EXHIBIT PEG-10RT

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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

REBUTTAL TESTIMONY OF

PHILIP E. GRATE

ON BEHALF OF

QWEST CORPORATION

APRIL 17, 2003

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IDENTIFICATION OF WITNESS

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Philip E. Grate. My business address is 1600 Bell Plaza, Room 3008, Seattle, Washington 98191.

Q. ARE YOU THE SAME PHILIP E. GRATE WHO FILED DIRECT TESTIMONY IN THIS PROCEEDING?

A. Yes.

PURPOSE OF TESTIMONY

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

A. The purpose of my testimony is to rebut various facts asserted, arguments made and conclusions reached in the direct testimonies of:

- Dr. Lee Selwyn on behalf of the Staff of the Washington Utilities and Transportation Commission (hereinafter referred to as "Staff");
- Michael Brosch on behalf of the Washington Attorney General – Public Counsel Section, AARP and Washington Electronic Business & Telecommunications Coalition (hereinafter referred to collectively as "Public Counsel"); and
- Charles W. King, on behalf of the United States Department of Defense and all other Federal Executive Agencies (hereinafter, "DOD").

I will refer to them collectively as the "opposing parties."

Q. THROUGHOUT THE REMAINDER OF THIS TESTIMONY, HOW WILL YOU REFER TO THE ENTITIES INVOLVED?

A. I will refer to Qwest Corporation, the provider of telecommunications services in Washington, as "QC." I will refer to QC's predecessors in Washington, which include U S WEST Communications, Pacific Northwest Bell Telephone Company, The Pacific Telephone and Telegraph Company, Sunset Telephone and Telegraph Company, and several other corporations as "the Company." I will refer to QC's corporate parent, Qwest Services Corporation, as "QSC." I will refer to QSC's directory subsidiary, Qwest Dex, Inc., which is being sold and which is the subject of this proceeding, as Dex. I will refer to as Qwest Communications International Inc., QSC's parent corporation and the ultimate parent of QC and Dex, as "QCI."

Q. WHAT PARTICULAR ISSUES WILL YOU ADDRESS?

A. I will address assertions and arguments made by Dr. Selwyn, Mr. Brosch and Mr. King concerning:

- the significance of the longstanding subsidy that directory operations has provided ratepayers in the determination of how the gain should be allocated between owners and ratepayers;
- the application of the principles of gain allocation on the disposition of assets set forth in *Democratic Central Committee of the District of Columbia v. Washington Metropolitan Transit Commission,* 458 F. 2d 786 (D.C. Cir. 1973), reh den, cert den, 415 US 935 (1973) (hereinafter "*DCC")* and its progeny, *Illinois Public Telecommunications Association v. Federal Communications Commission and United States of America,* 326 U.S. App. D.C. 1 at 43: 117 F3d 555; (July 1, 1997) (hereinafter "*IPTA*");
- the changes in the regulatory scheme in Washington over time, the history of the Company's telephone operations and directory publishing operations in Washington and the resultant shifting of risks and burdens between shareholders and ratepayers;
- the attribution of sources of the gain from the sale; and,
- the recommendations regarding the disposition of that gain.

I will also provide rebuttal to specific arguments that each witness raises and facts that each witness asserts.

RATEPAYER SUBSIDY AND RATEPAYER HARM

Q. HAS THE DIRECTORY PUBLISHING BUSINESS THAT IS NOW PART OF DEX PROVIDED WASHINGTON RATEPAYERS A SUBSIDY?

A. Without question. Mr. King makes this very point where he concludes:

> Clearly, one of the reasons that US WEST, and now Qwest, received the directory function, rather than AT&T, was to "subsidize" local telephone rates.[1]

Exhibit PEG-4 to my direct testimony sets forth the history of revenues and expenses from directory operations between 1914 and 1984. It shows that from 1918 forward, the Company's revenues from sales of unregulated directory products exceeded directory expenses. Once the Commission established effective cost-of-service regulation in Washington in 1923, the Washington portion of the excess of revenues from unregulated directory services over the costs of producing and distributing directories that was includable in rates was a subsidy to ratepayers of regulated telephone service. The publishing fees the Company has received since 1984 and the imputations the Commission has ordered have also provided a subsidy to telephone service rates.

Q. DOES THE FACT THAT THIS SUBSIDY HAS BEEN LONGSTANDING SUGGEST THAT RATEPAYERS ARE ENTITLED TO THE GAIN ON THE SALE OF DEX?

A. No. It suggests just the opposite. The D.C. Circuit Court explained the doctrinal considerations of utility asset gain allocation as follows:

> IV BASIS FOR ALLOCATION OF CAPITAL GAINS ON OPERATING UTILITY ASSETS

[1] Direct Testimony of Charles W. King, dated March 18, 2003 ("King"), page 10, lines 15 and 16.

> * * *
>
> A. Doctrinal Considerations
>
> The ratemaking process involves fundamentally "a balancing of the investor and the consumer interests." The investor's interest lies in the integrity of his investment and a fair opportunity for a reasonable return thereon. The consumer's interest lies in governmental protection against unreasonable charges for the monopolistic service to which he subscribes. In terms of property value appreciations, the balance is best struck at the point at which the interests of both groups receive maximum accommodation. We think two accepted principles which have served comparably to effect satisfactory adjustments in other aspects of ratemaking can do equal service here.
>
> One is the principle that the right to capital gains on utility assets is tied to the risk of capital losses. The other is the principle that he who bears the financial burden of particular utility activity should also reap the benefit resulting therefrom. The justice inherent in these principles is self-evident…[2]
>
> * * *
>
> The allocation between investors and consumers of capital gains on in-service utility assets, we have declared, rests essentially on equitable considerations. The allocative process, we have said, necessitates a delicate balancing of the interests of investors and consumers in light of the governing equitable principles. The constant effort must be a distribution of the gains as fairness and justice may require. In particular instances, however, the direction in which the equities lie is so vividly marked by the circumstances of the case that the allocation properly to be made emerges plainly.[3]

As I explain in my direct testimony, the Company pioneered telephony in Washington from 1883 to 1923, a 40-year time span characterized by substantial periods of head-to-head competition in local and long distance service, poor earnings, and regulatory indifference to the Company's financial wellbeing.

In the Company's 1916 Washington rate case, the Commission found that that vast majority of the Company's exchanges operated at a loss and that the Company's rates in the aggregate did not show an adequate rate of return. The available evidence also suggests the Company endured poor earnings from 1913 through 1922.

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[2] *Democratic Central Committee of the District of Columbia v. Washington Metropolitan Transit Commission,* 458 F. 2d 786, 806 (internal footnotes omitted).
[3] *Id.,* at 807 (internal footnotes omitted).

The first 40 years was a period in which local and state regulators did not act to make ratepayers financially responsible for the Company's financial security. Local regulation - in the guise of a price cap - was concerned with protecting the interests of local ratepayers and showed no apparent regard for the Company's financial wellbeing. At pages 11 through 15 of Exhibit PEG-3 I recount in detail that State regulators did not act to raise the Company's rates when they became aware of the Company's poor earnings. They chose, instead, to let the Company fend for itself. The Commission's predecessors did not set rates based on achieving a sufficient and reasonable rate of return until 1923. Notably, no witness has offered testimony suggesting otherwise.

The Company established its directory publishing operation and its directory advertising business during this often financially unrewarding and competitively challenging 40-year period, not, as some witnesses would have the Commission believe, during the period of monopoly and cost-of-service based rates that was to follow. Without any risk to, or burden on, ratepayers during this 40-year period, the Company developed an unregulated advertising business. The available evidence shows it did not generate positive margins until the last five years of this 40-year period. The evidence also shows that ever since the Department of Public Works brought the Company under effective cost-of-service regulation in 1923, this business has generated unregulated revenues that have always provided ratepayers a subsidy. No witness has offered evidence to refute these facts either.

It is certainly understandable why the opposing parties would prefer that the Commission ignore this 40-year period and focus instead on the period of growing subsidies that followed. As I will discuss, none of these witnesses is able to offer any evidence that ratepayers bore any of the risk of pioneering and developing telephony in Washington during this 40-year period. None of these witnesses has shown that Washington ratepayers bore any of the burden of the Company's operations (including its directory operations) during this period. None has suggested ratepayers had any financial responsibility whatsoever in creating the Company or in creating the directory operation that provided them a subsidy.

Here, the equities are vividly marked by the circumstances. If the revenues from unregulated directory products and services produced a subsidy, then it necessarily follows that ratepayers were not supporting the directory operations with the rates they paid; it was just the opposite. Ratepayers have been recipients of financial benefits from directory operations, not providers of financial resources to it. Furthermore, over the first 40 years of the Company's history in Washington, ratepayers took none of the risks and bore none of the financial burden of starting and establishing either the Company or its directory operations in Washington.

Witnesses Selwyn and Brosch identify linkages between the Company's directory operation and the telephone operation. However, they ignore the fact that the Company's owners bore all the risk of capital losses and all the financial burden of establishing the telephone operation (including the directory operation). The owners bore the risk of capital losses and burden of <u>all</u> of the Company's operations (including its directory operations and advertising business) during the first 40 years of the Company's existence in Washington. Under these vividly marked equities, the owners who created and established the subsidy-providing directory publishing business are entitled to the gain, not the recipients of the subsidy.

Q. PLEASE EXPLAIN WHAT THE CURRENT REGULATORY SCHEME SUGGESTS ABOUT RATEPAYERS' ENTITLEMENT TO THE GAIN ON THE SALE OF DEX.

A. During U. S. District Court Judge Harold Greene's evaluation of the Modification of Final Judgement (MFJ) that caused the 1984 divestiture of Bell Operating Companies from

AT&T, he determined that Yellow Pages should be assigned to the Operating Companies instead of AT&T, as had been proposed. His principal reason was not to provide the Operating Companies a subsidy. Rather, his primary concern was for competition:

> [T]he prohibition on directory production by the Operating Companies is distinctly anticompetitive in its effects, for at least two reasons. In the first place, the production of the Yellow Pages will be transferred from a number of smaller entities to one nationwide company -- AT&T. This type of concentration is itself anathema to the antitrust laws. Furthermore, possession of the franchise for the printed directories will give AT&T a substantial advantage over its competitors in providing electronic directory advertising -- a market in which the Operating Companies will not be engaged.[4]

However, Judge Greene was not unmindful of the subsidy Yellow Pages would provide to the Operating Companies:

> In addition to these factors directly related to competition, there are other reasons why the prohibition on publication of the Yellow Pages by the Operating Companies is not in the public interest. All those who have commented on or have studied the issue agree that the Yellow Pages provide a significant subsidy to local telephone rates. This subsidy would most likely continue if the Operating Companies were permitted to continue to publish the Yellow Pages.[5]

The prevailing regulatory scheme in 1982 was what is commonly known as "traditional" regulation, that is, cost-of-service regulation over companies that hold monopolies in the markets they serve. Judge Greene was well aware of this monopoly:

> After the divestiture, the Operating Companies will possess a monopoly over local telephone service. According to the Department of Justice, the Operating Companies must be barred from entering all competitive markets to ensure that they will not misuse their monopoly power.[6]

He also understood the effect of Yellow Pages on rates under traditional regulation:

> The loss of this large subsidy would have important consequences for the rates for local telephone service.[7]

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[4] *United States of America v. American Telephone and Telegraph Company*, 552 F. Supp. 131, 193 (U.S. District Court, 1982)
[5] *Id. at* 193 (internal footnotes omitted).
[6] *Id*. at 224.
[7] *Id*. at 193.

