SURREBUTTAL TESTIMONY

Q.  Please state your name, position and business address.

A.  My name is Lee L. Selwyn; I am president of Economics and Technology, Inc., One Washington Mall, Boston, Massachusetts 02108.

Q.  Have you previously submitted testimony in this proceeding?

A.  Yes, I submitted pre-filed direct testimony on behalf of the Staff of the Idaho Public Utilities Commission on November 26, 1996.

Q.  What is the purpose of your testimony at this time?

A.  I am responding to the rebuttal testimony offered by US West witnesses Easton and Vanston regarding Staff's recommendations on depreciation issues, Koehler-Christensen regarding yellow pages, and Wozniak and Owen regarding competition.  Staff had recommended that, with respect specifically to Title 61 services, US West be directed to apply the service lives and depreciation rates in effect at the time of enactment of the Idaho Telecommunica­tions Act of 1988, (Idaho Code §§ 62-601 et. seq.), and that again with respect to Title 61 services, the Company's proposal to apply Equal Life Group (ELG) accelerated depreciation be disallowed.  Staff's positions regarding depreciation rates and practices is limited to that portion of US West's asset base that is required for the provision of Title 61 services; Staff takes no position with respect to the manner in which US West chooses to treat the remaining portion of its assets — i.e., the portion associated with the provision of Title 62 services — or the manner in which the Company chooses to apply overall.  As such, Staff's recommend­ations go specifically to the manner in which total depreciation accruals are allocated to Title 61 services, rather than to the rates or methods by which such accruals are made for the Company as a whole.

Q.  Does Mr. Easton appear to understand the nature of Staff's treatment of depreciation issues?

A.  No, he doesn't.  Rather than address Staff's cost allocation recommend­ation directly, Mr. Easton merely rejects the notion that depreciation expenses are subject to Title 61/Title 62 disaggregation, and then proceeds to challenge Staff's position as if that position were directed at US West overall, which of course it is not.

Staff's position regarding depreciation rates is rooted in the statutory distinction between "regulated" (Title 61) and "nonregulated" (Title 62) services.  In enacting this paradigm, the Idaho legislature intended that the Title 61 services be subject to cost-of-service type regulation while allowing US West complete pricing and earnings freedom with respect to Title 62 services.  But, as Mr. Easton has recognized (rebuttal, pp. 12-13), "the same assets ... provide the different [Title 61 and Title 62] services."

Mr. Easton suggests that I "confuse[] services with the assets which [sic] provide the services" (Easton Rebuttal, at 12).  In fact, it is Mr. Easton who confuses depreciation with cost allocation.  His notion that a single, company-wide set of service lives and associated depreciation rates should apply would be valid only if all of the services that were produced by the assets in question were subject to some form of cost-of-service regulation.  (That is, pure RORR, or price caps with low-end protection, sharing of excess earnings, an earnings cap, and/or periodic reviews with the possibility of reinitialization or rate levels and other price cap parameters.)  In that circumstance, a single, company-wide "revenue requirement" would be determined, and the Commission could consider compre­hen­sively the rate structure applicable to all of the services that are produced out of the common asset base.  In so doing, the Commission could require deaveraging of various shared costs, including depreciation, or it could simply determine that those services that utilize the advanced capabilities of the latest technological equipment vintage should provide contribution toward the cost of basic services.  For example, services such as Caller ID, Call Return, and other so-called "CLASS" features are typically priced to provide substantial contribution over and above their specifically identified costs.  In Idaho, however, revenues from, and costs associated with, these and other such services are by law excluded from inclusion within the Title 61 "revenue requirement."  For this reason, the Commission needs to be concerned as to how the costs of the "assets" that jointly provide Title 61 and Title 62 services are allocated to each category.

Q.  Does the presence of the statutory distinction between regulated Title 61 and nonregulated Title 62 services influence the manner in which the Company would, if left to pursue its own best financial interests, assign shared and joint costs as between the two categories?

