that the beta for telephone companies used to be around .9, so once again according to the magical beta coefficient telephone companies, the RBOCs are becoming less risky, which I think is not the case.

Q. Less risky but still more risky than suggested by a .55 beta for gas distribution companies?

A. Yes. If beta -- if you believed in beta and that was all you used then that's what you would have to say, yes.

Q. Do you believe in beta to the extent you cited in your own exhibit schedule 13, don't you?

A. Yes. I don't want to get into a discussion of religion here, but I do utilize beta because I think the CAPM is a model that's widely discussed in the financial literature, but I think it's got some serious problems when it's applied to cost of capital analysis. There are lots of questions about it that are unanswered, so I use it. I've always used it but I don't place much weight on the result. Certainly wouldn't weight it equally with the DCF.

Q. Would you agree your testimony on the Standard and Poor's bond rating benchmarks, which you include on page 26, that the ranges you discuss also show that telephone companies are viewed as more risky than gas distribution companies?

A. Yes.

Q. Your testimony acknowledges that gas distributors have faced bypass problems similar to those faced by telephone companies; is that correct?

A. That's correct.

Q. Have you done any sort of analysis to compare the potential erosion in customer base due to bypass in the natural gas distribution industry versus the local exchange carriers?

A. I have not. My experience with gas distributors, especially in the east, is that bypass is an actively serious concern for the operating risk for those companies. There are so many trans-continental pipelines that go through, particularly my area of the country, it's very simple for an industrial customer to run a line to a pipeline. It's only a bit more expensive to drill their own well, and as a matter of fact some hospitals, large commercial customers, have drilled their own wells and bypassed the local distribution company, so it is a serious problem in that portion of the country. And although we've heard about bypass for a very long time in the telecommunications industry and we are beginning to see some signs of it now, in my view it's a more serious active problem in the gas distribution industry.

Q. You would agree there has to be a physical connection in order to deliver natural gas as opposed to the bypass threat in communications?

A. Right, or drilling your own well. I suppose that's a physical connection, yes.

Q. Is drilling a well a feasible bypass alternative in most situations?

A. Well, as I said, in gas rich areas of the

country it is. It's happened in West Virginia.
Q. Does the jurisdictions in which U S WEST Communications operates have gas rich areas of the country?
A. There are some gas rich areas in Montana, for example. I believe U S WEST operates in Montana but I would say in the main, no, is the answer to that question.
Q. Are local gas distribution companies faced with the threat of competitors using their service lines to provide service to retail customers?
A. No, not that I am aware.
Q. Are you familiar with the Commission's order issued in the interconnection proceeding in this state?
A. I'm familiar in general with some of the connection orders. I'm not familiar exactly with which one you're talking about in particular.
Q. Do you know whether there is any requirement in effect for gas distribution companies to open their systems to competitors for the provision of natural gas service at the retail level?
A. Is there an open access transmission in the distribution systems here, is that what you're asking?
Q. Yes.

A. I would doubt that's the case. I'm not sure but I would be surprised if it were.

Q. Are you familiar with the Commission's notice of inquiry regarding the regulation of local gas distribution companies?

A. No, I'm not.

Q. Would you accept subject to check that in the risk discussion in that order the Commission stated "LDC" -- and that's local distribution companies -- "still retain monopoly rights to serve a particular region so do not face many of the risks of competitive firms such as the risk of losing core customer market share to a competitor. At least for the short-term, several LDC functions (e.g., distributing gas to core customers) seem likely to remain a monopoly and hence appropriate for economic regulation." Do you agree with the Commission's statement?

A. Makes sense to me.

Q. Is it your position that under the regulatory scheme in effect in this state today U S WEST Communications has a core customer market share that it has no risk of losing to a competitor?

A. I wouldn't agree that it has no risk. It's my understanding that the Supreme Court has outlined that there are nonexclusive franchise areas, so it is conceivable that a local exchange telephone there, there is the potential for customer loss which is different than gas utilities. And I have no problem, as I've said already a couple of times, that gas distributors generally are less risky than telephones. I think my equity cost estimates prove that out.

Q. Have you performed any analysis of the impact of technology on the natural gas distribution industry versus the telecommunications industry?

A. I have not, but I can safely say that technology is not a driver of competition in the gas distribution industry and it is in the telecommunications industry.

Q. And would you agree that the introduction of new technology has an impact on the determination of useful lives for depreciation assets in the period over which the cost of depreciable assets must be recovered?

A. If that technology is better than the old technology, yes.

Q. All other things being equal, doesn't rapid introduction of new technology require shorter useful lives for depreciation?

A. It can, yes.

Q. And have you performed any analysis which compares the ability of a natural gas distribution company to recover the cost of its depreciable assets in rates versus the ability of telephone companies to do so?

A. I had not. I know that telephone company depreciation rates have been increasing and depreciation rates generally are a big issue for utilities. More so for telecommunications utilities. I had not done an analysis to determine their recoverability vis-a-vis other utilities. That's not in my testimony.

Q. But would you agree that telephone companies face greater risks than gas distribution companies regarding the ability to recover the costs of their depreciable assets in rates?

A. They could. That potential exists because of the speed of technological change.

Q. Are you aware of any gas distribution companies that have discontinued FAS 71 accounting?

A. Not off the top of my head, no.

Q. Like to turn to the portion of your testimony discussing DCF growth rates, and I guess particularly your exhibits. You calculate the DCF growth rates --

MR. CUNNINGHAM: Can you be more specific.

MR. VAN NOSTRAND: Table 6, table 7 of Exhibit 408.

Q. Turning to your schedule 6 and 7 of 408, the comparable companies that you looked at for purposes of your DCF analysis are grouped according to the gas distributors then the telephone companies; is that right?

A. That's right.

Q. And the calculations are shown on schedules 6 and 7?

A. Yes. The data, the retention growth data and the booked value per share growth data, the shares outstanding, internal and external growth are shown on schedule 6. The actual DCF growth rate calculations is shown on schedule 7, page 1. Page 2 shows my resulting growth rates in comparison to other available growth rates, and the actual DCF calculation is carried out on schedule 9.

Q. If we look at in particular the telephone companies your analysis of the growth rate parameters is shown on pages 1 through 3 of schedule 6 and pages 4 through 7 show your gas distributors; is that right?

A. Generally that's correct. It shows, as I said -- when you say calculations I sort of have to disagree with that word, but the information from which I derive my growth rates are shown on those pages.

Q. Yes. That's a more accurate statement, and in fact your ultimate growth rate determinations are shown on schedules 7?

A. That's correct.

Q. If we could look at a couple of companies, in particular looking at a telephone company, at Pacific Telesis, for example. According to schedule 7, page 1 you used a growth rate of 3.25 percent, is that correct, your B times R analysis, the first column on --

A. That's correct. Well, yeah, the B times R, but including the external growth the DCF growth rate is 3.66 percent.

Q. But your B times R number is 3.25 percent?

A. Yes, but that's only a part of the DCF growth rate.

Q. And if we look back then on schedule 6, page 2 of the numbers you relied upon for Pacific Telesis, the 3.25 percent growth rate isn't actually shown anywhere on schedule 6, page 2, is it?

A. That's right.

Q. In other words, we look at the -- can see the growth rate for the five years 1990 through 1994 under B times R analysis which shows 3.65 percent; is that right?

A. Right.

Q. What is the B or retention ratio portion of the equation which led you to conclude that 3.25 percent was the appropriate growth rate for Pacific Telesis?

A. If you look at Exhibit 409, which is the next exhibit, what I will find there is for each company is a vertical explanation of the information I considered in determining growth rates for Pacific Telesis as well as all the RBOCs as well as the gas distributors. So that gives you an idea of the process I went through in estimating the growth rate. In summary, and sort of an overview fashion we see that the internal growth for Pacific Telesis on page 2 of my schedule 6, Exhibit 408, as you noted over the past five years it had been 3.65. You see the projections for '95, '96 and 2000 for Value Line are significantly below the historical level.

Also, if we look over at schedule 7, page 2 of 4 we see that the available growth rate projection information for Pacific Telesis is quite mixed. We've got IBES projecting three and a half percent growth for the future five years while Value Line projects a negative one percent earnings per share growth, no dividend growth but a three and a half percent booked value growth, and as it turns out my internal growth rate 3.66 percent actually agrees pretty well with IBES earnings projections. It of course substantially overstates what Value Line expects.

Q. If we could return to the original question which is, what is the B or residential ratio which led you to conclude that 3.25 percent was the appropriate growth rate to use for Pacific Telesis?

A. I'm sorry. I went through that explanation as a way of telling you that I don't come up with a specific B and a specific R which will then turn into 3.25 percent. I think that's been done in the past in this jurisdiction. I believe Dr. Kosch used to do that sort of thing. I don't do it that way. I look at the growth rate historically what's projected, other available growth rates and come up with a growth rate I believe is sustainable.

Q. And so there's nothing on page 2 of schedule 6 which would show how you arrive at the 3.25 percent figure?

A. There's plenty there.

Q. But no specific B and no specific R that translates to 3.25 percent?

A. There's no specific B and no specific R on page 4 of schedule 6 that will produce, unless it's by accident, 3.25. However, there's plenty of other information in schedule 7 and Exhibit 409 in front of you which you or the Commission can discern that data.

Q. Is it fair to say that 3.25 percent is based on your judgment?

A. That's perfectly fair to say.

Q. And is the same true then for your analysis of the gas distributors on pages 4 through 7 of schedule 6? Taking and looking at MCN for example on page 6 you use a 5 percent growth rate for MCN. There's nothing on schedule 6 that would suggest what B and R led you to conclude that 5 percent was the appropriate number for MCN?

A. I would agree with you up until your last sentence. There is something on schedule 6, page 6 that gives you, quote, an idea, unquote of the 5 percent growth rate I came up with. You will see that for MCN growth rate that began the five year period at negative level, but jumped up to the 5 percent rate in the most recent year. The average is only 1.86 percent over the time period, but you see that's a very strong showing, and an increasing growth rate over the five years. That's a very strong showing for the company. Value line expects that growth rate to be maintained at the five or even the six percent level in the future.

Further, we see booked value growth doubling from 4 to 8. That in combination with the other kinds of growth rate information that I reviewed indicates to me that a sustainable growth rate for this company is 5 percent, so I would have agreed with you except for the last sentence which said there's not any information which gives you any idea of where I came up with the 5 percent number. That's plenty of information there. There's not a specific B and R which you can multiply together to give you 5 percent.

Q. I have just a few questions on the issue of flotation costs. Page 38, line 18 of your testimony you consider the cost rate of long-term debt and in so doing you added an increment of 20 basis points for issuance expenses; is that correct?