However, Judge Greene also foresaw the coming of competition and the loss of the Operating Companies' monopoly power:

> It is probable that, over time, the Operating Companies will lose the ability to leverage their monopoly power into the competitive markets from which they must now be barred.[8]

In 1982, when Judge Greene's issued the landmark ruling, the Operating Companies enjoyed continuing access line growth and faced virtually no local service competition. Commercial wireless service was just beginning to establish itself. A small portion of the population carried around portable "bag" and "brick" phones that provided expensive and unreliable analog cellular service. Cable companies provided nothing but cable TV service.

More than 20 years have passed since Judge Greene issued his MJF ruling. On April 11, 1996, shortly after the passage of The Federal Telecommunications Act of 1996 (the "Act") Judge Green vacated the MFJ.[9] The Act made it illegal for the Operating Companies to maintain monopolies over local service. Two years before the Act, the Washington courts had confirmed that the Company did not have a *de jure* monopoly in Washington.[10] The Commission and the FCC have found that Qwest can no longer "leverage…monopoly power into the competitive markets" from which the MFJ barred it; The Commission and FCC have concluded QC has satisfied the fourteen-point check-list required under section 271 of the Act to show that Qwest has opened its network to competition in Washington. Qwest now provides access to its network and sells its competitors unbundled network elements and retail services at wholesale prices. Cable television companies continue to

[8] *Id*. at 194.
[9] Order in Civil Action No. 82-0192, *United States of America v. Western Electric Company, Inc. et. al.,* United States District Court for the District of Columbia, April 11, 1996.
[10] *In the Matter of the Consolidated Cases Concerning the Registration of Electric Lightwave, Inc. and Registration and Classification of Digital Direct of Seattle, Inc. Electric Lightwave, Inc., et. al, Respondents, Washington Independent Telephone Association, et. al, Appellants, v. The Washington Utilities and Transportation Commission*, 123 Wn.2d 530; 869 P.2d 1045 (1994).

offer telephony to more customers every day. And many people rely on their pocket size PCS wireless telephones as their primary source of local and long distance voice telephony.

In 1982, virtually none of the Company's services were competitive. Washington law now allows telecommunications companies to petition to have services classified as competitive telecommunications services (CTS). Among the Qwest services that the WUTC has classified as CTS statewide are: Centrex Features; Speed Calling; Intracall (Intercom); Calling Card; Toll; Toll Operator Surcharges; and Directory Assistance. Among the services the WUTC has classified as CTS by location are: High Capacity Circuits (DS1, DS3, SONET, SHARP, SHNS, etc.) at Seattle Elliott, Main, Campus, Duwamish, Bellevue Glencourt, and Downtown Spokane; and Business Basic Exchange Services (all access line arrangements and vertical features that are technically provisioned over DS1's or above) at Seattle, Bellevue, Spokane, Vancouver.
For the first time since the Great Depression, Qwest access line counts in Washington are on the decline. Between the end of 2000 and the end of 2002, Qwest access lines in Washington decreased by a net of approximately 111,000.

The ubiquitously non-competitive, cost-of-service regulated monopoly for which Judge Greene determined a subsidy was appropriate no longer exists. Subsidizing ratepayers may have made sense when Qwest held a monopoly over its markets. But it is not necessary now that all of Qwest's markets are fully and undeniably open to competition.

Washington ratepayers have long enjoyed the benefits of the subsidy from the directory business. However, being the recipients (not the providers) of a subsidy that may have been reasonable historically does not support their entitlement to the gain on the subsidy-providing business now when the telecommunications marketplace is completely and undeniably open to competition.

Q. IS IT NECESSARY FOR THE SUBSIDY TO CONTINUE IN ORDER TO AVOID HARMING RATEPAYERS?

A. No. It is self evident that it is harder for competitors to compete against prices that are subsidized than against prices that are not. It follows that subsidizing services that do not yet qualify as CTS will tend to delay or possibly prevent them from becoming sufficiently competitive for the Commission to grant them CTS status. Consequently, the Commission would be fully justified in finding that ratepayers will suffer no harm if the subsidy is removed.

However, if the Commission believes that the public interest requires the continued subsidization of that are not CTS (hereinafter "tariffed") services, it is necessary and appropriate for the Commission to consider what level of subsidy these services still require and for how much longer. It is also necessary and appropriate for the Commission to determine what amount of gain would be required to provide the level of subsidy the Commission believes is necessary to prevent ratepayer harm over the period of time the Commission believes the subsidy remains necessary.

The number of services qualified as CTS in Washington has increased over time. If that historical trend continues in Washington, the percentage of Qwest's Washington revenues from tariffed rates subject to cost-of-service regulation is almost certain to continue declining. Of course, services are more likely to become CTS qualified if the Commission does not use subsidies to set rates that create price barriers to competition.

GAIN ALLOCATION PRINCIPLES AND FACTS

Q. IN YOUR DIRECT TESTIMONY, YOU RELY ON THE PRINCIPLES SET FORTH IN *DCC* AND *IPTA* TO DETERMINE WHO SHOULD RECEIVE THE GAIN ON

THE SALE OF DEX. DO THE OPPOSING PARTIES ASSERT THAT THESE CASES ARE NOT AN APPROPRIATE BASIS FOR DETERMINING WHO SHOULD RECEIVE THE GAIN?

A. No. None of these witnesses has asserted that the principles of *DCC* and *IPTA* are inappropriate for determining who should receive the gain.[11] Dr. Selwyn affirmatively endorses reliance on them where he testifies, "[T]he Commission should apply the principles set forth in the landmark federal court decision, *Democratic Central Committee of the District of Columbia v. Washington Metropolitan Transit Commission.*"[12] My direct testimony quotes the relevant portions of both cases and I will not repeat the quotes here.

Q. WHAT ARE THE PRINCIPLES SET FORTH BY THESE CASES?

A. These cases establish eight identifiable principles:

1) Ratepayers pay for service and thus do not acquire <u>any</u> interest, <u>legal or equitable</u>, in the property of a utility company.[13]

2) Utility property belongs to the utility company.[14]

3) Neither ratepayers nor the utility company (and thus its shareholders) are <u>necessarily</u> entitled to increases in the value of assets employed in the utility's operations.[15]

4) Increases in the value of assets employed in the utility's operations are to be <u>allocated</u> under a two-step test in which the court first asks which party bears the risk of loss on the

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[11] In her testimony Ms. Koehler-Christensen describes how to appropriately calculate the gain to which these principles should be applied.

[12] Direct Testimony of Dr. Lee Selwyn, dated March 18, 2003 ("Selwyn") at page 55, lines 18 to 20, emphasis added.

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

[14] *Id*.

[15] " Investors, we have concluded, are not automatically entitled to gains in value of operating utility properties simply as an incident of the ownership conferred by their investments. And it goes without saying that consumers do not succeed to such gains simply because they are users of the service furnished by the utility." *Democratic Central Committee of the District of Columbia v. Washington Metropolitan Transit Commission,* 458 F. 2d 786, 805 (D.C. Cir. 1973), reh den, cert den, 415 US 935 (1973).

assets. The party that bore the risk of loss is the party entitled to the capital gains on the assets.[16]

5) Only if it is difficult to determine who bore the risk of loss will the second principle come into play, namely, that those who bear the financial burden of particular utility activity should also reap the benefits resulting therefrom.[17]
6) Which party bore the risk of loss of an asset or the burden of a utility activity is a question of fact.[18]
7) Which party bears the risk of loss and burden may change over time, depending on the regulatory scheme in place.[19]
8) Some regulatory schemes impose the risk of loss and burden on ratepayers and some (price caps regulation, for example) do not.[20]

Q. HOW DO THESE PRINCIPLES APPLY IN THIS CASE?

A. Because ratepayers do not acquire any interest, legal or equitable, in the property of a utility company, and because utility property belongs to the utility, there is no presumption that the gain on the sale of a utility business belongs to ratepayers. As my testimony will show, opposing parties incorrectly rely on just such a presumption.

Because neither shareholders nor ratepayers are necessarily entitled to increases in the value of assets employed in the utility's operations, it is necessary for the Commission to determine ratepayers' and shareholders' compensatory interest in the business being sold by applying the two-step test set forth in *DCC* and *IPTA*. These tests are not whether integral linkages existed between the telephone business and the business being sold. The tests do

[16] *Illinois Public Telecommunications Association v. Federal Communications Commission and United States of America*, 326 U.S. App. D.C. 1, 43, 117 F.3d 555 (1997).
[17] *Id.* at 44.
[18] *Id*. at 45 and 46.
[19] *Id*. at 45.
[20] *Id.* at 45 to 47.

not ask whether there has been a longstanding history of a subsidy flowing from the business being sold to the ratepayers of the telephone business. The tests are not about whether the telephone business operated as a monopoly (whether franchised or not). Nor do these tests require a <u>quantification</u> of risks borne, losses incurred, or the amount of the financial burdens borne.

Instead, the two-step test recognizes that shareholders are the owners of the utility's assets, but a regulatory scheme can require ratepayers to compensate the owners for the loss in the value of their assets. If the regulatory scheme obligates ratepayers to compensate owners for capital losses on particular assets, then equity dictates that ratepayers be entitled to the gain on the same asset as compensating for bearing the risk of the capital loss.

There is also a time dimension involved. The principles recognize that the risk of capital loss can shift over time. Consequently, the shifting of risk of capital loss over time must be evaluated to allocate the gain and thereby protect the interests of both shareholders and ratepayers.

Only if it is difficult to determine who bore the risk of capital loss on the assets does the question of who bore the financial burden of the regulatory activity come into play. Under the principles of *DCC* and *IPTA*, if the risk of loss is difficult to determine, then the gain is allocated based on the equitable principle that the gain belongs to whomever bore the financial burden of the utility activity that was supported by the utility assets that the owners are selling.

The principles incorporated into *DCC* and *IPTA* in no way support an argument that ratepayers should receive the gain on a sale of assets the owners are selling because the ratepayers are losing the subsidy that those assets provided. The equities lie vividly in support of the opposite conclusion. If those who received the subsidy were entitled to the gain, it would not be under the principles of equity upon which *DCC* and *IPTA* rely, but despite them.

Q. DO THE OPPOSING PARTIES TAKE INTO ACCOUNT THE DIMINISHING ROLE THAT COST-OF-SERVICE RATE MAKING PLAYS IN WASHINGTON?

A. No. All three witnesses argue ratepayers must receive 100% of the gain (as they variously calculate it) in order to avoid being harmed. However, none of these witnesses offers any analysis of what amount of imputation ratepayers need in order to avoid being harmed in the current regulatory environment in Washington.

Q. DO THE OPPOSING PARTIES CORRECTLY APPLY THE PRINCIPLES OF GAIN SHARING ESTABLISHED IN *DCC* AND *ITPA*?

A. No. All three conclude that 100% of Washington's share of the gain on the sale of Dex that they identify belongs to ratepayers and none to shareholders. It is impossible to reach this conclusion under a correct application of the principles of these two cases. These witnesses reach this conclusion by failing to apply the principles of *DCC* and *ITPA* properly or by failing to apply them at all. Further, where they endeavor to apply the principles of *DCC* and *ITPA* they misapprehend or disregard important facts. In the remainder of this section of my testimony I will address generally how opposing parties either fail to apply the principles of *DCC* and *ITPA* or fail to apply them correctly, and how they misapprehend or disregard important facts.

Designation of the directory publishing function as a "regulatory asset" does not determine who is entitled to gain under the principles set forth in *DCC* and *IPTA*

Q HAS THE COMMISSION DEEMED THE DIRECTORY PUBLISHING BUSINESS NOW OPERATED BY DEX TO BE A "REGULATORY ASSET?"