A.  Yes, indeed it does.  In fact, the statutory distinction, which is unusual, creates a set of incentives for US West that are decidedly adverse to the interests of its Title 61 customers.  Specifically, because only the Title 61 services are priced on the basis of cost, the Company has a strong financial incentive to assign as much of the joint capital and operating costs of assets (and other joint activities) to those (Title 61) services whose prices are cost-driven, and to exclude as much as possible of costs from those (Title 62) services whose prices are market-driven.  Mr. Easton may well be "shocked" at Staff's attempt to address this issue, but his self-described emotional reaction does not make it wrong.

Q.  Does Staff's position with respect to the assignment of depreciation costs to Title 61 services affect the manner in which US West depreciates its plant overall?

A.  No, in fact, US West is free to depreciate plant that is used jointly to support Title 61 and Title 62 services any way it wants to, and to recover such costs as it can from the non­regulated Title 62 category.  The issue before this Commission, and the issue that I specifi­cally address in my direct testimony, is how much of the depreciation expenses associated with jointly-used assets should be borne by services classified under Title 61.  Mr. Easton may seek to obfuscate this central question by being "shocked" and by offering the largely irrelevant testimony of Dr. Vanston, but he can't obscure the fact that ETI was addressing the question of cost allocation, not of how, from a company-wide perspective, the jointly-used assets should be depreciated or recovered.

Q.  Mr. Easton claims that Staff is revisiting issues that had been previously addressed and decided by the Commission.  Do you agree?

A.  No.  As I explained in my direct testimony at 29, I was "advised by Staff Counsel that neither of the Staff letters [October 21, 1991 and August 31, 1993] constituted Commission authorization, for rate-making purposes, of revised depreciation lives and rates for US West's Idaho plant (see Schedule 1 of Exhibit 160).  Counsel has advised me that the Commission allowed the Company to implement these changes for booking purposes while the Revenue Sharing Plan was in operation, but not for rate-making purposes."  Both the 1991 and 1993 Staff letters bear this out.  In addition, the Company's letter requesting the right to "adjust" booking rates in 1991 and 1993 acknowledges specifically that the Commission was "not being asked to formally approve this [1991] change in depreciation methodology during the life of the Revenue Sharing Plan."   Schedule 2, Exhibit 160.  The 1991 letter states at page 2:

USWC recognizes that the Commission has in prior cases rejected the use

of the ELG depreciation methodology.  However, given the existence of

the Revenue Sharing Plan [and that changes in depreciation lives do not

increase rates], Title 61 ratepayers will not be adversely affected by the

Company's use of ELG.  If the Revenue Sharing Plan ceases to exist at

some time in the future, the impact of using one depreciation methodology

as compared to another will be an issue for the Commission's

consideration on a going forward basis, at least as to assets used in the

provision of services subject to Title 61 economic regulation.  ...the

Company [does not] view the change in methodology during the term of

the Revenue Sharing Plan as precedential or in any way binding on the

Commission beyond the life of the Plan.

Emphasis added.  (Schedule 2, Exhibit 160.)  The 1993 request letter contains similar language:

In making this request [to implement the 1993 three-way depreciation

rates], the Company is not asking the Commission to establish any

precedents relative to the appropriate depreciation levels...

(Schedule 2, Exhibit 160).  Thus, as I concluded in my direct testimony, "[c]onsequently, it appears that the Commission last granted formal approval of changes to US West's depreciation lives and rates in the 1988 decision, Order 21949, discussed earlier in my testimony."  (In this regard, Mr. Easton's criticism (at 5) that I had never discussed these letters with Mr. Lansing is immaterial, since I did rely upon the documents and had no reason to believe that advice to be incorrect.  Furthermore, it is noteworthy that during the course of the deposition of Mr. Lansing, he was never asked whether he discussed depreciation matters with Ms. Baldwin (which he did) or whether other Staff members had discussions with either Ms. Baldwin or myself.  Significantly, Mr. Easton does not appear to directly confront Staff counsel's opinion, but instead seeks to dismiss its validity because it has been relied upon by the Staff's "paid consultant.")

Q.  Why is it appropriate for the Commission to address the assignment of depreciation costs to Title 61 services at this time?