A. That's right.

Q. And this increment increases the cost rate for new long-term debt from 7.55 to 7.75?

A. That's correct.

Q. And what are included in these issuance expenses?

A. Issuance expenses for long-term debt are included, primarily they're discounts, they're afforded to underwriters. They also represent printing fees, legal fees. In essence those costs are the very same kind of costs that your witness Mr. Cummings say that it should be included in flotation costs to be incorporated in the costs of equity capital. They are reasonable to include in the costs of debt because of the contractual arrangement that is involved. The debt costs, they're not reasonably included in the cost of equity because there is no contractual arrangement. We must discern the cost of equity from market data. Those kinds of costs are accounted for in the market data and it's unnecessary for many reasons to include that sort of costs in the cost of equity capital.

Q. You would agree that the cost of debt is the yield to investor plus the increment for issuance expenses?

A. Yes. I think that by accounting convention the embedded cost of debt is the coupon rate, and depending on whether there's a premium or a discount involved in the issuances then the embedded cost of debt could be above or below the coupon rate.

MR. VAN NOSTRAND: Thank you. I have no further questions, Your Honor.

JUDGE WALLIS: Questions from other counsel?

MR. VAN NOSTRAND: Sorry, Your Honor. Could I offer 414 into evidence?

JUDGE WALLIS: Is there objection?

MR. CUNNINGHAM: There was nothing specific with respect to item 16. I gather that response is intended to be implicit within the questioning, Mr. Van Nostrand, with respect to the comparative risk of gas companies?

MR. VAN NOSTRAND: Yes.

MR. CUNNINGHAM: I have no objection.

JUDGE WALLIS: Exhibit 414 is received.

(Admitted Exhibit 414.)

JUDGE WALLIS: Commissioner questions.

CHAIRMAN NELSON: Pass.

COMMISSIONER HEMSTAD: I have none.

COMMISSIONER GILLIS: Let me just ask one.

EXAMINATION

BY COMMISSIONER GILLIS:

Q. You stated at the outset that you're suggesting that we consider the lower range rather than mid range of your bands because capital costs have gone down. Is it your opinion that both short run and long run capital costs have declined substantially since August?

A. Long run costs have declined to a greater extent than short run costs. You know, in 1994 the Fed ran up the short-term rates to slow down the economy which they were successful in doing. Prior to that there was a great discrepancy between long-term cost rates and short-term cost rates. The Fed actively made that differential smaller. Since October of '94, November of '94, long-term debt cost rates have started to head south. The reason for that was that investors saw the economy slowing down and that has not abated. The economy is moving along at a relatively slow pace and a noninflationary pace which bond investors enjoy. As a result I think long-term T bonds, for example, I think when I did my testimony were 6 and a half. This morning they were 6.1. A couple of weeks ago they were 6. They jumped up a couple of points because of the budget squabble going on. I think the outlook is for continued reductions in interest rates. Short-term rates have come down but not quite as much.

JUDGE WALLIS: Anything further?

MR. CUNNINGHAM: Just one question, Your Honor.

REDIRECT EXAMINATION

BY MR. CUNNINGHAM:

Q. In connection with page 1 of Exhibit 414 in your discussion with Mr. Van Nostrand with respect to reallocation, I note that the response indicates that it would be possible for USWC to recapitalize its Washington jurisdictional operations by recapitalization. Do you visualize that as a likelihood and under what circumstances could you visualize that this might occur?

A. Well, quite frankly, I don't think it's a likelihood. I think that the company has been operating with a high equity ratio for quite some time, and it's advantageous for them to do so because with a high equity ratio the cash flows are very high. Also with a high equity ratio the dollar returns they earn can be translated into a relatively low percentage, so they can come to the regulators and say we're not earning enough. We need a higher return. However, I think if competition comes to the local exchange market in a big way, if I can simply select my local carrier by pushing a button or something as simple as that in which we do have true competition, I think you will see those equity ratios fall.

One way the company can lower its costs is to get rid of those big equity ratios. Equity on a pre-tax basis is twice the cost of debt capital. It's expensive for those companies to have high equity ratios. It's my testimony that costs shouldn't be passed on to ratepayers. I think the Commission would be operating as it's supposed to as a surrogate for the marketplace by setting rates with a lower equity ratio. I think when and if competition does come, full competition, you will see those equity ratios fall.

MR. CUNNINGHAM: Thank you. Nothing further.

JUDGE WALLIS: Anything further? Very well. Mr. Hill, thank you for appearing today. Let's be off the record for a few moments while the next witness steps forward.

(Recess.)

JUDGE WALLIS: Let's be back on the record, please. Public counsel has called William Dunkel to the stand.

Whereupon,

WILLIAM DUNKEL,

having been first duly sworn, was called as a witness herein and was examined and testified as follows:

BY MR. TROTTER:

Q. Will you please state your name and spell your last name.

JUDGE WALLIS: Excuse me, Counsel, by your leave and by our convention I would like to place in the record at this point the identification of the exhibits, and note that Mr. Dunkel's direct testimony is identified as 420TC for identification, an errata sheet including an additional sheet distributed today as 421 and 421C. His resume is 422 for identification. WWD-2 Washington rate spread summary is 423 for identification.

WWD-3, U S WEST return on investment is 424C for identification. WWD-4 is 425 for identification. WWD-5 is 426C for identification. 427 for identification is assigned WWD-6. WWD-7, comparison of depreciation rates is 428C for identification. WWD-8, one party flat rate is 429C for identification.

WWD-9 is 430. WWD-10 unseparated loop costs is 431. WWD-11, residential rate in ceiling is 432 for identification. WWD-12 is 433 for identification. WWD-13, 434 for identification. WWD-14 is 435 for identification. WWD-15, joint telecom project is 436 for identification.

WWD-16 is 437; WWD-17 is 438; WWD-18 is for 439; WWD-19 is 440; and WWD-20 is 441 for identification. WWD-21, Washington small business customers is 422C for identification; and WWD-22 is 443 for identification. The witness's cross rebuttal testimony is 444TC for identification. An errata sheet including additional pages distributed today is 445C for identification. WWD-23 is 446 for identification. WWD-24 is 447. WWD-25 is 448C, WWD-26 is 449. WWD-27 is 450. WWD-28 is 451. WWD-29 is 452. WWD-30 is 453. WWD-31 is 454, and WWD-32 is 455C for identification.

WWD-33 is 456. WWD-34 is 457. WWD-35 is 458. WWD-36 is 459C. WWD-37 is 460 for identification. WWD-38 is 461. WWD-39 is 462, and WWD-40 is 463. WDD-41 staff response to data request 26 is 464. WWD-42 is 465. WWD-43 is 466. WWD-44 is 467C for identification. Supplemental testimony on costing is 468T. An errata sheet including a sheet distributed today is 469 for identification. WWD-45 is 470 for identification. WWD-46 is 471. A revised WWD-2 is 472 and a revised WWD-46 is 473 for identification.

(Marked Exhibits 421, 422, 423, 424C, 425, 426C, 427, 428C, 429C, 430, 431, 432, 433, 434, 435, 436, 437, 438, 439C, 440, 441, 442C, 443, 444TC, 445C, 446, 447, 448C, 449, 450, 451, 452, 453, 454, 455C, 456, 457, 458, 459C, 460, 461, 462, 463, 464, 465, 466 and 467C, 468T, 469, 470, 471, 472 and 473.)

MR. TROTTER: Thank you, Your Honor.

DIRECT EXAMINATION

BY MR. TROTTER:

Q. Could you please state your name and spell your last name for the record?

A. My name is William Dunkel, D U N K E L.

Q. What is your business address?

A. Rural Route 2, Pleasant Plains, Illinois.

Q. And you are a principal of William Dunkel and Associates, a consulting firm?

A. That's correct.

Q. Were you retained by public counsel and AARP to provide testimony and exhibits in this proceeding?

A. That's correct.

Q. Turning to your to Exhibit 420TC, is that your direct testimony?

A. Yes, it is.

Q. Was that prepared by you?

A. Yes, by me or under my supervision and direction.

Q. Is it true and correct to the best of your knowledge as corrected?

A. Yes, it is.

Q. If I asked you the questions that appear there would you give the answers that appear there?

A. Yes.

Q. In that testimony you referred to, counting your errata sheet, you refer to Exhibits 421 through 423, Exhibit 424C, 425, 426C, 427, 428C, 429C, 430 through 438, 439C, 440, 441, 442C and 443; is that correct?

A. That's correct.

Q. Are those exhibits prepared by you or under your direction and/or are they documents on which you have relied that have been provided by others?

A. Yes.

Q. Turning your attention to Exhibit 444TC, is that your cross rebuttal testimony?

A. Yes, it is.

Q. Was it prepared by you or under your direction or supervision?

A. Yes.

Q. As corrected, if I asked you the questions that appeared there, would you give the answers that appeared there?

A. Yes.

Q. In that testimony as corrected you refer to Exhibits 446 and 447, 448C, 449 through 454, 455C, 456C, 457 and 458, 459C, 460 through 466 and 467C;

is that right?
A. That's correct.
Q. Were those exhibits prepared by you or under your direction and/or are they information supplied by you upon which you are relying?
A. It was supplied to me, yes, that's correct.
Q. Turning your attention to Exhibit 468T, is that your supplemental testimony?
A. Yes, it is.
Q. And as corrected is it true and correct to the best of your knowledge?
A. Yes.
Q. Was it prepared by you or under your direction?
A. Yes.
Q. If I asked you the questions that appeared there, would you give the answers that appeared there?
A. Yes.
Q. In that testimony you refer to exhibits 470 and 471; is that right?
A. I have to admit I didn't number those.
Q. 470 is WWD-45 and 471 is WWD-46.
A. Yes.
Q. Were those prepared by you or under your depreciation or were they data responses that you

supplied?

A. These were prepared by me and/or under my supervision.

Q. Also you have revisions to Exhibit 423 which has been identified as Exhibit 472 and revision to Exhibit 459C which has been identified as 473C; is that correct?

A. That's my understanding. Was the last one WWD-46?

Q. Correct.

A. Yes, that's correct.

Q. Those last two exhibits, were the changes there occasioned by the changes provided by Mr. Lundquist yesterday?

A. Part of it was. In addition Mr. Purkey had revised some numbers in his exhibit as well, and in addition we had received a data response which provided a different figure for the directory assistance revenues generated from other carriers, so those were the three things which caused the changes on those documents.

MR. TROTTER: Your Honor, I would move for admission of all of the exhibits that you identified at the beginning of my examination.

MR. HARLOW: Your Honor, I might dare if I would be able to ask some very brief voir dire to clarify a portion of the rebuttal testimony.

JUDGE WALLIS: Very brief.

VOIR DIRE EXAMINATION

BY MR. HARLOW:

Q. At page 120 of Exhibit 444TC, starting on line 8 you argue that it is appropriate that these services, referring to interstate and intrastate toll calls and operator assisted services, support a portion of the pay phone costs since they share the pay phones. Do you have that testimony in mind?

A. Yes, I do.

Q. In giving that testimony, are you addressing the question of whether or not U S WEST pay phones are subsidized or are you addressing the question of whether or not U S WEST pay phone interplay of its pay phone rates and PAL rates create a price squeeze?