A. Yes. In the Company's 1995 rate case, the Commission discussed proposed adjustments SA-1 and C-3 entitled "Yellow Page Imputation" as follows:

> In the Second Supplemental Order, Cause No. U-86-156, the Commission treated the Directory as a regulatory asset and determined that the public interest requires the full reasonable value of directory publishing be available to PNB for ratemaking purposes.
>
> * * *
>
> The Commission finds the directory publishing business to be a regulatory asset. Commissions have historically been authorized to impute revenues from interrelated operations that have been transferred to affiliates, to prevent utilities from taking profitable aspects and leaving captive utility customers with expenses of the operation but with reduced offsetting revenues from related services.[21]

Q. DID THE COMMISSION USE THE TERM "REGULATORY ASSET" IN THE CONVENTIONAL SENSE IN WHICH IT IS USED?

A. No. The term "regulatory asset" is a term of financial accounting. It describes assets that, under certain specified circumstances,[22] can be recorded on the books of account of a utility due to rate actions of a regulator that provide reasonable assurance to the utility that the assets are recoverable from ratepayers through regulated rates.[23] I am aware of at least one case in which the Commission used the term in "regulatory asset" in its conventional

[21] *Washington Utilities and Transportation Commission v. U S WEST Communications, Inc.,* Docket No. UT-950200, Fifteenth Supplemental Order; Commission and Order Rejecting Tariff Revisions; Requiring Refiling, (April 11, 1996) discussion of proposed adjustments SA-1 and C-3.
[22] *See* Statement of Financial Accounting Standards No. 71, Accounting for the Effects of Certain Types of Regulation, paragraph 5.
[23] *Id.*, paragraph 9.

sense.[24] Directory publishing is clearly not a "regulatory asset" in the conventional sense of the term.

Q. WHAT DO YOU UNDERSTAND THE COMMISSION MEANS WHEN IT USES THE TERM "REGULATORY ASSET" IN REFERENCE TO THE DIRECTORY PUBLISHING BUSINESS?

A. The Commission uses the term "regulatory asset" to refer to the longstanding practice of the directory publishing business providing a subsidy to the regulated telephone rates.

> Before 1984, Pacific Northwest Bell, the predecessor in Washington State of US WEST Communications, Inc., published its own telephone directory, including Yellow Pages. The publishing revenues and expenses were a part of the Company's results of operation for regulatory purposes and constituted a regulatory asset of the Company.[25]

Q. HOW HAVE MR. BROSCH AND DR. SELWYN USED OF THE TERM "REGULATORY ASSET" WITH REGARD TO DIRECTORY PUBLISHING?

A. They have used it in the same sense as the Commission. Mr. Brosch testifies:

> This Commission has treated the entire directory publishing business in Washington as a regulatory asset, but has not required any regulatory asset accounting on the books of QC or its predecessors since the transfer of the business to the publishing affiliate. Instead, imputation was calculated for ratemaking purposes only to effect the regulatory treatment of Dex (and predecessors) as if the printed directory business was entirely jurisdictional and was not transferred.[26]

Mr. Brosch apparently places some significance on the characterization of Dex as a "regulatory asset"; the phrase appears 21 times in his testimony. Mr. Brosch's comment that the Commission has not "required" regulatory asset accounting on the books of QC or its

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[24] *In the Matter of the Application of Avista Corporation for Authority to Sell its Interests in the Coal-Fired Centralia Power Plant, et al.*, Docket Nos. UE-991255, UE-991262, UE-991409, Second Supplemental Order, Order Approving Sale with Conditions (March 6, 2000). The Commission refers to "regulatory asset" in the conventional sense where, in section III, C, 1, e, and ponders the question: "Should the Commission Write Down Regulatory Assets With the Ratepayers' Portion of the Gain?"

[25] *Washington Utilities and Transportation Commission v. U S WEST Communications, Inc.,* Docket No. UT-950200, Fifteenth Supplemental Order; Commission and Order Rejecting Tariff Revisions; Requiring Refiling, (April 11, 1996) discussion of proposed adjustments SA-1 and C-3. (Footnote and testimony reference omitted).

[26] Direct Testimony of Michael L. Brosch, dated March 18, 2003 ("Brosch"), page 25, lines 1 to 7.

affiliates could be misleading. There is no accounting basis for recording the directory publishing business as a regulatory asset on the Company's books.

Dr. Selwyn also describes Dex's business as a regulatory asset:

> Q. Is there any doubt that the business activity that Qwest proposes to sell is a "regulatory asset" and an integral part of its business?
>
> A. No.[27]

Q. DO DR. SELWYN AND MR. BROSCH RELY ON THE CHARACTERIZATION OF DEX AS A "REGULATORY ASSET" TO SUPPORT THEIR POSITION THAT RATEPAYERS ARE ENTITLED TO 100% OF THE GAIN ON THE SALE OF DEX?

A. Yes. Mr. Brosch testifies:

> [T]he sale of Dex and the large gain on sale to be realized by QCI on the transaction requires regulatory attention because the Dex business represents a regulatory asset. If most of the gain on this extraordinary sale event is attributed to shareholders, as advocated by Qwest, customers of regulated telephone services will be denied equitable participation in the liquidation profits associated with a business that has historically been treated as a regulatory asset by regulators.[28]

Dr. Selwyn testifies:

> [I]f the Commission were to authorize the sale, it should impute the Washington share of the fair market value of the directory publishing assets, rather than simply the Washington share of the [confidential portion omitted] sale proceeds, in order to properly compensate Washington ratepayers for loss of the "regulatory asset" of the directory business.[29]

Q. DOES CHARACTERIZATION OF THE DIRECTORY PUBLISHING BUSINESS AS A "REGULATORY ASSET" WARRANT RATEPAYERS RECEIVING 100% OF THE GAIN?

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[27] Selwyn, page 57, line 21 to page 58, line 1.
[28] Brosch, page 22, lines 5 to 10.
[29] Selwyn, page 57, line 21 to page 58, line 1.

A. No. The fact that the Commission and witnesses Brosch and Selwyn refer to the subsidy from the directory business as a “regulatory asset” does not confer ownership of the publishing business on ratepayers, as *DCC* and *IPTA* make abundantly clear. Nor does this nomenclature determine the treatment of the gain. It simply indicates that disposition of the gain is at issue. It puts the directory publishing assets in the same position as any other of QC’s utility assets regarding the need to conduct an analysis of the facts under the principles of *DCC* and *IPTA*. Because all of QC’s utility assets are subject to the principles of *DCC* and *IPTA*, it is utterly incorrect to suggest that the gain on the directory publishing assets belongs to ratepayers simply because the directory operations have been described unconventionally as a “regulatory asset.”

An argument that ratepayers are entitled to 100% of the gain on Dex because it is a “regulatory asset” would rely on obviously circular logic. The circular argument is as follows: the publishing function is a “regulatory asset” because it provides ratepayers a subsidy; ratepayers are entitled to the subsidy/gain because it is a “regulatory asset.” The Commission cannot reasonably rely on logic that is obviously circular and fails to address, much less satisfy, either part of the two-part test under *DCC* and *IPTA*.

Describing Dex as a “regulatory asset” may raise the question of gain disposition, but it does not answer it.

The Commission made it clear in its most recent order regarding the Yellow Pages business that it had not mandated any particular outcome regarding the “regulatory asset” when and if it were to be sold.

> The Commission will continue to use imputation to preserve and balance the positions of stockholders and ratepayers until the Company demonstrates a change in conditions that warrants a change in imputation.

The Commission will then have the opportunity to determine whether to end imputation and, if so, determine the appropriate disposition of any gain.[30]

Q. HOW HAS THE COMMISSION ANALYZED ISSUES OF GAIN CALCULATION IN OTHER CASES?

A. The Commission's Second Supplemental Order in Docket Nos. UE-991255, UE-991262, and UE-991409 addressed the question of what to do with the gain on the sale of the Centralia steam plant, coal mine, and related facilities. The Commission's conclusion was that the case-specific circumstances warranted a reasonable allocation between the shareholders and the ratepayers of the benefit of the gain on sale of the Centralia facilities. In the its findings of fact the Commission found that based on the risks borne by each, a fair allocation of the proceeds from the sale was: "net book value to shareholders; remainder, up to original cost, to ratepayers; of the remainder (appreciation) one-half to shareholders and one-half to ratepayers ratepayers; taxes to be paid by shareholders and ratepayers in proportion to taxable gain awarded."[31]

Whether ratepayers bore the risk of capital loss of the owners' assets or the burden of the utility activity the owners are selling must be determined with regard to the specific assets and the specific utility activity, not the utility as a whole.

Q. HOW DOES DR. SELWYN BELIEVE THE BURDEN OF A UTILITY ACTIVITY SHOULD BE DETERMINED?

A. As illogical as it seems, Dr. Selwyn apparently believes that the determination of the financial burden of a particular utility activity under *DCC* and *IPTA* should not be made by determining who bore the financial burden of that particular utility activity.[32] Dr. Selwyn

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[30] *In Re the Petition of U S WEST Communications, Inc. for an Accounting Order,* Docket No. UT-980948, Fourteenth Supplemental Order, Order Denying Petition, July 27, 2000, ¶¶179 and 180.

[31] *In the Matter of the Application of Avista Corporation for Authority to Sell its Interests in the Coal-Fired Centralia Power Plant, et al.*, Docket Nos. UE-991255, UE-991262, UE-991409, Second Supplemental Order, Order Approving Sale with Conditions, Finding of Fact 20, ¶55 (March 6, 2000).

[32] The determination of whether ratepayers have borne the burden associated with the incumbent LEC's directory business does not depend upon whether that particular business segment, on a stand-alone basis, has produced revenues in excess of the associated costs. Selwyn, page 63, lines 16 to 18.

urges the Commission to ignore the holding of *DCC* and the equitable principles that underlie it even as he quotes that standard in his testimony:

> "[T]he Commission should apply the principles set forth in the landmark federal court decision, *Democratic Central Committee of the District of Columbia v. Washington Metropolitan Transit Commission* (hereinafter, "*DCC*"). That case holds that "the right to capital gains on utility assets is tied to the risk of capital losses," and that "he who bears the financial burden <u>of a particular utility activity</u> should also reap the benefit resulting therefrom."[33]

In an attempt to divert the Commission's attention away from the particular utility activity being sold, Dr. Selwyn urges the Commission to consider not the risks and burdens of the directory operation and advertising business but instead all of the Company's utility activities, most of which the Company is not selling.[34] This attempt to deviate from the principles of *DCC* and *IPTA* is clearly inappropriate and self-serving.

In *DCC*, the D.C. Circuit Court applied its two-step test to the disposition of tangible assets, specifically, parcels of land. Having determined that the land was not subject to the first step of the test the court examined the second step. The court found such an examination required an "examination of the history of the acquisition <u>of the questioned assets</u>, the allocation of burdens and the accrual of advantages associated with the holding of <u>those assets</u>, and thereafter a balancing of the respective interests competing for the gains at stake.[35]

[33] Selwyn, page 55, lines 18 to 23, emphasis added, footnotes omitted.
[34] "Qwest attempts to isolate the directory publishing business, arguing that ratepayers are neither at risk or burdened by an identifiable portion of the business that is profitable. * * * The principle in *DCC* requires that regulators look at the *whole* business." Selwyn, page 57, lines 12 to 17.
[35] *Democratic Central Committee of the District of Columbia v. Washington Metropolitan Transit Commission*, 458 F. 2d 786 at 811 (D.C. Cir. 1973), reh den, cert den, 415 US 935 (1973).

The court's analysis of burden was not directed to the utility as a whole. It clearly focused specifically on the parcels of land.[36] The court's reliance in *DCC* on the burdens specifically associated with the properties clearly refutes Dr. Selwyn's argument.

Whether ratepayers have borne the burden depends on whether they bore the burden specifically of what is being sold, in this case the directory operations and directory advertising business. Washington ratepayers have never borne the burden of either the directory operations or the directory advertising business.

