

**BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION
COMMISSION**

IN THE MATTER OF CONTINUED)	
COSTING AND PRICING OF)	DOCKET NO. UT-003013
UNBUNDLED NETWORK ELEMENTS,)	<i>Part A</i>
TRANSPORT, TERMINATION, AND)	
RESALE)	

REBUTTAL TESTIMONY

OF

CARL INOUYE

Lead Director – Financial Advocacy

ON BEHALF OF

QWEST CORPORATION

August 4, 2000

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

2 My name is Carl Inouye and my business address is 1600 7th Avenue, Seattle, Washington,
3 98191.

4
5 **Q. PLEASE STATE YOUR POSITION AND RESPONSIBILITIES WITH QWEST**
6 **CORPORATION (“QWEST” OR “COMPANY”).**

7 A. I am employed by Qwest as Lead Director-Financial Advocacy. In that capacity I am
8 responsible for the presentation of financial matters before the state regulatory commissions
9 that regulate Qwest.

10

11 **Q. PLEASE DESCRIBE YOUR EDUCATION AND PROFESSIONAL**
12 **EXPERIENCE.**

13 A. Exhibit CTI-2 attached to this testimony, describes my education and professional
14 experience.

15

16 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

17 A. The purpose of my testimony is to respond to the testimony of Staff witness Spinks with
18 respect to the Company’s earnings.

19

20 **Q. REFERRING TO MR. SPINKS’ TESTIMONY AT PAGE 8 THAT OSS COSTS**
21 **CAN BE PRESUMED TO HAVE BEEN RECOVERED IF QWEST MET OR**
22 **EXCEEDED IT AUTHORIZED RATE OF RETURN, DO YOU AGREE?**

23 A. No, I do not. First, as Mr. Reynolds explains in his testimony, consideration of OSS cost
24 recovery in this docket should not be predicated on a rate-of-return review such as that

1 employed by Mr. Spinks. Second, I believe Mr. Spinks incorrectly applies rate of return
2 regulation principles.

3

4 **Q. UNDER QWEST'S RATE-OF-RETURN PRINCIPLES, IS IT APPROPRIATE TO**
5 **EVALUATE A SPECIFIC PROPOSAL, SUCH AS OSS COST RECOVERY**
6 **BASED ON A "STATIC" EARNINGS CALCULATION?**

7 A. No.

8

9 The 9.36% referred to by Mr. Spinks is the particular rate of return used by the
10 Commission in Docket No. UT-950200 for the purpose of setting rates. It was developed
11 in the context of Docket UT-950200 and its purpose was only for setting rates at the time
12 of Docket No. UT-950200. Its purpose was not in any way to act as an authorized limit
13 on the Company's earnings in the post UT-950200 period. Mr. Spinks cites no authority
14 for his testimony that 9.36% is Qwest's "current" authorized rate of return.

15

16 **Q. WHY IS IT INAPPROPRIATE TO CONSIDER AN AUTHORIZED RATE-OF-**
17 **RETURN OUTSIDE THE CONTEXT OF A RATE CASE?**

18 A. The Commission does not regulate the Company's level of earnings on a monthly or even
19 an annual basis, but rather does so only indirectly through the occasional setting of rates
20 in a rate case proceeding. The actual rate of return that results from a schedule of rates
21 may be higher or lower than the rate of return that was used to set rates. Just as the
22 Company is not guaranteed that it will earn the rate of return used by the Commission to
23 set rates, the "authorized rate of return," as Mr. Spinks appears to use the term, does not
24 act as any sort of "authorized" level of earnings.

1

2 One reason why the rate of return used to set rates has no continuing relevance is because
3 the rate of return used to set rates is determined at a point in time.¹ Capital costs,
4 however, fluctuate over time.

5

6 **Q. DOES IT MAKE ANY SENSE THAT 9.36% WOULD BE RELEVANT FOR**
7 **DETERMINING OVER OR UNDER-EARNING IN 1998 OR 1999 AS MR.**
8 **SPINKS ATTEMPTS ON PAGE 9 OF HIS TESTIMONY?**

9 A. No, it does not. It is unreasonable to make a judgment as to the Company's earnings
10 between rate cases without also considering changes in capital costs.

11

12 The 9.36% rate of return was set in Docket No. UT-950200 using cost of capital market
13 data from 1995. It does not make any sense that a determination of over-earnings in 1998
14 and 1999 would be made on any other basis than using 1998 and 1999 cost of capital
15 market data.

16

17 **Q. HAS ANOTHER STATE COMMISSION RECOGNIZED THAT THERE IS NO**
18 **SUCH THING AS AN AUTHORIZED RATE OF RETURN BETWEEN RATE**
19 **CASES?**

20 A. Yes. The Oregon Public Utility Commission has stated:

21

¹ In actuality, the Commission determines a range of reasonable rates of return and picks a single point within the range of reasonableness for the purpose of setting a schedule of rates.

1 Capital costs fluctuate continuously. A reasonable rate of return
2 fixed in a rate proceeding is for the purpose of setting a particular
3 schedule of rates and has no ongoing function. To use it as a
4 benchmark for measuring the reasonableness of the company's
5 earnings at some other point in time is inappropriate. (Order No.
6 88-442, Public Utility Commission of Oregon, April 14, 1988,
7 attached as exhibit CTI-3.)

8

9 **Q. CAN A DETERMINATION OF OVER OR UNDER-EARNINGS BE MADE**
10 **OUTSIDE OF A RATE CASE PROCEEDING?**

11 A. No. Such a determination is a time consuming process, highly complex and often
12 controversial. In my opinion, a determination by the Commission can only be made in a
13 rate case proceeding.