A. Well, as this response indicates, I'm referring to Ms. Murray's exhibits that I was afraid might be misinterpreted, and that is what I'm addressing.

Q. You understand her analysis to relate to price squeeze issues or subsidization issues?

A. I would have to review her testimony. She was not advocating a price increase of U S WEST local pay phone rates so she may have been addressing the price squeeze issue, as I understand it, but her testimony would stand as it's written.

Q. Do you understand the distinction between cross subsidy issues and price squeeze issues?

A. Yes.

Q. Could you briefly state the distinction.

MR. SHAW: Your Honor, I'm going to object at this time. This just seems to be out of order cross.

JUDGE WALLIS: I think we are getting into cross.

MR. HARLOW: Well, let me just state a qualified objection and then perhaps Mr. Trotter can clarify. We would object and move to strike lines 7 through 13 on page 120 of Exhibit 444TC to the extent that it's offered as addressing the price squeeze analysis conducted by Ms. Murray. The grounds for the objection is that the Commission has recently been through these issues in docket UT-920174 and made the determination for price squeeze purposes. To the extent the testimony is offered simply to address whether or not pay phone services are cross subsidized then we would not object to the testimony.

MR. TROTTER: We think it's admissible and we'll just offer it. Counsel can cross.

JUDGE WALLIS: I do not believe that the testimony is subject to exclusion on the basis stated and will overrule the objection. And there being no other objections the exhibits are received in evidence.

(Admitted Exhibits 421-423, 424C, 425, 426C, 427, 428C, 429C, 430-438, 439C, 440, 441, 442C, 443, 444TC, 445C, 446, 447, 448C, 449-454, 455C, 456-458, 459C, 460-466, 467C, 468T, 469-473.)

MR. TROTTER: Witness is available for cross.

CROSS-EXAMINATION

BY MR. SHAW:

Q. Good afternoon, Mr. Dunkel. I'm Ed Shaw of U S WEST Communications and I want to congratulate you. I think, I'm not sure but I think you've set a new record for amount of testimony and exhibits on one subject. Congratulations.

A. There was a lot of work involved.

Q. The hearing room will be pleased to know that I don't intend to grind through these many

exhibits. What I want to do this afternoon is ask you a series of hypothetical questions to test your cost and pricing principles that you're urging in this case. I want you to assume a single telephone company, a simple telephone company with 25 percent business customers and 75 percent residential customers. Do you have that assumption in mind?
A. Yes.
Q. I want you to further assume that the business customers typically in the case of telephone companies are on average higher density shorter loops and that the residential customers on average are lower density and longer loops. Do you have that assumption in mind?
A. I understand that assumption.
Q. And that there is one switch and distribution plant to the customers. I further want you to assume that there is no toll or interexchange service in this hypothetical at this point. Do you understand that?
A. I understand that last assumption but that's unrealistic but I do understand that unrealistic assumption.
Q. Now, this hypothetical telephone company is going to price its exchange services and it has two

general considerations, does it not, measured service and flat rate service or a combination of those two. Would you agree with that?

A. Those are certainly two of the options it has.

Q. In terms of pricing simple local exchange service, are there any other options?

A. There are various options which include message service where you charge per call but do not time it. There are measured services which have packages which include a certain amount of time. Those are the major options and then there's flat rate.

Q. Let's discuss measured service as a category to include those last that you mentioned. One way that this hypothetical telephone company could price its services would be to compute a loop charge or a link charge on average and charge in addition each customer usage either on a per call basis or a full measured basis or a packet basis, could it not?

A. That is one way it could charge, yes.

Q. That charge would be fair, just and reasonable, would it not, in that each customer would pay a loop charge and would pay usage designed to approximate each customer's usage?

A. That would probably be one of the many possible rate designs that would be termed fair, just and reasonable. There's usually a wide range that meet that criteria.

Q. It would not make it unfair, unjust and unreasonable for this hypothetical company to average its business customers and its residential customers together and charge them one average loop charge, would it?

A. That depends. Typically we do recognize the difference in loop length. Typically in cost calculations, including mine, I recognize the residential loop on average is longer than the business and therefore have the cost of a residential loop being higher than the cost of business.

Q. In your opinion, would this hypothetical phone company averaging together its short business loops and its longer residential loops to produce an average loop price produce an unfair, unjust and unreasonable loop rate to its business customers?

A. It would depend on the information. Typically usage goes the other way. Usually the usage cost per residence call is lower than per business call because the residence calls tend to be off peak, so those two balance each other.

Q. Let me redirect you back to the question. We're talking about loop charges, not usage charges. Remember the question and the assumption. In designing the rate, this hypothetical phone company is going to charge an average loop charge or link charge and then usage to each customer. Would the loop portion or the link portion of the charge be unfair, unjust and unreasonable if it averaged together all loops, long loops and short loops?

A. I would not term that as being unfair, unjust or unreasonable. I would say I prefer to do it recognizing that cost difference, but there are other people who use what's called a loop is a loop concept and basically one of the arguments they use is that the phone company decided where to build the central office and therefore a given customer has no control over how far they are from the central office. So there are two concepts, and I accept both of them as being reasonable. I prefer to recognize the difference in loop lengths which means residential loop costs are typically higher than business loop costs, and I include that in my studies in this case.

Q. In this simple hypothetical it would be then more fair, more just and more reasonable to deaverage the loop charge or the link charge and

charge a different loop rate or link rate to business customers which would be lower than the loop or link rate charged to residential customers?
A. Yes, and that's the concept that I have built into my costs I've done in this case. I recognize residential loops are typically longer and more expensive than business and that is recognized in what I have done. By the way, usage usually goes the other way and that should also be recognized, what your company fails to recognize.
Q. Why don't you wait for a question. We were talking about loop charges. Did I ask you any questions about usage?
MR. TROTTER: Your Honor, argumentative.
MR. SHAW: Your Honor, we'll be here until midnight if I have to fight with this witness.
JUDGE WALLIS: I am going to ask the witness to listen to the question and respond to the question, and then if you need to explain it, go ahead and explain it, but it would be very helpful if you merely answered the question rather than proceed on subjects as to which there's no pending question.
THE WITNESS: Certainly.
MR. TROTTER: I would also request that counsel argue with me and the ALJ rather than the

witness.

JUDGE WALLIS: So noted.

Q. Another option for this hypothetical phone company would be to flat rate all of its customers a sum sufficient to add up to its revenue requirement, simple revenue requirement in my hypothetical. For example, all customers could be flat rated at $20 a month. Is that one option that this company could consider?

A. I would have to object to the $20 a month figure since that greatly exceeds any reasonable cost calculation we have in this case. If you're saying hypothetical that's the number it would have to be I will take that as a hypothetical.

Q. I've given you no assumptions about the costs of this hypothetical phone company, have I?

A. No, you haven't. You asked me to agree to $20 without any hypothetical and therefore I do not agree to $20.

Q. Assume the revenue requirement would require this phone company to charge each customer $20 a month in order to meet its revenue requirement. Would then the rate of $20 be indicated?

A. That's one way they could collect that revenue, and I assume you mean by per line instead of per customer.

Q. Yes, per line. Thank you. In your opinion, would that produce fair, just and reasonable rates to all the customers of this hypothetical phone company?

A. That would tend to overcharge residential customers and undercharge business because business tends to have a higher percent of their traffic on peak than do residential customers. The on-peak usage is more expensive to serve than the off-peak traffic. In addition, business customers tend to place more calls per line than do residential customers so that would also be an indication that the costs of usage for a residence line is typically lower than the cost of a business line per usage.

Q. And to charge all customers a flat rate no matter where they live no matter how long their loops are no matter how much usage each individual customer has results in over charging many customers and under charging many customers, correct?

A. Over and under charge has to be relative to what?

Q. To their usage and their loop length.

A. As far as usage, actually flat rate is a more efficient way of providing service than measured.

If you're going to do it other than flat rate then you have to measure for every call and record data for every call and a lot of times the cost of doing that exceeds whatever the benefit you think you're getting from measuring the calls.
Q. Therefore you think it is a more fair, just and reasonable rate to flat rate all customers and not charge for usage, correct?
A. Within a given customer class such as residential, flat rate is the most efficient way to provide a given amount of usage because it doesn't incur the cost of measuring each call and recording the data and processing the data.
Q. And this hypothetical phone company attempting to decide how to charge its customers, it would have to make a decision on whether the additional incremental cost of measurement was worth the additional fairness that would be achieved by measuring usage, would it not?
A. That would be the additional fairness would be one of the considerations.
Q. Assume that this hypothetical company settles on the simple practice of charging at $20 per month per line to all of its customers without distinction of whether they're a short loop customer,

long loop customer, a high usage customer or a low usage customer. Assume with me further that the residential customers of this hypothetical company enjoying the association of people over 50 who don't own businesses and protest to the town fathers that they are overpaying for their residential service compared to what business customers are paying based upon all the arguments that you've made in your testimony, and in response the town fathers raise the business rate, flat rate, $30 and lower the residential rate to $10 designed to meet the same revenue requirement. Do you have that assumption in mind?

A. Yes, I do.

Q. And as I take it your testimony you continue to believe that this is a fair, just and reasonable rate for both the business customers and for the residential customers?

A. What are you calling this in that question?

Q. A rate structure wherein business customers are charged anywhere from two to three times as much as residential customers in order to arrive at the revenue requirement of the company?

A. Yes, it is. There are some differences you haven't mentioned such as the business service including a very valuable Yellow Page listing that the residence service does not include.

Q. I asked you to assume that the argument made all of the arguments that you make in your testimony, including that one.

MR. TROTTER: Your Honor, the witness had not completed his answer.

MR. SHAW: I thought he had.

MR. TROTTER: He was talking about differences between business and residential.

A. Right. There are a number of differences. Businesses receive faster repair than residence, almost twice as fast on the average. Again, this is because --

MR. SHAW: Your Honor, I specifically asked the witness to assume that this rate change was made on the basis of all the arguments he made in his direct testimony. I don't need him to recite what arguments he did make. I presume he knows what arguments he made.

MR. TROTTER: Well, Your Honor, that leaves the record very unfair.

MR. SHAW: The record is complete with his direct testimony which makes all the arguments.

MR. TROTTER: The question was whether the scenario that Mr. Shaw, the hypothetical scenario that

Mr. Shaw enunciated was fair, just and reasonable and the witness proceeded to answer that. Now, I realize it's late in the day but other witnesses throughout this proceeding have been allowed to explain their answers and I don't want to carve out an exception.

MR. SHAW: Your Honor, I don't mind an explanation to a question, an explanation of an answer to a question I asked, but I don't think that an explanation to a question that I don't ask is appropriate.

JUDGE WALLIS: I believe that the objection is well founded and believe it should be sustained. I did hear Mr. Shaw in framing his hypothetical include the matters that the witness was speaking to, and I do feel it's repetitive for him to restate those arguments.