Ratepayers have never borne the burden of the owners' intangible assets specifically because they have been subsidized by them.

Q. HAS THE REGULATORY SCHEME IN WASHINGTON EVER REQUIRED RATEPAYERS TO PAY OWNERS A RETURN ON THEIR INTANGIBLE ASSETS?

A. No. Ratepayers have never been required to pay a return on the intangible assets that create the value for which Dex's Buyer is paying. The value of these intangible assets has never been recognized for regulatory accounting or rate making purposes. Consequently, ratepayers have never been required to provide the owners a return on those assets.

However, the unregulated directory advertising revenues that those intangible assets have been able to produce have been included in regulated results of operations in Washington. It is those revenues that are the source of the subsidy that ratepayers have enjoyed.

[36] "To the foregoing circumstances must be added others -- hardly less important, and equally contributors to a potential windfall. After Transit's acquisition from Capital, the properties now questioned remained in operating status for various periods, and indeed two apparently always so remained. In that status they have possessed incidents and immunities they could not summon below the line. They have commanded preferred real estate tax treatment. They were, as above-the-line assets, a part of Transit's rate base during the years prior to adoption of the operating ratio method of establishing its margins of return. Even under the latter method, in vogue since 1960, the properties have counted in the computation of Transit's equity, a factor in turn influencing Transit's rate of return from transportation operations. . . . the crowning consideration is the incontrovertible fact that the conversion, at full cost to the farepayers, was the sine qua non to release of valuable real properties from operating roles in the transportation scheme for uses in non-transportation ventures. *Id*. at 816 (internal footnotes omitted).

It is very significant that none of the opposing parties argues that ratepayers actually bore the financial burden of the Company's directory operations. They are very careful to sidestep this important point. Instead, they argue that ratepayers bore the risk of a decline in the imputation[37] or the risk of operating losses.[38] As I shall show, these risks do not entitle ratepayers to capital gains under the two-step test of *DCC* and *IPTA*.

Neither step of the two-step test of *DCC* and *IPTA* is whether ratepayers were at risk of bearing the financial burden.

Q. IS RISK OF AN OPERATING LOSS OR OF AN IMPUTATION REDUCTION ONE OF THE TWO STEPS OF THE TEST UNDER DCC AND IPTA?

A. No. As Dr. Selwyn testifies:

> [*DC*C]… holds that "the right to capital gains on utility assets is tied to the risk of capital losses," and that "he who bears the financial burden of a particular utility activity should also reap the benefit resulting therefrom."[39]

Capital losses are different from operating losses. A capital loss occurs only when there is a

[37] King, page 14, line 18 to page 15, line 1.
[38] Brosch, page 24, lines 5 to 11.
[39] Selwyn, page 55, lines 19 to 23, emphasis added.

disposition of an asset, such as a sale.[40] An operating loss occurs when revenues are insufficient to recover all of the costs of an activity. Ratepayers bear the burden of a utility activity's operating loss if the regulatory scheme in effect includes that operating loss in the calculation of rates.

Actually bearing a burden (such as an operating loss) is not the same as being at risk of bearing a burden. I am at risk of paying for repairs to my car but I do not actually bear any burden unless my car requires repairs. Ratepayers actually bear the burden of a utility activity when the rates they pay reflect all of the costs of that utility activity.[41] However, ratepayers who actual receive a subsidy from a utility activity cannot be bearing the burden of that utility activity, as the two are obviously mutually exclusive.

The test under *DCC* and *IPTA* does not reward ratepayers with capital gains on utility assets because they were at risk that they might have had to bear the burden of a utility activity. The principles of equity upon which *DCC* and *IPTA* rely require ratepayers to experience real financial sacrifice, either when capital losses occur or, if that is difficult to determine, as and while ratepayers are receiving services from the utility activity.

It is obvious that ratepayers who receive a subsidy from a utility activity are not bearing the burden of that utility activity and cannot pass the second part of the two-step test, even if they are at risk of losing the subsidy and bearing the burden of the utility activity.

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[40] *See* discussion of "Right to Gain Follows Risk of Loss," *Democratic Central Committee of the District of Columbia v. Washington Metropolitan Transit Commission*, 458 F. 2d 786, 806-808 (D.C. Cir. 1973), reh den, cert den, 415 US 935 (1973).

[41] See discussion of "Economic Benefit Follows Economic Burden.," *Democratic Central Committee of the District of Columbia v. Washington Metropolitan Transit Commission*, 458 F. 2d 786, 808-811 (D.C. Cir. 1973), reh den, cert. den, 415 US 935 (1973).

Q. DOES THE SAME REASONING APPLY TO THE RISK OF A DECLINE IN IMPUTATION?

A. Yes. Being at risk of a decline in imputation does not satisfy either step of the two step test under *DCC* and *IPTA*, which are rooted in basic equity principles of financial risk and burden as illustrated by the following hypothetical.

Suppose that I have a brother who becomes wealthy. He decides to start a trust fund for my children's education. Each year for several years he deposits money in the trust fund. His trust fund deposits are a substantial benefit. They provide me a financial subsidy because each dollar he pays into the trust is one less dollar I need to save for my children's college education. Then suppose that my brother loses some of his wealth. He can no longer afford to deposit as much money into the trust fund as he did before. Clearly, I receive less benefit than I did before and I lose part of my subsidy. Now I must use more of my own money to fund my children's college costs than did before I lost part of my subsidy.

In my hypothetical, I have clearly lost a subsidy. I have to use more of my own money to pay for my children's education. However, the cost is my responsibility to bear in the first place. Regardless of how much or how little my brother can subsidize me, I am ultimately responsible for paying my bills. Webster's defines "harm" as injury or physical or mental damage. Under the basic principle of equity that I am responsible to pay my own bills, (including my children's college education), I cannot complain that I have suffered harm because I have lost a subsidy. Nor can ratepayers. If the amount of subsidy from directory advertising were to decline, ratepayers would not suffer harm, they would simply lose a subsidy that had relieved them of a part of their responsibility to pay the cost of their service.

While ratepayers may bear the risk of a decline in the directory-advertising subsidy, that risk does not satisfy either of the two steps of the test under *DCC* and *IPTA*, which are based on principles of equity. Ratepayers have no equitable claim that a loss of subsidy entitles them to gain on the assets that provide them subsidy any more than I have a claim on the disposition of assets in my brother's portfolio because he subsidized me with the earnings from those assets.

Q. DR. SELWYN ARGUES THAT YOUR ANALYSIS OF RISK AND BURDEN WOULD "LEAD TO THE CONCLUSION THAT…ONLY THE UNPROFITABLE SEGMENTS OF THE ILEC'S BUSINESS COULD BE TAPPED AS A POTENTIAL SOURCE OF 'GAIN.'"[42] HOW DO YOU RESPOND?

A. Dr. Selwyn can only reach this conclusion by ignoring obvious facts. Dr. Selwyn testifies:

> [W]hile the part of Qwest's business associated with directory publishing activity has generally been profitable, it was acquired and successfully expanded as an integral part of the ILEC. Not every part of the ILEC's business was as profitable as the directory publishing activity, but ratepayers supported the entire package.[43]

Of course, this testimony is quite inaccurate because ratepayers did not support the entire package. They did not support the directory operations; the directory operations supported them, which is precisely why the sale of Dex is controversial. The "profits" of the directory operations differ fundamentally from the "profits" of the Company's regulated telephone service operations. The revenues that generated the regulated telephone operations' "profits" came from ratepayers while the revenues that generated the directory operations' "profits" were from advertisers who weren't necessarily telephone service customers. If revenues from ratepayers were excluded, none of the Company's operations would be remotely profitable except the directory operations.

[42] Selwyn, page 64, lines 2 to 7.
[43] Selwyn, page 57, lines 9 to 12.

From the ratepayers' perspective, the only operation that was profitable was the directory operation. None of the other services was profitable to them because they had to pay the revenue requirement on them. Ratepayers bore the burden of individual services such as toll, carrier access, and vertical services because they paid for those services. They did not bear the burden of directory operations, because advertisers paid that cost and more. By intentionally ignoring the important distinction between the source of directory operations "profits" and the telephone operations "profits," Dr. Selwyn attempts to sidestep the fact that ratepayers did not bear the financial burden of directory operations but, instead, enjoyed a subsidy from it.

Neither step of the two-step test under the principles of *DCC* and *IPTA* is "linkages" between the Company's telephone operation and directory operation.

Q. DO "LINKAGES" BETWEEN THE COMPANY'S TELEPHONE OPERATION AND ITS DIRECTORY OPERATION SUPPORT THE POSITION THAT RATEPAYERS ARE ENTITLED TO 100% OF THE GAIN ON THE SALE OF DEX?

A. No. However, both Mr. Brosch and Dr. Selwyn make this argument. Mr. Brosch testifies:

> Q. Do the linkages between the telephone company and the publishing affiliate justify the continued attribution of virtually all of the value of the directory business to telephone ratepayers, even when the directory publishing business is sold?
>
> A. Yes.[44]

Similarly, Dr. Selwyn testifies:

> . . . it is clear that directory publishing was developed and grew as an integral part of the ILEC's franchised, local exchange telecommunications.[45]
>
> * * *

[44] Brosch, page 38, lines 8 to 12.
[45] Selwyn, page 58, lines 1 to 7.

> [T]he Dex " first mover" advantage results from the years that it operated as the Commission-protected sole yellow page publisher in Washington State, linked to the monopoly local phone company. [46]

Mr. Brosch's and Dr. Selwyn's arguments are red herrings because they completely miss the point. The two-step test assumes that the assets being sold are part of the utility's operations. Were that not the case, there would be no doubt that ratepayers have no compensatory interest in the assets. The two-step test also recognizes that ratepayers do not own any of the assets being sold, even though they are a part of the utility's operation.

Ms. Koehler-Christensen's rebuttal testimony shows that many of the linkages opposing parties allege have no economic value. However, to the extent any of the linkages have economic value, that value is an intangible asset. Under *DCC* and *IPTA* the utility's shareholder own all of its assets, including intangible assets. However, *DCC* and *IPTA* provide that ratepayers can have an interest in capital gains from the disposition of an intangible asset if the regulatory scheme has required ratepayers to compensate the owners for capital losses on that intangible asset.

The two-part test under *DCC* and *IPTA* requires more analysis than merely alleging the assets are linked to, or part of, the utility operation. It requires an analysis of the facts regarding each intangible asset to determine who bears the risk of capital loss on it and, if that cannot be determined, who bore the financial burden of the utility activity it supports. Under *DCC* and *IPTA*, a linkage that constitutes an intangible asset would only impose the risk of loss on ratepayers if the regulatory scheme in effect obligated ratepayers to compensate owners for capital losses on it. Similarly, ratepayers would bear the financial burden of a utility activity if they were obligated to pay rates to compensate the utility owners for the cost of the activity.

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[46] Selwyn, page 88, lines 2 to 4.

Ratepayers have never borne the risk of capital losses on the intangible assets being sold.

Q. DR. SELWYN WRITES SEVERAL PAGES OF TESTIMONY IDENTIFYING THE INTANGIBLE ASSETS AND ASCRIBING VARIOUS LEVELS OF VALUE TO THEM.[47] IS THIS IDENTIFICATION AND ASCRIPTION IMPORTANT TO DETERMINE THE DISPOSITION OF THE GAIN?

No. Dr. Selwyn has conducted no study or analysis to support his ascription of value,[48] but it ultimately makes no difference. Regardless of whether he has correctly identified them and correctly valued them, two facts remain. First, all of the intangible assets belong to the owners and second, ratepayers have never been at risk of a capital loss on the Company's intangible assets. None of the intangible assets Dr. Selwyn identifies have been included in the Company's rate base. Consequently, there is simply no way for ratepayers to bear capital losses on these assets.