14

15 **Q. MR. SPINKS CLAIMS TO PRESENT EVIDENCE OF OVER-EARNINGS. HAS**
16 **MR. SPINKS FAIRLY REPRESENTED THE COMPANY'S FINANCIAL**
17 **REPORTS?**

18 A. No, he has not. Qwest files monthly financial reports with the Commission. The 1998
19 and 1999 year-end financial reports, which apparently Mr. Spinks relies upon, are
20 attached as Exhibit CTI-4. Mr. Spinks ignores the portion of the report that shows the
21 Company's "normalized" rates of returns of 9.77% in 1998 and 9.53% in 1999.

22

23 **Q. WHAT ARE THE "NORMALIZED" RATES OF RETURN?**

24 A. The Company's financial results include adjustments that relate to other time periods that
25 are routinely "normalized" out of financial results. The Company provides this
26 information monthly to the Staff, including a detailed specification of the "normalized"
27 calculation. It is incomprehensible that Mr. Spinks would acknowledge that such

1 information exists and then ignore it in his calculations.

2

3 **Q. DO YOU AGREE WITH MR. SPINKS CLAIM THAT QWEST OVER-EARNED**
4 **BY \$72 MILLION IN 1999?**

5 A. Absolutely not. Mr. Spinks has not provided the details of his \$72 million calculation.
6 However, it appears to be consistent with the 12.67% rate-of-return that Mr. Spinks
7 claims is the relevant rate of return. As I stated above, the “normalized” 1999 rate-of-
8 return was 9.53%. Obviously, Mr. Spinks would be unable to assert \$72 million of over-
9 earnings based upon the 9.53%.

10

11 **Q. WOULD MR. SPINKS BE ABLE TO ASSERT ANY LEVEL OF OVER-**
12 **EARNING IF EARNINGS WERE COMPARED TO THE COMPANY’S 1999**
13 **COST OF CAPITAL?**

14 A. No, he would not be able to do so because the Commission has made no determination of
15 a reasonable rate of return that is reflective of 1999 capital market data. Such a
16 determination would normally not be made except in a rate proceeding.

17

18 **Q. WOULD THE SAME BE TRUE FOR ANY CALCULATION OF 1998 OVER-**
19 **EARNINGS?**

20 A. Yes, it would be.

21

22 **Q. EVEN IF THE COMMISSION WAS TO DETERMINE THAT THE RATE**
23 **RETURN FROM DOCKET NO. UT-950200 WAS RELEVANT, COULD A**
24 **DETERMINATION OF OVER-EARNINGS BE MADE?**

1 A. No. Mr. Sprinks ignores that determination of reasonable earnings is not an exact science,
2 but rather a determination of a range of reasonableness. The fact of the matter is that the
3 Commission in Docket No. UT-950200 determined that at that time a reasonable return
4 on equity was in the range of 11% to 12.7%. That determination recognized that a
5 determination of the Company's cost of capital cannot be done with specificity. The
6 range of returns on equity translates into a range of rates of return between 9.21% and
7 10.095%.

8

9 In other words, earnings between 9.21% and 10.095% are within a range of
10 reasonableness where no determination over-earnings could be made. The Company's
11 1998 and 1999 normalized rates of return fall within that range of reasonableness.

12

13 **WHAT IS YOUR RECOMMENDATION WITH REGARD TO THIS TESTIMONY?**

14 A. First and foremost, the Commission should reject Mr. Sprinks' attempt to link OSS cost
15 recovery with Qwest's rate-of-return, based on the reasons cited in Mr. Reynolds' and Ms.
16 Million's testimony. If the Commission is interested in pursuing the rate-of-return issue,
17 it should do so only in the context of a proceeding that can produce all of the necessary
18 information for such a review and not based on the cursory analysis contained in Mr.
19 Sprinks' testimony.

20

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

22 A. Yes.

23

Carl Inouye
Witness Qualifications

Present Employment:

Lead Director – Financial Advocacy
Responsible for regulatory matters of a financial nature in the states USWC operates

Academic Experience:

BA – University of Washington, Economics
BS – University of Washington, Mechanical Engineering
MA – University of Washington, Economics

Prior Work Experience:

1974-1977: Pacific Northwest Bell Telephone Company, Business Research Section; responsible for economic and econometric studies

1978-1981: AT&T; managed preparation of witnesses and their economic studies for the U.S. v. AT&T antitrust suit that led to the breakup of the Bell System, worked in areas of financial effects of divestiture on the Bell System, network planning and operations, demand and cost modeling, organization theory and design, and research and development.

1992-1987: U S WEST Communications; worked in various positions in finance and treasury involving long term debt financing, jurisdictional separations, acquisitions, financial planning

Testifying Experience:

Oregon:

UT 80: Alternative Form of Regulation
UT 85: general rate case
UM 295: research and development policy
UP 96: sale of telephone exchanges to PTI
UT 119: collocation tariff
CP 1, 14, 15: entry of local exchange competitors
UM 351: pricing and costing policy
UT 125: general rate case

Utah:

91-049-13: deregulation of voice messaging
92-049-05: general rate case
94-049-08: general rate case
95-049-05: general rate case
97-049-08: general rate case
92-999-04: adoption of SFAS 106
93-049-22: adoption of SFAS 112
94-049-02/03: sale of exchanges
89-049-11/21: contribution expenses on remand
88-049-18: tax reform act on remand
93-999-01: competitive entry and regulatory reform

Washington

UT-961596: sale of Bellcore
UT-970766: general rate case

UT-980948: directory imputation
UT-991358: Qwest/U S WEST merger

Idaho

USW-S-96-5: general rate case

Arizona

T-01051B-99-0497: Qwest/U S WEST merger