Q. In our hypothetical we now have a situation where business customers are charged $30 and all residential customers are charged $10 per line all adding up to this hypothetical company's revenue requirement. Assume further now that the business customers in reaction to this purchase private lines or dedicated circuits from this telephone company, provide their own switch in the form of a PBX for traffic between the businesses in this community and for calls off this private network to the residential customers and from the residential customers that are connected to the telephone company's switched network. Do you have that assumption in mind?

A. Yes, I do.

Q. Under your direct testimony wherein you testify that those who used loops should pay for the loops, what portion of the residential loop cost in this hypothetical company should be allocated to private line service?

A. Well, first of all can you show the reference in my testimony where I stated those that use the loops should pay for the loops. I may have said those that share the loops.

Q. Okay. Do you agree that these businesses, in order to avoid the switched prices of this phone company, electing the option to build their own private network and to dump their off net traffic on to the loops serving residential customers that is destined for those customers, are sharing the loops?

A. Of the residential customers?

Q. Yes.

A. Yes. They are and they would be expected to pay -- I'm sure the phone company who is serving the residential customers paying the cost of the loops and passing a traffic over these loops would expect some payment, a CCLC charge of some sort, whether it would be payment in kind or what. If I were the owner of the company serving the residential customers and you came to me and said I would like to dump traffic onto the loops, you maintain the loops, you invest in the loops and I would pay you nothing, I would tell you I'm not interested. I wouldn't want to pay it. And that's what the CCLC is. In fact it's -- for interchange carriers it's a similar type of payment.

Q. So you would urge this Commission to charge private networks such as constructed by the state or the Boeing Company or any number of other large business consumers a per minute carrier common line charge for traffic that is leaked off of their private networks on to the public switched network?

A. The answer is there is what's called a leaky PBX charge that does just that. However, you've now moved entirely away from anything I've testified to in this case.

Q. In the state of Washington is there any kind of a leaky PBX surcharge on private line, private network facilities that leak traffic onto the public switched network?

A. Do not know. I had not investigated for the very simple reason I'm not testifying about PBX traffic or leaky PBX in this whatsoever. If I were I would have done discovery to find out what the current situation is.

Q. To be consistent with your cost and pricing principles which you urge upon the Commission in this case, it would be necessary for you to advocate a carrier common line charge to be paid by operators of private networks, would it not?

A. No, sir. What you are dealing with here is a very oddball situation. It is called the leaky PBX. It's a recognized problem and the fact that it's difficult to measure and difficult to bill for does not relate to any principle. It is simply an oddball situation that I'm not addressing in this case. If you're asking me in principle if someone is sharing the loop should they pay for it, the answer is yes.

Q. So if the Commission adopts the logic of your position it should impose a carrier common line charge or some other kind of charge on the operators' private networks in order to allocate a portion of the residential loop to the private networks that benefit from the use of those loops; isn't that correct?

A. Not if the private network doesn't connect or use those loops. If they do not connect and benefit from those loops there would be no reason to charge them in any way.

Q. Remember the hypothetical that they connect with the public switched network and when members of that private network call a residential phone number they necessarily use the residential loop, correct?

A. If there is a situation where the PBX traffic connects to the local network they should pay a charge for connecting to the local network, and that is the typical arrangement nationwide. There are special charges which are called for a leaky PBX have been instituted in some states and in some jurisdictions. Whether you have one here or not, I don't know.

Q. In your recommendations for the pricing of private line services in this case, have you made any specific recommendation to include in the cost of those private lines an allocation of residential loop cost?

A. That question doesn't even make any sense. A private line is something like a burglar alarm. It goes from one location to the other and does not connect to the switched network. Only if it goes through something else like a PBX which uses PBX trunks does it connect to the switched network. The definition of private line is typically one that is not switched and doesn't go through the switched network.

Q. Has the company advocated a PBX trunk service and rate in this case?

A. Yes.

Q. Do you support the company's advocacy of a PBX trunk and rate in this case?

A. I support the concept of a PBX trunk which is higher than a 1FB. I think our rates are different but the concept I have supported, yes.

Q. Do you urge this Commission to apply in addition to the other costs identified with that PBX trunk a carrier common line loop allocation and a payment on a usage basis for that cost allocation?

A. The PBX trunk rate is a flat rate which includes usage so, yes, I advocate that the PBX trunk rate include a charge for usage. I am not advocating anything else other than that, other than what is presented in my testimony.

Q. Do you advocate a charge based upon usage, that is, a measured rate like the carrier common line charge assessed against interexchange carriers?

A. Again, you're dealing with PBX trunk rates?

Q. Yes.

A. The PBX trunk rate which I recommend is higher than the 1FB rate, in part because the average traffic on a PBX trunk is higher than the average trunk on a 1FB line. Therefore, the reason for the higher 1FB rate is to reflect the higher level of average usage.
Q. Is that based upon a concept of allocating a portion of the residential loop cost to the PBX trunk?
A. Since that's local traffic the answer is no.
Q. Assume that taking note of the rate disparity of $30 versus $10 for a business and residential services being charged by this phone company a new entrepreneur enters the community, purchases a switch, builds loops to the business customers concentrated in the downtown core of this phone company and enters the local business service telephone business. Do you have that assumption in mind?
A. Yes.
Q. Now, for his customers, business customers only, to call residential customers and for residential customers to call the business customers you will have to interconnect with the loops of the

existing phone company, will you not?

A. Typically they interconnect the switches and then the traffic can go through the switches to the loops of the other company.

Q. Assume that this new entrepreneur connects his switch to the switch of the preexisting phone company with high capacity dedicated circuits. Do you have that assumption in mind?

A. Yes, I do.

Q. To be consistent with your advocacy that a portion of the residential loop be allocated to those who share the use of the loop should the preexisting phone company allocate to the high capacity dedicated circuits that connect the two phone companies a portion of their loop cost?

A. Your question assumes testimony which I have not presented. I have not stated that one local service -- that the costs of a residential loop should be allocated to another local service, and if you can identify in my testimony this assumption you claim I have presented in my testimony I would like to see that. What I have presented is that toll services which share the loop should pay for a part of the cost of the loop. Switched access which share the loop should pay for a part of the cost of the loop. Those are not other local services. Local services also carry a heavy burden of the cost of the loop, the majority, so your question misstates my testimony.

Q. Well, not at all, Mr. Dunkel. Let's return to the question. You agree that you have advocated to this Commission that those who share the use of the loop should have a percentage of the cost of that loop allocated to them and they should pay through rates their share of the cost of the loop; isn't that correct?

A. Not exactly. What I have stated is toll services which share the loop should pay for a part of the cost of the loop. Local services which share the loop should pay for a part of the cost of the loop. Switched access services which share the loop should pay for part of the cost of the loop. I have not testified that there should be some subdivision within a local service, for example.

Q. You have testified that leaky PBXs serving private networks should share in the cost of the loop?

A. That's correct. Leaky PBX charge was for toll traffic that was getting into the local network through the PBX without paying an appropriate switched access or other charge. That's what is involved in the leaky PBX concept not local traffic versus local traffic.

Q. Let's talk about your principles. On what basis do you urge this Commission to assign cost of local loops to toll traffic and not to providers of just business local service. What is the --

A. First of all, I haven't made that recommendation. The basis -- what I have addressed is local service versus toll service versus switched access service. If you get into trying to subdivide local versus local, I have not addressed that. The answer there would be normally it's called benefit or payment in kind. Typically your line receives incoming calls and also places outgoing local calls. So if you started charging someone for an incoming local call use of your line and then they charged you when you called them back you would end up with a lot of bookkeeping that would probably cancel out. So it's simply impractical and we don't advocate that. When you're involved with toll service or switched access service where it's very significant use and it does not necessarily cancel out and it is an additional entire category that's sharing the access line, that additional category should bear part of the cost of the line instead of dumping it all on one service which is local or one category of service.

Q. Let's return to the hypothetical, the simple phone company providing business local service and residential local service and private lines to private networks, three products. Do you understand the hypothetical?

A. Yes.

Q. And because of the high business rates it charges a new business only telephone company enters town, declines to build any loops to local service -- local residential customers, builds loops only to business customers, installs a switch and when his customers want to call residential customers he dumps the traffic on to the network of the preexisting phone company. Do you have that assumption in mind?

A. Yes, I do.

Q. Now, to be consistent with your principle, the principle that users or those that share the residential loop should pay a portion of the cost of that residential loop, on what basis do you exempt this example from your assertion that interexchange carriers should pay a portion of the local loop? On what principle?

A. Your example does not mention interchange carriers whatsoever. Therefore you have simply not even addressed anything I've testified to.

Q. You have and repeatedly in your answers keep referring to interexchange carriers and toll service. In this simple hypothetical there is no toll or interchange service. I will get to that in a minute. But I understand your testimony is that interexchange carriers should pay a cost of the loop and now your testimony is business carriers should not. I want to know on what principle you make that distinction.

A. I'm not sure what you mean by business carriers should not.

Q. Do you understand the hypothetical that this second phone company holds itself out to business customers only and will not take residential customers?

A. That's fine. I understand your hypothetical. Assuming this is all local traffic, you're not dealing with toll or switched access, what you have is all the traffic on all of the loops is local. Therefore you aren't even addressing the issue of toll use of the loops or sharing the loops or switched access sharing of the loops. So now let's address the issue of what happens if we have all local traffic with no sharing of any -- with toll or switched access. In that case you would have to recover all of the loop costs in some form in local rates. Now, if we had traffic where residential loops were -- residential customers were placing calls out on their loop and it was going to a business and the business was owned by a different company, business loop, theoretically you could have the company that owns the residential lines pay the one that owns the business lines for that call. Then when the business calls back theoretically you would make the same payment in the opposite direction which would be a lot of bookkeeping, a lot of measured usage, measured service, measured cost, which would probably cancel out when you got all done. What you're dealing with here is a major category, local. In your example that's the only service sharing the loop in which case local service should pay the full cost of the loop. In the real world it's not the only service sharing the loop. Interexchange carriers share the loop for access and usage as does toll service.

Q. Limit yourself to the hypothetical and we'll go along a lot faster. I promise you that we will talk about interexchange traffic. As I understand your answer, each of these companies should bear the cost of their own loops and necessarily the residential subscribers in this town should pay the full cost of their loops?

A. No. Theoretically you would have payment in kind, which is either you would bill each other for usage or else you would --

JUDGE WALLIS: Mr. Dunkel, just a moment, please.

Q. I'll assume that you didn't listen or hear the question. Should residential customers of the phone company, should the residential customers in this simple hypothetical bear the full cost of the loops?

A. To the extent that there was no other service, toll or access, et cetera, sharing them, then the full cost of the loops would have to be borne entirely by local service. If there are two different companies providing the local service, which is what you've identified, then you would probably be reasonable to work out some arrangement which reflected the fact that two different local companies are involved in providing the local service. That would probably be either a very complex billing arrangement that would cancel out or payment in kind, which is typically what happens with EAS service.