None of the opposing witnesses has identified any mechanism by which ratepayers would be obligated to compensate the owners for capital losses on the owners' intangible assets. If any of these intangible assets loses value, the regulatory scheme in Washington has never provided any mechanism by which Washington ratepayers would be obligated to compensate the owners for this loss in value. It follows that the regulatory scheme in Washington has <u>never</u> put ratepayers at risk for compensating owners for capital losses on their intangible assets. Consequently, under the principles of *DCC* and *IPTA*, ratepayers have no claim on the gain from these assets, which are indisputably the source of the gain in this transaction.[49]

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[47] Selwyn, page 77, line 18 to page 97, line 11.
[48] Staff's Response to Qwest's Data Request No. 46.
[49] *See,* for example, Selwyn, page 66, lines 14 to 17: " Q. When the Commission expressly limited QC's authority regarding the transfer of directory publishing to certain limited depreciable property, did this decision preserve the interests of QC and its ratepayers the corpus <u>of intangible assets that represent the core value</u> of the directory publishing business?" (emphasis added)

REBUTTAL OF DR. SELWYN

Dr. Selwyn fails to apply correctly the two-step test of *DCC* and *IPTA*

Q. DOES DR. SELWYN DISAGREE THAT *DCC* AND *IPTA* REQUIRE AN ANALYSIS OF THE REGULATORY SCHEMES IN EFFECT DURING THE LIFE OF THE BUSINESS BEING SOLD?

A. Apparently so. Dr. Selwyn testifies:

> I utterly disagree with Mr. Grate's attempt to create a directory publishing "pie" that goes back to the pre-regulatory period extant during the late nineteenth century. Even if his characterizations of the risk attendant to ratepayers vs. shareholders during the three historical periods he describes were valid, which they are not, I do not agree that the determination of risks/burdens under the *DCC* case can be translated into "risk-years," as Mr. Grate attempts to do here. Because Mr. Grate is attempting to allocate risk based upon the proportion of the directory business' "lifeline" that he attributes to its existence in either a "competitive" or a "noncompetitive" market, it is clearly in his interest to "pad" the so-called "competitive" years.[50]

Q. DOES YOUR ANALYSIS "PAD" THE COMPETITIVE YEARS AS DR. SELWYN SUGGESTS?

A. No. My direct testimony gives no weighting to the relative level of competition that existed during a particular period. Instead, my analysis is focused on carefully evaluating whether the regulatory scheme in effect during a given period shifted the risks of capital losses from the owners of the assets to ratepayers and, if that is not readily determinable, whether the regulatory scheme in effect shifted the financial burden of the directory publishing activity from owners to ratepayers.

Prior to 1923, the Company faced periods of direct head-to-head competition in local service and toll that it did not face during the 60-year period that followed. Similarly, in the period following 1983, the Company has faced ever increasing levels of head-to-head competition. It follows that, if anything, my analysis of risk and burden under the regulatory schemes that

[50] Selwyn, page 61, lines 8 to 16.

have existed during the 120 year existence of the Company is conservative. Had I attempted to weight the amount of competitive risk involved, I would have had to weight more heavily the 40 year period prior to 1923 and the 20 year period after 1983, when owners clearly bore all of the risk and burden, instead of the 60 year period between 1923 and 1983 when the Company faced little or no competition.

Q. DO YOU AGREE WITH DR. SELWYN THAT DETERMINATION OF RISKS/BURDENS UNDER THE *DCC* CASE CAN NOT BE TRANSLATED INTO "RISK-YEARS"?

A. Certainly not. Dr. Selwyn argues, "the pre-regulatory period (before 1923) is irrelevant."[51] Mr. King takes the same approach:

> Q. DO YOU AGREE WITH MR. GRATE THAT RATEPAYERS HAVE BORNE NO RISK OF LOSS FROM DIRECTORY OPERATIONS?
>
> A. No, I do not. Ratepayers have borne all the risk of loss in the directory business since the inception of rate regulation in Washington.[52]

I can understand why Dr. Selwyn and Mr. King would like the Commission to ignore the first 40 years of the Company's 120-year history. Ignoring 33% (not 40% as Dr. Selwyn computes) of the Company's operations is, to use Dr. Selwyn's words, "transparently results-oriented."

The principles set forth in *DCC* and *IPTA* are not that the winner-takes-all. Instead, the D.C. Circuit Court refers to the allocation of the gain based on changes in regulatory scheme that is necessary "to protect not only the interests of ratepayers, but also the competing

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[51] Selwyn, page 61, lines 18 to 19.
[52] King, page 14, lines 10 to 11.

interests of shareholders."[53] Under the principles of *DCC* and *IPTA,* Dr. Selwyn's and Mr. Lee's attempt to disregard 33% of the history of regulatory scheme lacks a rational basis.

These witnesses would have the Commission ignore the regulatory scheme in effect during the 40-year period when there is no evidence to suggest ratepayers bore any risk or burden. In an effort to divert the Commission's attention from this period, Dr. Selwyn inaccurately describes it as "pre-regulatory." During the period before 1923, the Company was subject to regulation by Washington cities, the Railroad Commission of Washington, the Public Service Commission of Washington, and the Department of Public Works of Washington. There is nothing "pre-regulatory" about this period that justifies Dr. Selwyn's results-oriented desire for the Commission to ignore it.

In any event, it is obviously prejudicial to limit the review of the regulatory scheme in effect to only those periods when a particular regulatory scheme was in effect. Suppose half the rooms in a house were painted green and the other half were blue. By intentionally ignoring the blue rooms, I could claim that the whole interior of the house was green, but I would not be correct. Nor is Dr. Selwyn correct to ignore 40 years of history of a 120-year history.

Dr. Selwyn's assertion that risks were "captured" in 1923 is nonsensical.

Q. DR. SELWYN ARGUES: "WHATEVER RISKS WERE ATTENDANT TO THE DIRECTORY PUBLISHING BUSINESS (OR, FOR THAT MATTER, THE LOCAL TELEPHONE BUSINESS OVERALL) BEFORE THE ESTABLISHMENT OF THE ILEC'S REGULATORY RATE BASE WERE CAPTURED WHEN IT CAME UNDER REGULATION."[54] DO YOU AGREE?

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[53] *Illinois Public Telecommunications Association v. Federal Communications Commission*, 326 U.S. App. D.C. 1, 44 (1997).

[54] Selwyn, page 61, lines 19 to 21.

A. No. Forty years of history were not erased when the Company went under effect cost-of-service regulation in 1923. The establishment of a cost-of-service ratebase in 1923 did not capture the prior forty years of risk and burden. Nothing in the record from the 1923 rate case or the rate case that preceded it or the rate case that followed it suggests that the Commission obligated ratepayers to compensate the Company's owners for any of the risks of capital losses or burdens of inadequate earnings they had already borne.

Q. DOES DR. SELWYN EVER EXPLAIN HOW COST-OF-SERVICE REGULATION COMMENCING IN 1923 ELIMINATES THE PRIOR 40 YEARS OF RISK AND BURDEN?

A. No, he does not. Instead he offers only that: "From that point on, the entirety of the utility's investment base — including its directory publishing operations — constituted the rate base upon which the utility's return on investment was determined."[55] He does not attempt to explain how inclusion of tangible assets (but not intangible) in ratebase did anything to "capture" from the Company's owners any of the risks of capital losses or burdens of inadequate earnings they had already borne. The assertion that 40 years of risks and burdens were "captured" in ratebase lacks any factual foundation and is nonsensical.

Dr. Selwyn's assertion that the Company agreed to earnings limitations in exchange for a monopoly franchise is mistaken

Q. DR. SELWYN ARGUES THAT WHEN THE COMPANY "CAME UNDER REGULATION…THE SHAREHOLDERS OF QWEST'S PREDECESSOR (PT&T) AGREED TO BE SUBJECT TO EARNINGS LIMITATIONS IN EXCHANGE FOR A GOVERNMENT-PROTECTED MONOPOLY FRANCHISE AND THE OPPORTUNITY

[55] Selwyn, page 61, lines 21 to 23.

TO EARN A 'REASONABLE' RETURN ON THEIR INVESTMENT."[56] DO YOU AGREE?

A. No. Dr. Selwyn could not be more mistaken. The Washington laws that subjected the Company to statewide regulation in the second and third decades of the last century were not optional. The Company's owners had no choice about whether their business' rates would be subject to regulation. There is no record indicating they agreed to be regulated. Nor is there any evidence the owners started their business in 1883 with the knowledge that it would fall under cost-of-service regulation some forty years later.

The State of Washington abhors monopolies.[57] It comes as no surprise then, that no arm of

[56] Selwyn, page 61, line 23 to page 62, line 2.

[57] "Neither Const. art. 12, § 19 nor Const. art. 12, § 22 represents an absolute prohibition against monopolies. *See State ex rel. Department of Pub. Works v. Inland Forwarding Corp., 164 Wash. 412, 2 P.2d 888 (1931); Kitsap Cy. Transp. Co. v. Manitou Beach-Agate Pass Ferry Ass'n, 176 Wash. 486, 496, 30 P.2d 233 (1934)* (permitting State to prohibit entry of competitor when entrance would be "inimical to the best interests of the ... public at large"); *Chas. Uhden, Inc. v. Greenough, 181 Wash. 412, 43 P.2d 983, 98 A.L.R. 1181 (1935).* They do however manifest the state's abhorrence of monopolies." *In the Matter of the Consolidated Cases Concerning the Registration of Electric Lightwave, Inc. and Registration and Classification of Digital Direct of Seattle, Inc. Electric Lightwave, Inc., et al, Respondents, Washington Independent Telephone Association, et al, Appellants, v. The Washington Utilities and Transportation Commission*, 123 Wn.2d 530; 869 P.2d 1045 (1994).

Washington government has ever granted the Company a monopoly franchise. Washington courts have made clear that the Company did not have a *de jure* monopoly in Washington.[58]

Dr. Selwyn's assertion that all of the value of the directory publishing operation arises from a monopoly franchise is unfounded.

Q. DOES DR. SELWYN ASSERT THAT VIRTUALLY ALL OF THE VALUE OF THE DIRECTORY PUBLISHING OPERATION ARISES FROM A MONOPOLY FRANCHISE?

A. Yes. Dr. Selwyn testifies:

> Virtually all of the value of the directory publishing operations arises from the QC legacy local service monopoly franchise, and not from any investment or innovation on the part of Dex.[59]

> The identifiable intangibles included in the Qwest sale, as an economic matter, derive their value from the QC's position as the legacy franchised monopoly provider of basic local exchange telephone service.[60]

Q. DID THE COMPANY EVER HAVE A MONOPOLY FRANCHISE?

A. As I have already explained, no.

Q. DID THE COMPANY START AND DEVELOP ITS DIRECTORY OPERATIONS AFTER THE END OF THE COMPETITIVE PERIOD THAT PRECEDED 1923?

A. No. The Company started its directory operation sometime before 1894, probably not long after it began service in 1883.

Q. DOES EITHER STEP OF THE *DCC* AND *IPTA* TEST ASK WHETHER THE UTILITY HELD A MONOPOLY?

A. No.

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[58] *Id.*
[59] Selwyn, page 10, lines 8 to 10.
[60] Selwyn, page 82, lines 4 to 6.

Dr. Selwyn's conclusions under the two-step test of DCC and IPTA is based on assumptions, not facts.

Q. WHY DOES DR. SELWYN CONCLUDE THAT RATEPAYERS SHOULD RECEIVE THAT GAIN ON THE SALE OF THE PORTION OF ITS BUSINESS THAT QWEST NOW SEEKS TO SELL TO THE BUYER?

A. Dr. Selwyn's analysis of risk and burden under *DCC* and *IPTA* is the following four sentences:

> As the court in *DCC* explains, the traditional ratemaking " practice in the utility field has long imposed upon consumers substantial risks of loss and financial burden associated with the assets employed in the utility's business." This has certainly been the case with respect to Qwest and its predecessors with respect to its Washington operations. At the same time, as observed by the Washington Supreme Court, " [i]t is an exaggeration to say [the ILEC's] shareholders took any significant risk in developing the directory publishing business, and we find that the public interest in those assets to be beyond dispute." [61]

Q. HAS THE REGULATORY SCHEME IN WASHINGTON ALWAYS IMPOSED UPON CONSUMERS SUBSTANTIAL RISKS OF LOSS AND FINANCIAL BURDEN ASSOCIATED WITH THE ASSETS EMPLOYED IN THE COMPANY'S BUSINESS IN WASHINGTON, AS DR. SELWYN ALLEGES?

A. No. In the 40-year period before 1923, the Company was not regulated under so-called "traditional" ratemaking. Ratepayers bore none of the Company's risks of capital losses and none of the Company's financial burdens during this 40-year period. Ratepayers bore none of the burden of the directory operations during the following 80-year period because it provided them a subsidy. Ratepayers have never been at risk for capital losses on any of the intangible assets that create the value of the Dex enterprise. As I have already explained, there was simply no regulatory mechanism to make this happen.

[61] Selwyn, page 55, lines 19 to 23, emphasis added, cite omitted.

Q. DO YOU AGREE WITH THE ASSUMPTION THAT THE COMPANY'S SHAREHOLDERS TOOK NO SIGNIFICANT RISK IN DEVELOPING THE DIRECTORY PUBLISHING BUSINESS?

A. No, I do not, and the facts show this assumption is incorrect. During the period leading up to 1923, the Company's shareholders faced substantial risks from pioneering a new and commercially unproven technology, periods of head-to-head competition for local and toll service, rate regulation that was indifferent to the Company's financial performance, and all the other risks inherent in starting and expanding a business. The directory publishing operation (which opposing parties eagerly point out was developed in concert with the Company's telephone operations) was not insulated from any of these risks.

The Company's first mover advantage belongs to its owners.

Q. DOES DR. SELWYN ARGUE THAT PART OF THE VALUE OF DEX RESULTS FROM ITS "FIRST MOVER" ADVANTAGE?

A. Yes. Dr. Selwyn testifies:

> [Dex's] legacy market share is a direct result of (1) Dex's "first mover" advantage arising out of the historic QC local phone service monopoly and the historical and ongoing relationship between QC and Dex…. [62]

* * *

[62] Selwyn, page 85, lines 6 to 8.

Q. What is the source of the “ network externalities” that exist in the case of Dex?
A. Dex was a protected monopoly “ first mover.”[63]

Q. DID THE COMPANY ACQUIRE THE “FIRST MOVER” ADVANTAGE BEFORE IT CAME UNDER EFFECTIVE COST-OF-SERVICE REGULATION IN 1923?

A. Yes. My direct testimony explains how the Company established its telephone operation and it directory operation over a 40 year period leading up to 1923.

Q. DR. SELWYN ALLEGES THE DIRECTORY OPERATION WAS A “MINUTE ENTERPRISE BEFORE IT BECAME ASSOCIATED WITH THE REGULATED TELEPHONE MONOPOLY”[64] DO YOU AGREE?

A. No. My direct testimony recounts that the Company had a directory operation as early as 1893, and probably earlier. The directory operation was commensurate in size with the size of the telephone business of the day. I do not accept that either the directory operations or the telephone operations that it supported were minute enterprises in their day. They were certainly large enough and important enough that the Washington legislature saw fit to bring them under the jurisdiction of a state regulatory body and the federal government saw fit to nationalize them in 1918.

Q. UNDER THE PRINCIPLES OF *DCC* AND *IPTA*, DO RATEPAYERS OWN THE “FIRST MOVER” ADVANTAGE?

A. No. Under *DCC* and *IPTA*, the shareholders own the first “mover advantage,” not the ratepayers. Ratepayers bore no risk of capital losses on the “first mover” advantage and did not pay rates that included any “first mover” expenses.

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[63] Selwyn, page 87, lines 18 to 20.
[64] Selwyn, page 62, lines 2 to 4.

REBUTTAL OF MICHAEL BROSCH

Mr. Brosch's argument that ratepayers have a claim on the going concern value or goodwill of the directory operations are incorrect under the two-step *DCC* and *IPTA* test.

Q. MR. BROSCH ASSERTS "RATEPAYERS HAVE A CONTINUING CLAIM UPON THE VALUE OF THE INTANGIBLE GOODWILL ASSETS RELATED TO THE DIRECTORY PUBLISHING FUNCTION"[65] DO YOU AGREE?

A. No. Under the principles of *DCC* and *IPTA*, ratepayers have no claim to capital gains from goodwill or going concern value of the owners' business. Mr. Brosch argues:

> The intangible, going concern value of the directory publishing business is what this Commission has recognized to be a regulatory asset for many years.[66]
>
> * * *
>
> Mr. Grate provides another definition of goodwill at page 15 of his testimony from Black's Law Dictionary that includes, "patronage of any established trade or business; the benefit or advantage of having established a business and secured its patronage by the public." This is the same going concern or patronage value that the Commission has treated as a regulatory asset.[67]

As I have already explained, the designation of the directory operation as a "regulatory asset" does not determine whether ratepayers have any claim on capital gains from the sale of assets. The relevant facts must be determined under the *DCC* and *IPTA* two-step test before any ratepayers' and shareholders' compensable interest can be established.

Q. MR. BROSCH ASSERTS THE COMPANY'S OWNERS BORE NO COSTS OR RISKS TO ESTABLISH THIS GOODWILL OR "GOING CONCERN" ASSET. DO YOU AGREE?

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[65] Brosch, page 30, lines 13 to 14.
[66] Brosch, page 31, lines 5 and 6.
[67] Brosch, page 81, lines 5 to 10.

A. No. Mr. Brosch asserts shareholders bore no costs or risks to establish the going concern value because:

> [I]t arose from the telephone company's unique opportunity to publish the directory listings of its subscribers within its official telephone directories and also include in the phone books advertising that was commercially valuable. Thus, directory going concern value was realized at no cost or risk to shareholders.[68]

Mr. Brosch cannot know what costs shareholders incurred to establish the directory operation's going concern value before July 1, 1912, because no Company financial records for periods prior to that have been found. The records that are available show that from July 1, 1912 through the end of 1917, the Company's directory operations operated at a loss, which the Company's shareholders bore. They also bore the cost of the inadequate earnings the Company achieved overall during the same period and later.

Q. HOW IS THIS RELEVANT TO THE DCC/IPTA ANALYSIS?

A. The first test of the two-step test under *DCC* and *IPTA* is whether ratepayers or shareholders bore the risk of capital losses on assets. Clearly, until 1923, ratepayers bore the risk of capital losses on <u>none</u> of the Company's assets, including the intangible assets such as going concern value that the Company established during this period.

Mr. Brosch argues ratepayers are entitled to the goodwill of the directory operations because:

> Investors have not been required to finance any goodwill investment nor have they ever paid fair value for the intangible assets being referenced by Mr. Grate. Consequently, investors are not entitled to any compensation when such assets are rightfully attributed to telephone customers upon realization as a gain upon sale of Dex.[69]

I disagree that investors never made any investment to establish goodwill. I recount in my direct testimony that in the Company's 1916 rate case, the Commission found that the large

[68] Brosch, page 89, lines 14 to 19.
[69] Brosch, page 90, lines 14 to 18.

majority of the Company's exchanges operated at a loss. It is clear that even as late as 1915, establishing telephone service in a Washington community was a money-losing proposition. The losses that owners suffered were not capitalized on the company's books. Instead, they flowed through to the owners, who had to finance them. It may be fair to say that the owners were not "required" to finance the cost of creating goodwill, because they were under no obligation to open new exchanges, but it is not accurate to say they did not, in fact finance the cost of establishing the goodwill.

Q. MR. BROSCH ARGUES RATEPAYERS HAVE A CONTINUING CLAIM ON THE INTANGIBLE GOODWILL ASSETS OF THE DIRECTORY PUBLISHING FUNCTION. DO YOU AGREE?

A. No. Mr. Brosch testifies:

> The entire directory publishing business, including both tangible and intangible assets and the earnings produced from such assets, has been treated as jurisdictional and includable in determining telephone revenue requirements. Thus, ratepayers have a continuing claim upon the value of the intangible goodwill assets related to the directory publishing function.[70]

Mr. Brosch's assertion that the intangible assets that make up the value of this sale have been included in determining telephone revenue requirements is not correct. None of the value of the intangible assets has ever been included in ratebase. His conclusion that ratepayers have a claim on the gain from those intangible assets rests on the incorrect assumption that by merely including tangible directory assets and directory profits in revenue requirement, ratepayers achieve entitlement to capital gains on intangible goodwill and going concern assets. However, because *DCC* and *IPTA* are based on principles of equity, the two-step test requires more of ratepayers than this. Ratepayers must bear the risk of capital losses on the intangible assets, which they clearly have not. Or, if the determination of risk is difficult to determine (which in this case it is not), they must have

[70] Brosch, page 30, lines 10 to 14.

borne the burden of the directory operations, which, as recipients of a subsidy, they clearly did not.

Q. MR. BROSCH ARGUES THAT IT IS "DISINGENUOUS FOR QWEST TO IMPLY THAT THE DEX PUBLISHING BUSINESS HAS BEEN DEVELOPED AT GREAT RISK AND COST TO SHAREHOLDERS…."[71] HOW DO YOU RESPOND?

A. Mr. Brosch misinterprets my testimony. It would indeed be disingenuous to assert that the publishing business was developed at "great" risk and cost and I make no such assertion. My investigation (which includes state archival research in Washington, Idaho and California) has not unearthed information sufficient to draw conclusions about whether the risks and costs were "great." My testimony does not argue that ratepayers have no interest in the gain on the sale because of great risk and cost borne by shareholders. Instead, my testimony is that ratepayers have no interest because they bore no risk of capital loss on the intangible assets being sold and no burden from directory operations that provided them a subsidy.

That shareholders bore all risk and burden during the 40-year start up period is not in doubt. *DCC* and *IPTA* does not ask whether the risks and burdens are great or small, only who bore them under the regulatory scheme in effect at a given point in time. Therefore, as is appropriate, my testimony takes no liberties to weight the amount of risk and burden at any particular point in time, even though such weighting would clearly favor shareholders' claim to the gain.

Q. MR. BROSCH ARGUES: "WHAT IS MISSING FROM THE COMPANY'S ANALYSIS IS ANY ECONOMIC JUSTIFICATION FOR THE PROPOSED

[71] Brosch, page 82, lines 6 to 7.

CREDITING OF ALMOST TWO THIRDS OF THE DEX GAIN ON SALE TO SHAREHOLDERS."[72] DO YOU AGREE?

A. No. The equities and the economic justification are clear. Shareholders bore the risk and burden of creating the directory business, which sells unregulated advertising. In the early years, it did not turn a profit. The Shareholders bore those losses. Shortly after it began to turn a profit, telephone rates became cost-of-service regulated. The profits from the directory business were used to subsidize telephone service, to the substantial benefit of ratepayers. Ratepayers have done nothing but take profits out of the directory business that shareholders established and financed during the period when it was not profitable. The economic and equitable justification for entitling shareholders to keep the gain is clear and compelling.

Under FCC accounting rules, the gain on the sale of a directory publishing operation with the right to serve its customers is recorded below-the-line.