A good example is EAS where you have a local type service provided by two different companies. Typically instead of charging each other and tracking lots of data they will accept payment in kind. They will say I will terminate your traffic if you will terminate mine and we will call it even, which is a very reasonable way of doing it.

Q. So even though one company is providing more expensive, longer, lower density loops and the other company is limiting itself to providing short, less expensive, more dense loops, each company should be responsible for their own loop costs and there should be no access charges. Is that your testimony between these two local companies?

A. In purely local service, if there was a reasonable balance of the value being provided by one company to the other, payment in kind is the way to go, simply because there's a lot less record keeping and bookkeeping involved. If there was a significant difference in the value being provided in one direction than the other, then you might discuss some sort of charge to reflect that difference in value.

Q. Would you agree that the appropriate way for each of these companies to recover their costs of their loops is to charge each other an access charge based upon the costs of each company?

A. Only if it was worth the trouble of

measuring all of the traffic. What has happened, for example, in Rochester where this very similar event has occurred where there is more than one local provider is in Rochester, New York they've agreed to payment in kind as long as the traffic is relatively balanced in both directions. If it gets out of balance then cash payments are involved. And that's certainly a practical way of dealing with it.

Q.   You would agree that a reasonable way to compensate each company for its loop expense is to charge each other access charges based upon their own costs?

A.   Theoretically, yes, although in the real world it's usually not worth the bookkeeping problem.

Q.   So I take it your testimony is that this Commission should only allocate residential loop costs to those who share the use of those loops if a substantial amount of revenue exceeding the cost of collecting that revenue can be gained. Is that a fair understanding of your testimony?

A.   No. The payment in kind is a way of recovering revenues. You basically trade service with someone who is providing a similar service back to you, and if that's completely out of balance then you may have a cash payment, but in any proper rate design one of the things you consider is the cost of administering that rate design, and if the cost of administering it is not worth the value you receive then you shouldn't do it that way.

Q. In my hypothetical with one company providing short low cost loops and the other company providing on average more expensive longer loops, is bill and keep a fair way of mutual compensation?

A. Well, the usage would work the other way. The residential -- the company providing lines to the residential customers would be providing longer lines. However, their traffic would be more off peak than the other company's so you would have to analyze the details to see if it was worth measuring every call or if it was just better to have payment in kind.

Q. If the traffic is not in balance you would agree that there should be payment?

A. If it is significantly out of balance and there is a significant cost difference a payment would be possible.

Q. Let's expand the hypothetical to an adjoining company, community that it's adjoining, our first hypothetical company is smaller, less dense with fewer business customers and it charges flat rates to its users, $50 per month per access line for a

business customer and $30 a month per access line for its residential customer. Do you have that assumption in mind?
A. Yes, I do.
Q. Let's assume that the larger more dense company responds to the request of its customers who now want to call the smaller adjoining community, and the larger company builds a high capacity line between its switch and the switch of the smaller company and provides originating service to the customers at the other company. Do you have that assumption in mind?
A. Yes.
Q. Would you agree that under common terminology that that is an interexchange call?
A. Assuming this is not EAS traffic, if it's a toll call that's called an interexchange toll call.
Q. It's called an interexchange call, is it not? Toll relates to how you rate the call, would you agree with that?
A. Interexchange, there's several different definitions of interexchange. It would be called interoffice. It would be called interexchange but if it's EAS it's typically not grouped in with other interexchange traffic.
Q. Do you have the hypothetical in mind, two

different exchanges operated by two different operators? By definition a call from one to the other would be an interexchange call, would it not?

A. Well, the answer is sometimes yes, sometimes no. For some purposes if it's an EAS call it would be considered local. If for other purposes if it's an EAS it would be considered interexchange so please explain for what purpose.

Q. The term interexchange is simple, isn't it, inter, exchange, between two exchanges. Would you agree that in the plain English meaning of interexchange the hypothetical I just gave you was an interexchange call?

A. However if it's EAS, although it crosses an exchange boundary it would be categorized as a local call if it's an EAS call.

Q. Let's talk about rating the call, and that's what you're talking about, isn't it, when you mention EAS? Let's talk about rating the call to the originating customer. One way to rate this call by the company offering the service, the larger company in my hypothetical, would be to make no charge at all if it decided that it could meet its revenue requirement of the additional interexchange facility and switching capacity without increasing prices.

That would be one option, wouldn't it?

A. That's an option, but in your hypothetical you've assumed you're installing additional facilities and with no additional charge so it might not be your first option.

Q. Second option would be to raise the flat rate that you're charging to business customers and your residential customers because they now can call interexchange to the adjoining company. Would that be an option?

A. And assuming you didn't charge per call or per minute that would be an option and it's called EAS.

Q. Another option would be to charge a measured rate for the call originating in the large company and terminating in the smaller company, would it not?

A. That would be another option.

Q. And EAS can be at measured rates in the general practice of the telephone industry, can it not?

A. Yes, it can. I don't know if it is in this state or not but there are states which have measured EAS rates.

Q. So the fact that it's measured does not

necessarily determine that it's a toll call, as you use that term?
A. Not necessarily. There is a tendency for that to be true but it's not an absolute.
Q. You would agree, then, that an interexchange call can be rated locally, that is, no additional charge or bundled with the flat rate charge or a measured increment?
A. I believe so, yes.
Q. Now, the principle that you assert to the Commission is that this large company is now sharing the loops of the small company and has to be assigned a portion of the loop cost of the small company and put it in measured common carrier line charges; is that correct?
A. No, it does not have to be measured.
Q. It can be flat rated?
A. Yes. Other states use a flat rated carrier common line charge in which they charge interexchange carriers a fixed amount per month per line instead of a traffic sensitive amount which reflects the fact that the line cost is essentially fixed.
Q. Do you advocate to this Commission a flat rated carrier common line charge?
A. That's a reasonable option. I haven't

proposed it in this case but it's another option that's acceptable.

Q. To be consistent with cost causation the carrier common line charge should be flat rated, should it not?

A. That's an acceptable option.

Q. If you're going to be consistent with the cost causation an assignment of nontraffic sensitive expense to an interconnecting carrier customer that charge should be on a flat rate basis, should it not?

A. I do not oppose the concept of a flat rate CCLC, although there are some administrative problems with it. I don't oppose the concept.

Q. This situation you're not worried at all apparently about the additional expense and administrative burden of measuring traffic; is that correct?

A. I don't recall saying that.

Q. I'm asking you. In this situation where you are recommending a usage sensitive carrier common line charge to be assessed against any company that delivers traffic interexchange to another company, your recommendation to this Commission, as I understand it is for a measured carrier common line charge; is that correct?

A. I think if you will read my testimony at one point I did suggest another reasonable alternative as a flat rate carrier common line charge. I do not oppose that concept at all. What I am recommending is either through a measured or a flat rate carrier common line charge a portion of the loop cost be recovered from the interexchange carriers since they share those lines and share the benefit. Whether that is flat rate or per minute is not an issue with me.

Q. In your prefiled testimony in this case is it your testimony that you have recommended a flat rate carrier common line charge to this Commission?

A. Without reading my entire testimony I will state -- I've also testified in Iowa -- I have referred to the fact that in Pennsylvania among other states there is a flat rate CCLC charge and I do not object to that concept. And we can certainly sometime after I'm off the stand see if that is specifically referred to in here, but whether it's referred to in this testimony or in another state I will state that I am not tied to the CCLC charge being a per minute charge if a flat rate charge that is acceptable providing the administrative problems can be worked out.

Q. I understand your testimony at this point this afternoon is that adjoining companies wherein one of the companies provides a toll service or an interexchange service, whatever term you prefer between the two companies, if that service is two-way the companies should charge each other access charges which should contain an assignment of the loop costs of each respective company. Is that a correct understanding of your testimony?

A. Again, assuming that these are the only toll carriers involved, it's a simple little world, the answer is yes, that you would expect that one company would charge a terminating CCLC charge to the other and vice versa.

Q. The only distinction between these two adjoining companies and the two overlapping companies that we previously discussed is just that where access charges apply the two adjoining access charges should not apply where they overlap, and that's the distinction?

A. No. Even when they overlap theoretically you should have a charge if there's a significant difference. Real world experience has been typically payment in kind is more efficient way to handle those circumstances, whereas for toll if you get a call from New York there's no certainty your people are going to call New York back in any equal amount of traffic.

Q. On what principled basis do you recommend that for a call that can be rated either EAS or local or toll between two companies that only in the case when it's rated toll should access charges apply without fail but where it's rated EAS or local by the participating companies charges should only apply if the traffic is out of balance?

A. The principle is really dealing with the cost of measurement. For a toll call which is priced at whatever it is, let's say 20 cents a minute, the cost of measuring that is fairly insignificant compared with the cost of the call. For local service where the costs per call is fairly small, if you impose measuring costs on that you would actually have to have a significantly higher charge. You might have to double your costs for local usage just to cover your measurement as a rough example, and that it's simply inefficient.

Q. The cost of the call, whether it's rated toll or rated EAS is precisely the same, is it not?

A. The cost for what? What portion of it?

Q. We have two adjoining companies that have interexchange traffic between them. The decision whether to rate that call EAS or whether to rate it toll has absolutely no impact upon the costs to deliver that traffic, does it?

A. That's totally false. If you rate it toll you have to record traffic data, when the call originated, the duration of the call, et cetera. You have to process that data. You have to bill that data. Typically toll calls each call shows up separately up on your bill. There are billing and computer costs associated with all of that which are avoided if you have flat rate EAS.

Q. Do those costs that you just mentioned equate to the carrier common line charge which you are advocating in this case for toll rated interexchange calls?

A. No. They are a separate cost but that's not what you asked in your question.

Q. Do the costs other than the measurement and associated billing costs for this traffic change, depending upon whether it's rated, local or toll.

A. The cost of the billing does because typically toll --

Q. Listen to the question. Other than the measurement and associated billing expenses does the cost of the call that is interexchange change depending on whether it's rated local or toll?

A. Assuming identical facilities, no. In the real world, yes. Typically EAS routes are high enough traffic that you can have a direct connection. A lot of times, toll you don't have direct connection so you may be sending it to a tandem, your total route distance maybe longer and you may be going through a tandem switch. It's really due to the nature of the areas where EAS typically occurs.

Q. In your investigation in Washington, have you done any study of how much of the toll traffic, intraLATA toll traffic, provided by U S WEST is direct trunked versus tandem trunked?

A. No.

Q. In a revenue requirement ratemaking environment such as we have in the state of Washington, in my hypothetical, to the extent these two companies can charge measured rates for interexchange traffic rather than flat rate for interexchange traffic they can lower the per monthly charge for their flat-rated services, can they not?

A. I am not sure I understood that question.

Q. Let me try it again. In a revenue requirements environment, these two hypothetical companies, to the extent they can impose a higher per minute usage toll charge on traffic that could be rated either local or toll gives them the ability to lower the rates to their services that remain flat rated. Isn't that correct?

A. You use the term higher. Higher than what?

Q. Higher than the equivalent flat rate on average.

A. I still think it's a confused question. I can try and answer it as I understand it but I think it's confused at this point.

Q. Well, we have agreed that in an interexchange environment, such as we've been discussing there's two options. There can be flat rated and called EAS or local or it can be toll rated on a relatively high cents per minute charge and called toll traffic, right?

A. Those two things are not simply a selection. One occurs when you have a community of interest and that calling is within the community of interest and the other is when you're calling outside of the community of interest, so it's not simply an election that the calling makes.

Q. Are you familiar with the EAS rules of this Commission?

A. Yes. I helped design them.

Q. Are you familiar with the general public

policy statement in those rules that the customers in the state of Washington should be able to place 80 percent of their interstate calls without incurring a toll charge?
A. Yes, sir. Years ago I'm the one that came up with that. I was hired by the Commission staff to prepare a report. One of the recommendations I present in the report was that as an option and that was what was ultimately adopted. So you're talking to the person who came up with the 80 percent figure.
Q. You would agree that to the extent that a toll group is converted to a local route to satisfy that public policy objective revenues are reduced to the company that converts that route?
A. It depends how mechanically it's implemented but typically you would expect to generate less revenue or at least the same revenue after converting from toll to EAS. Sometimes what is done is you will carry more traffic under EAS but collect the same revenue. That's a typical arrangement in many states.
Q. And conversely if you converted an EAS route to a toll route you would have more money and assuming the revenue requirement stays the same you could reduce your flat rated or locally rated rates,

could you not?
A. There may be exceptions but typically that's the circumstance, yes. Everything else the same.
Q. Let's assume that these two hypothetical companies elect to charge relatively high measured rates on the order of your earlier statement of like 20 cents a minute instead of locally rated this traffic. And another entrepreneur enters spying a profit opportunity and provides just a facility between the two switches of the adjoining companies and markets to consumers who make these intercompany or interexchange calls toll service at rates lower than the two existing companies charge. Do you have that hypothetical in mind?
A. Yes, except for the lower. It would not necessarily be lower since he would have to pay -- he or she would have to pay switched access charges to both companies.
Q. We haven't made any assumptions about what these companies pay for access. Let's address that. You would agree that this new entrant would need, in order to operate, interconnection with the existing three companies in my hypothetical, the big company, the little company and the business only company to

route the calls from the customers that elect the interexchange service of this new entrant. That would be a requirement for this company to be in business, would it not?

A. Assuming he's not planning to build a loop to every home and business in that area, yes, he would need to be able to share the loops that are provided by the existing LECs.

Q. In my hypothetical he only plans to build the interexchange facility?

A. Given that assumption then he would have to share the loops of the LECs or else he would not be able to provide toll among all the premises.

Q. And in this situation you urge upon the company -- excuse me, the Commission -- that a significant portion of the loop expense of the three other companies be assigned to the access charges that this new entrepreneur would have to pay to interconnect his facilities with the facilities of the existing carriers, correct?

A. Assuming he chose to share the loops and utilize them and benefit from them he would be expected to pay some small part of the cost of the loops. This Commission uses 16.97 percent for all intrastate toll and switched allocation, so if he was one of two toll carriers he would get -- even if it was split 50/50 he might have to pay 8 or 9 percent of the loop costs for all originating and terminating traffic so it's not a large allocation.

Q. 16.97 percent of the intrastate total loop costs assigned for the category of switched access?

A. No. The allocation this Commission has adopted allocates 16.95 percent of the total loop costs to all intrastate toll and switched access combined, so if you are one of the toll carriers in the state you and all the other toll carriers are paying paying together 16.95 of the loop costs for intrastate access and toll use or sharing of the loops so if you're one of those you're paying less than that of course.

Q. In my hypothetical it is the large company that provides the toll service and the small company does not. Is that in fact the way intraLATA toll service has been provided in the state of Washington, the large company, i.e., the Bell company, provides the toll service and the smaller independent company does not?

A. That's one way it can be provided.

Q. Assuming the hypothetical in this new entry, the existing larger company no longer provides this interexchange service then would the single remaining toll provider bear the entire cost of this allocation you've just discussed?

A. If it was then the only toll provider that was sharing the access lines for intrastate toll and intrastate switched access, yes, it would and under your assumption it would have all the traffic of that type.

Q. Assume this single interexchange carrier merges with the business only local exchange carrier competing for the business service of the large company and bundles its toll service with its business only service and interconnects, as we have previously discussed, through a dedicated facility between the two local switches. Is your testimony that this interexchange carrier combined interexchange business only local carrier should continue to pay 16.9 percent of the other company's loop costs through access charges?

A. For the traffic that it is terminating or originating that is toll traffic that is terminating/originating on the lines owned by someone else, some other company, yes, they will pay a CCLC charge whether it's measured or flat rate as their contribution toward the cost of the loops from which they are benefiting and they are sharing.

Q. And that's your recommendation in this case?

A. Absolutely.

Q. And so the only criterion for assigning a significant portion of the local loop costs of the preexisting company is whether the interconnecting carrier toll rates or flat rates or locally rates their service; is that correct?

A. Yes. For purposes of these allocations, for example, the 16.95, that is the allocation that exists for intrastate toll and switched access. There is another allocation, which is about 58 percent, that exists for local. So if the traffic you are handling is called local, you are involved in that 58 percent allocation. If the traffic you're handling is called intrastate toll or switched access you're involved in the 16.95 allocation. If the track you're handling is called interstate then you're involved in a 25 percent allocation. Each category has a portion of the loop costs to cover and if you're one of the several people or companies in that category you get a part of that cost.

Q. Let me return to the hypothetical. The one interexchange carrier merges with the business only local carrier and provides toll rated service to its customers and provides business only service to local exchange customers. In terms of bearing an allocation of the toll costs of the other company that it's interconnected with, the sole distinction in your testimony is whether or not the service it provides in turn to its customers be toll rated or locally rated; is that correct?

A. No for several reasons. First of all, the fact that a company merges with a local service provider does not change the CCLC charge or requirement for toll. If they are separate companies there actually is a CCL payment that occurs. If it's the same company providing toll as local it's an imputed CCLC charge, so the fact that you are a company that provides local service and toll does not get you out of supporting or making what amounts to a payment from your toll services towards the cost of the local loop. It's called an imputed CCLC instead of an actual one. And the reason it's imputed is no one wants to send a check from themselves to themselves. It's still in there. It's just nobody mails the check so that's the first assumption that's incorrect.

The second assumption is that for some

reason there is an allocation that's different based upon whether you call it EAS or toll. What has happened is you're stepping into a different category. When these allocations were arrived at, for example, 58 percent local and 16.95 toll, that was based upon the data that existed. If you are in one of those categories you are going to support -- if you're in the local category you're going to help support 58 percent of the loop costs. You don't get out of supporting the loop costs. If you're in the toll category you're going to help -- toll switched access category you're going to help support 16.95 percent of the loop costs. So if you move into the local category you're going to send up supporting more of the loop costs than if you stay as a loop carrier.

Q. In the hypothetical how does this business only local exchange provider that uses the residential loops of the company it's interconnected with to complete calls from its business only customers to other residential customers get allocated any portion of the loop costs at 50 percent levels?

A. What do you mean at 50 percent levels?

Q. Didn't you just testify that if you're in the local business you get an allocation of 50 percent to the loop costs?

A. 58 percent is what this Commission has used. The 58 percent goes to local. 16.95 goes to intrastate toll including intrastate switched access and 25 percent to interstate. I should run that out on the calculator to be sure my memory is correct. That should add up to 100.

Q. Redirecting you to the question I asked you, how does this business only local service provider get allocated 58 percent of the local loop cost of the interconnected company?

A. It does not get allocated 58 percent. If it is providing part of the local traffic then it is part of the company that supports the 58 percent. In most cases there was only one company involved in the local traffic so their local rates support the full 58 percent. Under the extended hypothetical you've created you've assumed there are now two companies involved in providing the local traffic in a given area and therefore presumably there would be some method in that situation for them to share that cost, the costs they are benefiting from, but this has nothing to do with anything I'm testifying in this case. What you are doing is subdividing the local category, et cetera, and that's nothing we've addressed in this case.

Q. In reality, in the state of Washington there are overlapping competing local exchange companies wherein the in your entrant hold themselves out only to business customers; isn't that correct?

A. I'm not sure if they say only but I'm sure that's one of their major market goals. I'm not sure they deny they're ever going to provide a residential service.

Q. Talking about today, do you know of any wire line, local exchange competitor of U S WEST that provides residential service?

A. I would have to look at every filing by everyone and I haven't done that. I would agree that they are primarily at least in the initial phases of expansion interested in business but I certainly am not going to testify that they have denied they will ever provide a residential service.

Q. And in your direct testimony and in your testimony you've given this afternoon you are advocating no allocation at 58 percent levels of the loop costs of U S WEST to these local providers, are you?

A. I haven't addressed interconnection between local service providers in this case. That's not even in this docket. There was another docket that this Commission a while back that addressed that issue and that's -- maybe we're in the wrong hearing.

Q. Would you agree that this is a general rate case?

A. Yes.

Q. And that the revenues produced by all of the company's rates for the carrier customers and to end user customers should be designed to add up to the company's revenue requirement in the period that the rates are expected to be in effect?

A. In general, yes, but no one has even addressed the interconnection charges between AECs and LECs in one local area in this case. It's not an issue.

Q. I understand that. Your principal assertion to this Commission is that in setting the rates for both local customers and for toll service that the Commission should allocate the costs of the local loop to those who share the use of that loop; isn't that correct?

A. That's correct, and I have addressed it by the major category areas. If you want to get into how do you subdivide it within the categories, that's a different subject.

Q. Would you agree that there are overlay wireless local exchange providers that interconnect with the wire line public switched network?

A. Cellular providers, for example?

Q. Yes.

A. Yes.

Q. Based upon the principles that you are supporting in this case, do you advocate that a percentage of the local loop that they share in using be allocated to them and paid for by them in interconnection charges?

A. Typically the cellular carriers do pay an interconnection charge for terminating traffic into the LEC's network and although that's not a subject matter of this case but that is typical and appropriate.

Q. Your advocacy to this Commission would be that a portion of the loop expense should be allocated to the interconnection charges paid by wireless carriers; is that correct?

A. Typically to the extent if it was identifiable as toll traffic that would be called toll traffic and they along with any other toll carriers would take care of that part of the loop cost. If it's local traffic then they would be one of those who is helping to support the local portion of the loop cost.