Q. MR. BROSCH TESTIFIES: "[T]HE TRADITIONAL REGULATORY PRACTICE FOR MANY YEARS, AS CODIFIED IN THE FCC'S UNIFORM SYSTEM OF ACCOUNTS AND RECOGNIZED BY THIS COMMISSION FOR MANY YEARS, IS TO TREAT DIRECTORY ADVERTISING AND OTHER DIRECTORY PUBLISHING REVENUES AS ABOVE-THE-LINE FOR RATEMAKING PURPOSES."[73] DO YOU AGREE?

A. Yes. However, the issue here is not how to treat ongoing directory revenues and expenses but how to treat the gain on the sale of the directory publishing operation.

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[72] Brosch, page 71, lines 2 to 3.
[73] Brosch, page 28, lines 21 to 24.

Q. HOW DO THE FCC'S ACCOUNTING RULES TREAT THE GAIN ON THE DISPOSITION OF A BUSINESS SEGMENT, SUCH AS THE PUBLISHING OPERATION?

A. The sale of an entire business segment, including the right to provide service to the customers of that business is, in the parlance of FCC regulatory accounting, a sale of "plant with traffic." A sale of "plant with traffic" is a sale of both the assets used to provide services and the right to provide those services to the customers served by those assets. After a sale of "plant with traffic" closes, the purchaser is responsible for providing service to the customers who are served by the sold plant.

Regarding a sale of plant with traffic, the FCC's Uniform System of Accounts (USOA) provides:

> When the telecommunications plant is sold together with traffic associated therewith, the original cost of the property shall be credited to the applicable plant accounts and the estimated amounts carried with respect thereto in the accumulated depreciation and amortization accounts shall be charged to such accumulated accounts. The difference, if any, between the net amount of such debit and credit items and the consideration received (less commissions and other expenses of making the sale) for the property shall be included in Account 7350, Gains or Losses from the Disposition of Certain Property. The accounting for depreciable telecommunications plant sold without the traffic associated therewith shall be in accordance with the accounting provided in § 32.3100(c) of this subpart.[74]

This paragraph requires a company to remove from its books of account the original cost and accumulated depreciation of the plant in the business being sold. The difference between the sales price and net book, reduced by the expenses and taxes associated with the sale, is the gain or loss. In this particular instance, the sale of Dex will produce a gain. The FCC's USOA requires the seller of plant with traffic to record the gain or loss on the transaction to account 7350. The USOA classifies Account 7350 as a non-operating income and expense account, i.e. a below-the-line account. The phrase "below-the-line" refers to

[74] 47 CFR 32.2000(d)(5).

asset, liability, revenue, expense, and tax accounts that are not included in the calculation of rate base and cost of service used for establishing revenue requirements. Below-the-line treatment of gains and losses on sales of plant with traffic recognizes that shareholders, not ratepayers, are the owners of the business and ultimately bear the risk of loss and financial burden of the business as a whole.

The appropriate discount rate to amortize the gain is the post-tax cost of capital.

Q. WHAT DOES THE SCHEDULE OF CUSTOMER CREDITS CONTAINED IN EXHIBIT MLB-2C REPRESENT?

A. In Exhibit MLB-2C, Mr. Brosch shows a schedule that proposes the treatment of the gain from the Dex sale. The schedule shows the initial customer credit proposed for September 30, 2003 that he assumes to be the close date. However, he shows the calendar year revenue credits for the twenty years beginning January 1, 2004, instead of September 30, 2003. He uses time value of money principles to recognize the value of the post-tax regulatory liability based upon the future cost recognition using the rate of return first granted in Docket No. UT-950200 and utilized in Docket No. UT-970766 as the interest rate.[75]

Q. HOW DID MR. BROSCH MISAPPLY THE INPUTS AND ASSUMPTIONS IN THE SCHEDULE OF CUSTOMER CREDITS CONTAIN IN EXHIBIT MLB-2C?

A. Mr. Brosch creates an artificial need for an initial customer credit by: 1) using the nominal rate of return the Commission authorized in Docket No. UT-950200 instead of that rate of return correctly stated on a post-tax basis; 2) arbitrarily selecting 20 years of continuing revenue credits instead of the number of years necessary to fully amortize the post-tax

[75] Here the term interest rate refers to the earning power of the firm, also commonly measured by its cost of capital. In other contexts, interest can also refer to the earnings rate of financial instruments such as bonds and savings accounts. In a time value of money formula, the same interest rate is known as the discount factor because money or value received later is worth less than the same amount of money or value received immediately (present value).

liability to ratepayers; and 3) beginning on January 1, 2004 instead of the assumed date of close..

Q. HOW WAS THE RATE OF RETURN DEVELOPED IN UT-950200?

A. In the Fifteenth Supplemental Order in Docket No. UT-950200, the Commission found the following:

Commission's Rate of Return/Capital Structure

Type of Capital	Ratios	Cost Rates	Weighted Costs
Long term debt	38.9000%	7.570%	2.945%
Short term debt	9.100%	6.000%	0.546%
Preferred equity	0.000%	0.000%	0.000%
Common Equity	52.000%	11.300%	5.876%
TOTAL	100.000%		9.367%

As is the common convention, the cost of long term and short-term debt included in the rate of return the Commission found is expressed as the actual, pre-tax amount of debt. The pre-tax cost of debt is the cost of debt before taking into account the effect of the income tax benefits arising from the deductibility of debt. Conversely, the cost of common equity is a post-tax cost. These costs are weighted by the Commission's approved capital structure.

Q. DOES THE RESULTING RATE OF RETURN ACCURATELY REPRESENT THE COMPANY'S ACTUAL COST OF CAPITAL?

A. No. A firm's actual cost of capital is comprised of its post-tax cost of debt and its post-tax cost of equity. The rate of return expressed above does not represent the actual cost of capital because, although it represents a post-tax cost of equity, it does not represent a post-tax cost of debt. In a rate case, the use of a pre-tax cost of debt and a post-tax cost of equity is appropriate because the deductibility of the debt for income tax purposes is accounted for in the calculation of tax expense included in revenue requirement.[76]

Q. COULD MR. BROSCH HAVE ACCOUNTED FOR THE INCOME TAX DEDUCTIBILITY OF DEBT IN HIS SCHEDULE OF CUSTOMER CREDITS?

A. Yes, he could have, just as Confidential Exhibits TAJ-4C and MSR–2C do. However, he did not. The rate of return Mr. Brosch's schedule uses fails to account for the effect of the income tax deductibility of the debt component of the cost of capital. If Mr. Brosch had properly accounted for the income tax deductibility of the pre-tax debt component of the 9.367% authorized cost of capital, in the column labeled "Interest at 9.367%," then he would have utilized the same rate of return utilized in Confidential Exhibits TAJ-4C and MSR-2C. His failure to account for the income tax deductibility of the pre-tax debt component of the 9.367% authorized rate of return overstates the actual cost of capital because it omits the reduction to cost of capital caused by that income tax deductibility. The effect of Mr. Brosch's failure to use a post-tax cost of debt in the cost of capital passes through to ratepayers a double tax benefit—one for the income tax factor up shown on line 17 of his Confidential Exhibit MLB-2C and the other from the failure to reduce the cost of capital he uses by the tax deductibility of the debt component of his cost of capital.

Q. HAVE PUBLIC COUNSEL AND THIS COMMISSION EMBRACED THE INCOME TAX DEDUCTIBILITY OF THE DEBT COMPONENT OF COST OF CAPITAL AS AN APPROPRIATE RATEMAKING PRINCIPLE?

A. Yes. The Commission, in Docket Nos. UT-950200 and UT-970766 incorporated this principle into the calculation of revenue requirement by employing an "interest

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[76] It is a mathematical choice that regulators traditionally use the pre-tax cost of debt and the post-tax cost of equity to determine rate of return. A Commission could use the post-tax cost of debt and post-tax cost of equity and coordinate the income tax expense calculation to the use of a post-tax cost of debt. Either method will derive the same revenue requirement.

synchronization" adjustment. The Commission's order in Docket No. UT-950200 refers to an interest synchronization proposal[77] of Steve Carver, who is consultant in Mr. Brosch's firm and was one of Public Counsel's witnesses in Docket No. UT-950200. According to the Commission, Mr. Carver "[S]tates that it is important to adjust the interest expense effect on the level of interest that the ratepayer is required to pay through the rate of return." The Commission accepted Mr. Carver's proposal.

Mr. Brosch's Condifential Exhibit MLB-2C fails to be consistent with his firm's, his client's, and the Commission's position that the income tax deductibility of the debt component of cost of capital should be taken into account for ratemaking. Inasmuch as Mr. Brosch's proposal is aimed at directly affecting ratemaking in Washington, he should have used the correct discount factor of 8.145% which properly reflects the income tax deductibility of the debt component of the cost of capital.

Q. WOULD IT HAVE BEEN DIFFICULT FOR MR. BROSCH TO HAVE USED THE APPROPRIATE COST OF CAPITAL?

A. No. He could have used the same post-tax cost of capital used in Confidential Exhibits TAJ-4C and MSR–2C.

Q. PLEASE SHOW HOW THIS DISCOUNT FACTOR IS DERIVED FROM THE COST OF CAPITAL THE COMMISSION AUTHORIZED IN UT-950200.

A. The calculation of this discount factor, based on the last Commission-authorized cost of capital for QC is as follows:

Type of Capital	Ratios	Pre-Tax Cost Rates	Post-Tax Cost Rates	Weighted Costs

[77] *Washington Utilities and Transportation Commission v. U S WEST Communications, Inc.,* Docket No. UT-950200, Fifteenth Supplemental Order; Commission and Order Rejecting Tariff Revisions; Requiring Refiling, (April 11, 1996), page 63.

Long term debt	38.9000%	7.570%	4.920%	1.91407%
Short term debt	9.100%	6.000%	3.900%	0.35490%
Preferred equity	0.000%		0.000%	0.000%
Common Equity	52.000%		11.300%	5.876 %
TOTAL	100.000%			8.145%

This discount factor properly utilizes the post-tax cost of debt and the post-tax cost of equity.

If the Commission accepts Mr. Brosch's proposal regarding ratepayers' share of the gain, then Revenue Credits should be for 23 years, not 20 years.

Q. IS MR. BROSCH'S RECOMMENDATION TO CONTINUE THE REVENUE CREDITS FOR 20 YEARS APPROPRIATE?

A. Mr. Brosch's selection of 20 years is speculative and essentially arbitrary. Using the subjective rationale on page 68 of his testimony, he could have just as easily selected an amortization period that left nothing for a one-time customer credit at close. The one-time customer credit at close is inappropriate because it creates a windfall for ratepayers that is unnecessary under a no harm standard. If Dex is not sold, ratepayers would not receive any one-time customer credits. Once the Commission has determined the portion of the gain to which it believes ratepayers are entitled, the Commission should use an amortization period sufficiently long to amortize that amount of gain without the need for one-time customer credits that create a windfall for ratepayers and unnecessarily harm shareholders.

Q. IF THE AMOUNT OF GAIN THAT MR. BROSCH PROPOSES BE GIVEN TO RATEPAYERS WERE AMORTIZED USING THE CORRECT DISCOUNT FACTOR OF 8.145%, AND WITHOUT BEING REDUCED BY ANY ONE-TIME CUSTOMER CREDITS, WHEN WOULD THE AMORTIZATION BE COMPLETE?

A. The amortization would be complete at the end of the year 2025 as shown in Confidential Exhibit PEG-11C.

<u>REBUTTAL OF CHARLES W. KING</u>

Mr. King erroneously asserts that rate regulation did not begin in Washington until 1923.