Q. Wireless carriers, it is your testimony provide local loops and therefore do not have to have an allocation of the wire line company's local loops?
A. I don't recall saying that.
Q. Under your recommendations to this Commission, would you urge that wireless carriers be allocated to call a portion of the cost of the loop for their local traffic or not?
A. Of whose loop? The loop of an interconnection LEC that they terminate traffic on?
Q. Yes.
A. Yes. It is appropriate that since they are one of the customers' carriers that is sharing in the local loop that in some manner they contribute towards a portion of the local loop of the LEC that they terminate traffic to.
Q. Just like any other overlay local exchange carrier, correct?
A. Well, cellular is a whole different matter. They get into the problem that sometimes their local service extends over a large geographic area over what is normally called toll so it's a very special circumstance.
Q. Is there any prohibition that you know of by this Commission that forbids an overlay wire line

carrier from defining its local service area differently than the incumbent wire line carrier?
A. I haven't looked at that since it's not anything I've addressed in this case nor have I had any reason to address in this case.
Q. In deciding what principles it's going to apply to rate design and cost assignment for this rate case, do you think it's reasonable for the Commission to consider how it's going to apply these cost assignments and pricing principles to all of the services of the company?
A. Absolutely, and that's why allocating the cost of a shared facility to only one of the benefited services while letting all of the other benefited services use it at no cost whatsoever or shared at no cost whatsoever is incorrect. Whatever is fair for one of the benefited or sharing services should be fair for all, and that's a major problem with U S WEST filings. It's not a major problem with the staff or my filings. We treat everyone equally and fairly.
Q. It's your testimony that you've allocated fair amounts of the local loop expense to all those who share the use of the loop. Is that your testimony?
A. By major categories. We have not --

within, for example, the toll category we have not gone in and said I want to collect this amount from AT&T, this amount from MCI, this amount from Sprint. What we have said is the toll carriers together should support a portion of the loop costs since they together are one of the benefited services. It's called carrier common line access or carrier access line service.

Q. In your testimony you are urging that only the toll carriers be assigned a portion of the loop --

A. That's absolutely false. 78 percent of the local loop costs go to local service. End users under my proposal the vast majority of the local loop costs go to local use customers under my proposal.

Q. You misconstrued my question. U S WEST is the local service provider in reality that we're addressing here, are we not? It bears its own expense of its own plant, it is expected to recover the expense of that plan through charges to customers, correct?

A. Yes.

Q. And one way it recovers its investment is to charge for residential service, correct?

A. That's one of several ways, yes.

Q. And another way it charges rates to

business customers, correct?
A. Correct.
Q. Your testimony is that a portion of the local loop expense used to serve business and residential local exchange customer should be assigned to interconnecting toll carriers, correct?
A. No. A part of the facility cost that is called the common line that is used to serve local customers as well as toll carriers should be recovered -- part of it should be recovered from the local customers, local end user customers and part from the toll carriers.
Q. And this common line, in your terminology, is in fact used by every telecommunications service that it's provided in the state of Washington, is it not, whether by U S WEST or any other provider?
A. Well, first of all the common line is not my term. It's a term that's in U S WEST tariffs and the FCC tariffs. That is the correct term for what we have been calling the loop. It's not my term. If you've ever heard of the carrier common line charge, quote, common line in the middle is referring to the common line.
Q. Can you give me a cite to the Washington intrastate tariffs of U S WEST that use the term

common line as a term synonymous with the local loop?

A. If you will look in your tariff for carrier common line, which is a charge in your tariff, you will see the words common line. If you look at the definition of that service you will find it's a service offered to the interexchange carriers that provides access to the end user over the common line.

Q. Is there any other place in U S WEST tariffs that use the term common line?

A. If you use the term end user common line charge that's another reference to common line. In your interstate tariffs, your interstate carrier common line tariff charge is another reference to common line.

Q. Let's return again to the previous question. Every telecommunications service provided in the state of Washington that either is originated by a U S WEST subscriber or terminates to a U S WEST subscriber uses U S WEST loop plant, does it not, the way that you have defined use?

A. The switched traffic does.

Q. The pay phone traffic of other pay phone providers does, does it not?

A. The pay phone, assuming it's connected to a U S WEST PAL line, is that your question?

Q. Yes.

A. The pay phone traffic of a pay phone provided by another company but connected to U S WEST's PAL line would be putting traffic on the U S WEST PAL line.

Q. Any kind of vertical services provided by U S WEST or any other provider uses the loop plant, does it not?

A. I'm not sure any would. Some of them certainly would.

Q. Can you think of any service that can be delivered by U S WEST other than by using its own loop plant?

A. Nonpub service might be considered a service that's not provided over your loop plan. There would be a very few, however, that are not.

Q. Can you think of anything besides directory services that does not use the loop plan of U S WEST?

A. If you're restricting to U S WEST Communications, the switched loop plant there are private line services that do not use the switched loop plant and that's one reason we need to talk about common line. The common line is the switched common line which is what I am addressing in my testimony. Typically for services that a customer uses in a residence or small business do share the common line.

Q. You have not advocated to this Commission to assign percentages of the loop plan of U S WEST to every service of U S WEST that uses that loop plant or to every other carrier who interconnects with U S WEST whose services use that loop plan, have you?

A. In fact, yes. That is the goal that we have and the concept we have.

Q. Let's take a specific example.

A. If I can finish my answer.

Q. Sure, go ahead.

A. Some of the uses are so small that we don't argue about them. Call forwarding, for example, people occasionally will set up -- will have call forwarding that has some very minor use of their loop. We do not normally split that out as a separate category. However, in my testimony I discuss the high contribution from call forwarding and that's certainly one thing you consider when you look at the overall profitability of residential service is that it's a very profitable service. We don't assign one tenth of one percent of the loop costs to call forwarding but we do consider that profitable when we analyze overall residential profitability, and that's in addition to what I've shown in my testimony as far as profitability of 1FR.

Q. So your recommendation simply comes down to that U S WEST loop plan which I believe you testified is some 41 percent of U S WEST's investment, $1.6 billion is a common cost that should be covered through rates for all other services, including residential services. Is that the sum total of your recommendations?

A. I'm not sure what you mean by all other services. The costs for the loop plant should be shared by the services that benefit and share the loop plant, yes.

Q. Which, as we've previously discussed, are all services except directory services, correct?

A. I am sure there are other exceptions to that but there are a number of services that would fall in that category.

Q. Name any other service that does not under your construction, share this loop plant other than directory services.

A. Burglar alarm line does not share the common line plant because it uses a dedicated loop. There are a number of other examples, and by burglar alarm I'm talking about a dedicated burglar alarm not one with a dialer on it.

Q. Any private line, as we've previously discussed, would share the common loop as you've constructed your argument, any switched private line such as a DIS or a PBX trunk?

A. I think you're mixing terms. PBX trunks are normally considered a type of business basic exchange service. Private line, the typical definition of private line is one that's not connected to the switch network, although as we all know there are hybrids where a private line network gets connected to the switch, but the standard definition of private line means it's not connected to the switch network and therefore would not be sharing the common line. That's why it's important to use the proper term common line, which means the loops on the switch network.

Q. Are there any other services other than point-to-point dedicated private line and directory services that should not be priced to cover the loop plant of the company?

A. I'm sure if I sat down with an index of all of your other services I would find others. I've named two off the top of my head. However, I can state that those services that do share the common line should be considered when pricing the common line not just one of the services that share the common line, which is your company's position.

Q. Let's return to the example of pay phone. U S WEST provided pay phone is connected to the public switched network, would you agree?

A. Yes.

Q. A competitor who provides a public pay phone is connected to the public switched network, would you agree with that?

A. Yes. Assuming he's connected to a PAL line of U S WEST.

Q. Should a portion of the common loop plan in your terminology be assigned to the PAL line and paid for by interconnecting pay phone providers?

A. I think your question was awkwardly asked but I will try and answer it. First of all you don't assign costs to the PAL line. There is a physical cost of the facilities that exists, and the problem we're dealing with is how do you recover that cost that exists. And in the interstate jurisdiction I can tell you 25 percent of the PAL line common line costs are in fact allocated to interstate and recovered in interstate rates, so there is an allocation that exists. All that's left is 75 percent to be recovered in intrastate rates for a PAL line.

Q. Let's talk about intrastate rates for a PAL line. Should a portion of the -- intrastate portion of the common loop plant be assigned to a PAL line in rates paid by interconnecting pay phone providers?
A. That question I don't think is well worded. I don't understand it. The costs we're dealing with are the costs of a facility, a pair of wires. Those costs exist. They're not an allocation of costs. They exist. What we're dealing with is how do you recover those costs among the benefited services.
Q. Is an interconnected pay phone a benefited service of the loop plant of the company?
A. A pay phone by itself is normally not called a service. It's usually local service or toll service so I would say that's an unusual definition of the term service to call a pay phone a service.
Q. Does U S WEST in fact have filed with this Commission tariffs defining its rates charged for pay phone service?
A. On U S WEST's own pay phones?
Q. Yes.
A. The answer is you have several tariffs showing services. You will have a tariff showing a charge for local service or local calls from a pay phone. You will have another tariff or another line

on a tariff that will show calls for toll service from a pay phone. You will have other tariffs that are for operator-assisted service from a pay phone, among others.
Q. Is it your testimony that the fair allocation of the company's loop costs are contained in those rates paid by a pay phone patron?
A. I haven't specifically analyzed the pay phone rates of your company in this case. Other than operator assisted charges, and I believe I made -- had very minimal recommendations there.
Q. You, based upon the company's fully distributed cost study you requested in discovery at page 15 of your direct you stated that the company had a .2 percent return. Is that without considering operator assisted revenues and toll generated from pay phones, that's a .2 percent return from its pay phone operation? Do you recall that testimony?
A. That I believe was a direct quote from the category as your company had prepared it so it's whatever your company put in there is in there. Whatever they didn't isn't.
Q. So you made no investigation of what revenues were included in the pay phone operation of U S WEST?

A. No. As a general rule if I'm not addressing an issue I don't usually spend resources investigating it.

Q. Is it your testimony that pay phone service as provided by U S WEST is underpriced, overpriced or priced just right?

A. Can you show me anywhere in my testimony where I made any recommendation pertaining to pay phone rates.

Q. I believe in your testimony responding to Ms. Murray you seemed to infer that you do not wish pay phone rates to be increased and is that in fact your testimony that you do not want pay phone rates to be increased?

A. No. What I said in that testimony she had prepared an exhibit for one purpose and I was concerned it might be misinterpreted and that is basically all I said. I have not made a recommendation for pay phone rates to be increased, decreased or stay the same. I haven't investigated pay phone rates in this case.

Q. In considering whether pay phone rates are properly set, do you include all of the revenues that you just previously listed at its local operator assisted and toll generated from pay phones?

A. First of all I haven't done any such study.

MR. TROTTER: Your Honor, I guess I will object to the question. We're not taking a position on that issue in this case as far as pay phone services go. We did not retain Mr. Dunkel to do that and so we perceive this as being beyond the scope of his testimony.

MR. SHAW: Well, I don't think it is beyond his testimony at all. Direct on page 15 he says that U S WEST, at least he strongly infers, that U S WEST does not earn enough from its pay phone operations and so I think I'm entitled to explore that.

JUDGE WALLIS: The question is permissible.

A. Can I have the question read back.

Q. Let me restate it in the interests of time. In considering whether U S WEST pay phone operation is priced appropriately, would you consider local call rate, the operator assisted services from pay phones and the toll generated from pay phones in making a fully distributed cost study?

A. You would certainly not consider all of the toll revenues. Typically it would be something like the CCLC portion of those revenues as going towards the cost of the line. For operator assisted that's a strange animal. There are operator costs involved. If the charge for an operator to call is two dollars and the operator cost is one dollar, well, you don't say I'm going to count two dollars of revenue for the pay phone because there are costs of operator assisted service other than the cost of the pay phone. The answer is, one thing I definitely would consider is the 25 percent allocation of both the common line that connects to the pay phone to interstate. That is definitely recovered in the interstate jurisdiction and it should not be recovered in the intrastate jurisdiction. That 25 percent of it should not.

Q. In evaluating whether U S WEST pay phone operation revenues was covering its expenses, would you consider an imputed PAL line?

A. I haven't done that analysis so I really can't say. If I was going to be addressing PAL service or pay phone service I would do extensive discovery to see what the situation was and I simply haven't done that so you're asking for speculation.

Q. The entirety of your testimony seems to be that the costs of services are based upon regulatory accounting rules and separation rules, and is that a fair reading of your testimony?

A. No, it's not. My first testimony is that the floor price of residential basic service, which includes none of the common line costs as TS LRIC rule requires, is a very small cost. It's classified but it's a few dollars.

Q.   Let me direct you back to the question.

MR. TROTTER: Your Honor --

MR. SHAW: Your Honor, doesn't even --

MR. TROTTER: He answered the question and then explained why that wasn't his position so I think it's fair.

MR. SHAW: I just can't agree, Your Honor. I asked him whether or not his recommendations were based upon accounting separation and he said no and then he talked about what his recommendation was, his bottom line recommendation was which doesn't have anything to do with the question.

JUDGE WALLIS: I believe the objection is well taken, and will strike the portion of the answer that was nonresponsive.

A.   The answer is there are several recommendations in my testimony. The one you have been focusing on includes an allocation and it's not an accounting allocation. It's a separations allocation and it is an allocation required by the U.S. Supreme Court. The concept of allocating is required by them. There are other portions of my testimony, in fact, that I really do rely on that do not include allocations. The TS LRIC that I develop for residential basic exchange service does not include an allocation of the common line, which is the same procedure your company uses for toll and switched access, TS LRIC. When that's done the 1FR cost is a few dollars, a very small number of dollars.

Q. The allocations of the so-called common line that you're using are the separations allocations derived from the regulatory separations process; is that correct?

A. In the study that includes an allocation, yes. In the study that does not include an allocation there is no allocation.

MR. SHAW: That's all I have. Thank you.

JUDGE WALLIS: Mr. Harlow.

MR. HARLOW: Thank you, Your Honor.

CROSS-EXAMINATION

BY MR. HARLOW:

Q. Mr. Dunkel, have you read the order of this Commission, the fourth supplemental order granting complaint in part in Northwest Payphone Association et al. versus U S WEST Communications which was docket No. UT-920174?

A. No, I have not. I've read a number of orders such as the term loop order and other orders but not that one.

Q. Are you aware that this Commission established in that order a test that compared the local calling revenues to the local cost of U S WEST of maintaining the pay phone plus an imputed cost for bottleneck monopoly elements?

MR. SHAW: Objection, he said he hadn't read the order.

MR. TROTTER: Join.

MR. HARLOW: Doesn't mean he's not aware of its terms.

JUDGE WALLIS: I will allow him to state whether he's aware of its terms.

A. Not aware of the terms. It's not negligence. I'm simply not testifying on that area in this case and therefore I haven't done the research on the areas that I am not testifying on.

Q. I take it from that answer that you have no opinion on whether or not Ms. Murray's testimony in the imputation analyses comply with the provisions of that order with regard to the revenues that she included in her imputation analysis?

A. No, I do not.

Q. In page 120 of your rebuttal testimony you

advocate including for some purpose operator assisted revenues, toll revenues to support U S WEST's pay phone costs. Do you recall that testimony?
A. My testimony is that it's appropriate that these services support a portion of the pay phone costs since they share the pay phones.
Q. Is it essential in your view that U S WEST be the provider of the pay phone itself in order to obtain the toll and operator service revenues that you refer to in this testimony?
A. Typically if a company provides -- someone other than the LEC provides the pay phone they typically arrange it so they or someone they're affiliated with or someone who will pay them money is the one that receives the operator assisted revenues absent some sort of dial around. That's a typical arrangement. It's not required, though.
Q. So in other words, if U S WEST were to be an entity that would pay money, as you put it, to the independent pay phone provider U S WEST could capture the operator and toll traffic that way without having to actually place the pay phone itself?
A. Yes, although there are exceptions. There's dial around procedures. There's basically the default provider of operator assist and toll that

comes into play. The end users can avoid it in some cases but in some cases they don't.

Q. I take it from some of your answers to Mr. Shaw's cross that you haven't done any analysis to determine what the costs of toll -- what the appropriate imputed costs of toll and operator service toll are to determine what extra revenues, if you will, if any there would be to attribute to the pay phone operation after taking into account the cost of providing the toll and the operator service themselves?

A. No. As you're aware in my testimony, I am really not addressing pay phone rates in this case. That's certainly not a major issue of mine. And I am not aware of anybody who is proposing a change in pay phone rates.

MR. HARLOW: Thank you, Mr. Dunkel. That's all the cross I have.

JUDGE WALLIS: Commissioner questions.

CHAIRMAN NELSON: No.

COMMISSIONER HEMSTAD: No.

REDIRECT EXAMINATION

BY MR. TROTTER:

Q. Mr. Dunkel, you were asked a question by

Mr. Shaw regarding 1.6 billion in I think he referred to it as common costs in relation to the loop. Do you characterize the loop as a common cost or joint cost or what?

A. The official name for what we've been calling the switched loop is the common line and it's called that because it's common to several services and this is what the FCC calls it and the company calls it in their tariffs.

Q. In relation to the term common overhead, would you consider it in that context a joint cost a shared cost or a or a common overhead?

A. It is not a common overhead. It is a cost that is shared by a family of services, although it may be a very large family it is a cost that is shared or joint to a family of services, and as such if you're doing incremental cost study you exclude it, properly exclude it from the cost of any of the services that share it, and that gives you a floor.

However, there's another method which we use which tries to provide a target or guidance to the Commission showing them what the price should be including a reasonable allocation of that shared cost. The TS LRIC excludes shared costs so it gives you a floor which is a very low number to residence, it's a dollar or two. Residence 12 FR service. For toll it's a small number. For switched accesses it's a small number but if you do that you don't cover your joint costs. So we do a second method which says all right, now we've calculated this tiny number that excludes the joint or shared costs, now here's another number that's useful for pricing that does include a portion of the shared costs.

Q. You were asked some questions about the leaky PBX problem. To your knowledge, did U S WEST identify this as a problem in their direct case?

A. Not that I am aware. The leaky PBX problem has been addressed nationwide for years and at least at one time there was a separate charge that was imposed on PBXs because they were leaking toll traffic into the local network and not paying access so they were charged a separate charge to be roughly equivalent to a CCLC or its equivalent.

Q. You were asked several questions involving a hypothetical about a company that just provided one service. Is that hypothetical consistent with the telecommunications industry in this country?

A. No, it's not. What they're proposing is similar to a stand-alone. That is, if you had residential local service and didn't have toll and didn't have switched access you would have to recover the full cost of the loop from basic local service. That's a stand-alone cost. That's a ceiling. That gives you what the ceiling is. Excluding all the shared costs gives you the floor. Including all the shared costs gives you the ceiling and then the reasonable number is somewhere in between. The company studies in this case for residential basic exchange in fact are ceiling costs. They've included 100 percent of the shared costs such as the common line. What that gives you is a number you shouldn't exceed, but not a number that you should be at. Typically you would be between the floor and the ceiling and that's why we do an allocated cost to give the Commission guidance as to where you should be between that floor and ceiling, assuming a reasonable sharing of the shared costs.

Q. And lastly, is it your opinion that the 1FR service is the sole cost causer of the loop?

A. No. And as a matter of fact if you use the definition of TS LRIC that virtually all the economists agree on, they say the way you can tell what causes a cost is to delete that service and see if the cost is deleted by deleting only that service. If you deleted local service and didn't delete toll or switched access you would still need the local loop or the common line. Therefore, the common line is not a cost caused by local service. The company also says there's something called end user access. I don't agree with that as a service, but even if I did that end user access is not the cost causer of the common line because there's another service called carrier common line access that's a service offered to the carriers that allows them to connect to the end user. So even if you call access a separate service you would have end user access and carrier common line access as two different access services sharing the same line facility, and so if you deleted end user access while not deleting carrier common line service you would still need the common line. So no matter how you play the game common line is not a cost caused by local service or end user access. Because if you delete either one of those while keeping all other services you still have that cost.

MR. TROTTER: Nothing further. Thank you.

MR. SHAW: Two questions prompted by Mr. Trotter's redirect.

RECROSS-EXAMINATION

BY MR. SHAW:

Q. In the cost studies that the company has presented in this case did it have any assignment of common costs to 1FR service?

A. The ADSR service -- ADSRC costs you have included do not include the common overhead costs nor did the ASIC.

Q. Can you just answer the question? Did the company include any common costs in its cost studies?

A. I will explain my problem. I'm working in several U S WEST states at the same time. I do not recall one of your exhibits showing an FAC, which is what you call it when you include an allocation of common costs so the answer would be look at your schedules. If you see ADSRC it does not include an allocation of common costs, if it says FAC it does.

Q. Finally, in your discussion with Mr. Trotter about if you withdrew a service whether the cost would go away, are you aware that the Commission has asked and the company has agreed to file a link or unbundled loop tariff in the state of Washington?

A. Yes, I am. And that is a tariff payable by carriers. So if anything that says the unbundled loop cost is billable to carriers not to the end user.

Q. You're not asserting that the rate for an unbundled loop should contain anything less than the full cost of the loop, are you?

A. No, I'm not. The rate for the unbundled loop should cover the full cost of the loop.

Q. Thank you, that's all I have.

A. However, that does not mean the end user service provided over that loop has to cover the full unbundled cost of the loop because the other companies are going to provide a bundled package. They're going to provide toll, local and a package of other services over that loop and they will split the cost of the unbundled loop among those services the same way U S WEST does.

MR. SHAW: That's all I have.

JUDGE WALLIS: Is there anything further? Let the record show that there is not. Mr. Dunkel, thank you for being with us today. You're excused from the stand at this time.

(Hearing adjourned at 6:17 p.m.)