Q. DOES MR. KING ASSERT THAT RATE REGULATION BEGAN IN 1923 IN WASHINGTON?

A. Yes. Following is a Qwest Data Request to the Federal Executive Agencies and Mr. King's response on this issue:

> Data Request 4: Please identify when Mr. King believes the inception of rate regulation in Washington occurred and provide all documentary evidence in support that belief.
>
> Response: Mr. King relied on the testimony of Qwest witness Philip Grate, who states that rate regulation began with the Commission's order on March 31, 1923. <u>See</u> Exhibit PEG-IT, page 18, line 20 through page 19, line 2.

Q. DID YOU TESTIFY THAT RATE REGULATION BEGAN IN 1923 IN WASHINGTON?

A. No. Following is the portion of my direct testimony upon which Mr. King relies.

> In ordering rates that the Commission had found to be sufficient (*see* Exhibit PEG-3, page 15) the Commission shifted the financial burden of telephone service operations from investors to ratepayers where it has remained until relatively recently when competition has shifted the financial burden of many services back to investors.[78]

Clearly, this testimony does not assert that rate regulation <u>began</u> in Washington in 1923. Exhibit PEG-3 to my direct testimony devotes six pages to the history of regulation of the Company's rates in Washington before March of 1923. That exhibit discusses price cap regulation, tariff filings, rate cases, the period of federal control of rates and rates after the

[78] Direct Testimony of Philip E. Grate dated January 17, 2003, ("Grate"), page 18, line 20 to page 19, line 2.

period of federal control leading up to 1923. In the face of this unrebutted evidence, Mr. King's assertion that ratepayers have borne all the risk of loss in the directory business since the inception of rate regulation in Washington is simply wrong.[79]

Q. DID YOUR DIRECT TESTIMONY ACKNOWLEDGE THAT RATEPAYERS BORE THE FULL RISK OF LOSS IN THE DIRECTORY BUSINESS PRIOR TO 1984?

A. No. My direct testimony is clearly to the contrary:

> Ratepayers have never borne any of the financial burden of the Company's directory publishing and advertising activities. Under this step of the two-step test, they are entitled to none of the gain.
>
> Ratepayers bore the risk of loss on the tangible assets that supported the Company's directory publishing and advertising activities for a maximum of 60 out of the 120 years the Company has been providing service in Washington. This 60-year period was less risky than the preceding and following periods during which the Company bore the risk of loss. Accordingly, ratepayers should receive no more than 50% of the gain realized from the disposition of the tangible assets.
>
> The vast majority of the gain on the sale of Dex is derived from the goodwill the business has built up over a period of more than 100 years of directory advertising sales. Ratepayers have borne none of the risk of loss of this goodwill. Accordingly, under the two-step test they are entitled to none of the gain attributable to the goodwill of the business.[80]

Mr. King's assertion that I have acknowledged ratepayers bore the full risk of loss in the directory business before 1984 is clearly incorrect and misleading.

Mr. King's opinion is clouded by a fundamental misunderstanding of the principle of risk of capital loss under *DCC* and *IPTA*.

Q. HAS MR. KING DESCRIBED THE CIRCUMSTANCES THAT MUST EXIST FOR SHAREHOLDERS TO HAVE BORNE THE RISK OF LOSS OF A PARTICULAR UTILITY ASSET OR THE BURDEN OF A PARTICULAR UTILITY OPERATION?

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[79] King, page 14, lines 10 to 14.
[80] Grate, page 25, lines 3 to 15.

A. Yes. Following is a Qwest Data Request to the Federal Executive Agencies and Mr. King's response on this issue:

> Data Request No. 35: Please describe all the facts and circumstances that must exist in order for shareholders to have borne the risk of loss of a particular utility asset or the burden of a particular utility operation.
>
> Response: The profitability of the operation or activity must bear no relation to the rates, charges, revenue recovery or service obligations that are established by legislation or regulation.

Q. IS MR. KING CORRECT?

A. Clearly not. In *IPTA*, the D.C. Circuit Court found:

> Cost reductions under the price cap scheme "do not trigger reductions in the cap," but rather increase the company's profits. [cite omitted] Thus, after 1990, the ratepayers no longer bore the risk of losses from payphone operation assets. To the extent a BOC incurred expenses in connection with payphone operations, company and shareholder profits declined. As a result, at least since 1990, investors rather than ratepayers have borne the risk of loss on payphone assets (tangible and intangible), and thus, under Democratic Central, investors should reap the benefit of increases in the value of such assets.[81]

Under the price caps, the profitability of the operation bears a very direct relation to the rates, charges, and revenue recovery established by the price cap regulation. A cap on prices bears directly on the revenues a utility activity can generate, which, in turn, bears directly on its profitability. Yet, under a price caps regulatory scheme, ratepayers clearly do not bear the risk of loss on the assets supporting the price-capped services. Mr. King's conclusions regarding risk and burden are clouded by a clearly incorrect understanding of how risk of capital loss is determined under *DCC* and *IPTA*.

[81] *Illinois Public Telecommunications Association v. Federal Communications Commission and United States of America,* 326 U.S. App. D.C. 1, 46, 117 F.3d 555 (1997).

Mr. King made no effort to ascertain facts that would determine who bore the risk of capital losses on the assets being sold or bore the burden of the particular utility activity.

Q. DID MR. KING MAKE ANY EFFORT TO GATHER EVIDENCE THAT WOULD ALLOW HIM TO DETERMINE THE ACTUAL FACTS OF THIS CASE?

A. No. The following Qwest Data Request to the Federal Executive Agencies and Mr. King's response indicate the extent of Mr. King's efforts:

> Data Request 3: Please describe Mr. King's efforts to ascertain whether ratepayers or shareholders bore the risk of loss on the directory business since the inception of rate regulation in Washington.
>
> Response: Mr. King's "efforts" are set forth on page 14, line 10 through page 16, line 16 of his Response Testimony.

Mr. King expended no effort to gather or review the facts regarding to the Company's history in Washington or changes in the regulatory scheme in Washington. Consequently his opinions regarding risk of capital loss of directory publishing assets (particularly the intangible, subsidy-producing assets) and the financial burden of the directory publishing utility activity in Washington are uninformed by knowledge of the facts. Instead, Mr. King relies on the MFJ that Judge Greene vacated in 1996 and a Washington Supreme Court case in which the record did not address the history of regulation or the Company's development in Washington. That case does quote a 1988 Colorado Supreme Court opinion regarding Mountain Bell:

> "The directory publishing business was developed over the past fifty years within the protective shelter of Mountain Bell's monopoly of telephone service."[82]

The Company's directory business in Washington did not develop in Colorado. The 50 years that the Colorado Supreme Court addressed was less than half of what was, in 1988, the Company's 109 year history in Colorado.[83]

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[82] *U S WEST Communications, Inc. v. Washington Utilities and Transportation Commission*, 134 Wn.2d 74, 949 P.2d 1337, 1351 (1997) citing *Mountain States Tel. & Tel. Co. v. Public Utilities Commission*, 763 P.2d 1020, 1027-28 (Colo. 1988).

Mr. King's opinion, that ratepayers have borne all the risk of loss, is informed by a fundamental misunderstanding of the principles of *DCC* and *IPTA*, by a disregard for the facts set forth in my testimony, and by a lack of any investigation into or personal knowledge of the actual facts of the case.

QCI will pay income taxes on the gain on the sale of Dex, regardless of whether it pays taxes with its 2002 and 2003 returns.

Q. DO OPPOSING PARTIES ASSERT THAT QCI WILL PAY NO INCOME TAXES ON THE GAIN FROM THE SALE OF DEX?

A. Yes. Mr. King testifies:

> First, given its extensive losses in the past few years, QCI is not likely to pay any tax whatever on its gain from the Dex sale. That being the case, a tax deduction from the ratepayer benefit is not a reflection of money passing from Qwest to the government, but of money passing from ratepayers to QCI.[84]

Mr. Brosch testifies:

> Q. … Will QCI pay any income taxes on the Dex sale gain it experiences?
>
> A. Probably not. As mentioned earlier in my testimony, QCI has accumulated large net operating loss ("NOL") carryforward balances for income tax purposes. In addition, the stock of LCI was included by Qwest in the assets being acquired by the purchaser for the apparent purpose of reducing income taxes otherwise payable on the transaction.[85]

Q. ARE MR. BROSCH AND MR. KING CORRECT?

A. Definitely not. The gain, as determined under Internal Revenue Code (IRC) section 1001, is taxable under IRC section 61. Nothing in the IRC or the federal income tax regulations allows a deduction against the gain on Dex for net operating loss carryforwards or from losses incurred on sales of other companies, such as LCI.

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[83] The Company started operations in Denver, Colorado in 1879.
[84] King, page 29, lines 4 to 8.
[85] Brosch, page 54, lines 12 to 17 (footnote omitted).

The assertion that QCI will not pay taxes on the Dex sale gain is based on two fallacious income tax accounting principles. The first is that the tax cost of a given period is equal to the amount of taxes paid to taxing authorities (cash taxes) during that period. The second is that the measurement of cash taxes should be based on consolidated cash taxes, i.e. the taxes paid by the parent corporation filing a consolidated income tax return. Neither of these principles is accepted under Generally Accepted Accounting Principles[86] and neither is

[86] Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes, provides as follows:
Proposals for Partial or No Recognition of Deferred Taxes That Were Rejected
Taxes Payable as Determined by the Tax Return
200. Some respondents to the Discussion Memorandum advocated that income tax expense for financial reporting should be the amount of taxes payable for the year as determined by the tax return. The rationale most frequently cited to support that proposal is summarized as follows:

a. The tax return determines the legal liability for income taxes.
b. Taxes are levied on aggregate taxable income, and individual events are merely indistinguishable pieces of the overall determination of aggregate taxable income.
c. Any tax payments for future years will be solely a consequence of generating taxable income in those future years.
d. Notational tax calculations based on the recognition and measurement of events for financial reporting are not appropriate.
e. All other approaches to accounting for income taxes are too complex.

201. The Board believes that the tax consequence of an individual event are separable from aggregate taxable income. For example, if the gain on an installment sale is taxable, both the sale and the tax consequence of the gain on the sale should be recognized in financial income for the same year. The tax law may permit an election to include some or all of the gain in the determination of taxable income in future years. That election, however, only affects when and not whether the gain will be included in determining taxable income. The tax consequences arose at the time of the sale and result from the gain on the sale.

incorporated into the FCC's Uniform System of Accounts.[87]

To illustrate the fallacy of the concepts, suppose that my spouse and I have a joint credit card account. Suppose that in April, she charges a $50 purchase to the card. Suppose further that we receive a $50 bill from the credit card company and pay it in May. Suppose that in June, she returns the $50 item purchased and receives a credit to our joint credit card account. Then suppose that in July, I make a $50 purchase on the card. When the bill for the card comes, we owe nothing because the $50 credit from her return offsets my $50 charge. I could claim that my purchase was free, but my spouse would be quick to point how truly incorrect this is.

Another illustration is this. Suppose a person held a job for which she drew a salary and that she also operated a business as a sole proprietor. Suppose further that in a given year the business generated losses that exceeded her salary so that, on her tax return for that year, she reported no net taxable income and paid no income taxes. Under the first fallacious principle, one could incorrectly conclude that she paid no income tax on her salary, even though her salary was taxable and her employer withheld income taxes from it as required by law. The losses from the business did not cause the salary to be un-taxed—it caused her <u>aggregate</u> income tax liability to be zero.

If QCI does not pay cash taxes to the IRS in 2002 or 2003, it will not be because the gain on the sale of Dex went un-taxed, but because of tax savings from <u>other</u> tax events that occurred either in the current period or in the past. Assertions that QCI will pay no income taxes on the gain from the sale of Dex are false and misleading.

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[87] *See* 47 CFR §32.22, Comprehensive Interperiod Tax Allocation

CONCLUSION

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.