A.  This is the first US West general rate case proceeding since the enactment of the new law in 1988 in which Title 61 rates are to be specifically set on the basis of cost.  As such, it is appropriate to start with the situation that prevailed at the time that the legislation was enacted, and that is the depreciation rates that were in existence as of 1988.  Indeed, even the 1988 depreciation rates were applied to plant that was (at the time) being used to provide services that would become nonregulated under Title 62.  Hence, if anything, even the 1988 rates, when expressed on a deaveraged basis, likely overstated the rates that should be applied for the services to be retained under Title 61 regulation.

Q.  Mr. Easton (at 4) seeks to dismiss Staff's recommendation by suggesting that it is "unique" among the 14 US West states.  Are you aware of any other jurisdiction in which the kind of deaveraging that you are recommending here has been adopted?

A.  No, but I am also not aware of any jurisdiction in which the regulatory paradigm is identical to that which exists in Idaho and in this case in particular.  North Dakota is the only other state of which I am aware where, by statute, a large portion of the services that are produced out of a local exchange carrier's common asset base are deregulated as they are here in Idaho (North Dakota Century Code, Volume 9B, 1995 Pocket Supplement, at Ch. 49-21).  However, the two situ­ations are not comparable.  North Dakota's rate-setting mechanism is based upon a price cap system where rates for "regulated" services are not tied to an embedded cost "revenue requirement" formulated under traditional rate of return regulation methods.  In North Dakota as in other "price cap" jurisdictions, the "costs" of the regulated services, as distinct from "non-regulated" ones, are not the basis of the prices charged for those services, and so the same types of cost allocation questions that are before the Idaho Commission here simply do not arise.  To the best of my knowledge, then, Idaho's combination of the Title 61/Title 62 division of services, and the use of embedded costs to set rates in the present case, is unique.  Because of the nature of the current case, then, "unique" regulatory solutions are required to correctly apply the law and to prevent the Company from cross-subsidizing its competitive Title 62 services through revenues generated via an over-assignment of costs to Title 61.

Thus, Mr. Easton's suggestion that the Staff's position is "unique" among the 14 US West states is of no particular importance, since the set of regulatory conditions involved here is similarly unique.  In fact, I would agree with a number of Mr. Easton's assertions were it not for the regulatory paradigm that exists in Idaho, and the details of the case at hand.  As I understand it, the specific structure that was adopted by the legislature was proposed and strongly supported by US West at the time that the legislation was pending.  The matter of cost assignment between the two service categories is necessary only because of the dramatically different philosophies under which each group is regulated and their extensive joint use of common plant, and because this case will be setting a rate based upon embedded costs.

It is difficult for me to believe that the Idaho legislature, by adopting distinct regulatory treatment for these two groups of services, intended that the Company would be able to shift costs that are driven by and incurred primarily to benefit Title 62 services into the Title 61 cost-based revenue requirement.  Such a tactic would, among other things, make entry by non-integrated competitors (i.e., those that do not provide services comparable to those classified under Title 61) virtually impossible.  Under Mr. Easton's interpretation, US West can acquire plant that will be jointly used, assign a substantial portion of its costs to Title 61 services, and be assured full recovery of such costs irrespective of how successful the Company is in developing the new services for which that plant had been acquired.  Since the Idaho legislature expressly anticipated that the new law would promote competition (SeeIdaho Code, at § 62-602), it could not have intended that US West or other ILECs be allowed to shift competitively-driven costs into the protected Title 61 column.

Q.  Do you agree with Dr. Vanston's theory of seemingly inevitable "technological substitution" as the driving force behind shorter economic lives and accelerated replacement of embedded telephone plant?

A.  No, I do not.  If there were any merit to Dr. Vanston's inevitability hypothesis, we would expect to see the pace of technological substitution being roughly the same across all sectors of the economy.  That obviously is not the case, because the pace of technological substitution and plant replacement varies from industry to industry and will, among other things, be heavily driven both by the pace of technological change as well as the economic benefits (in the form of increased sales and/or reduced costs) that would result from the substitution.  The airline industry, for example, substituted jet aircraft for propeller airplanes on major trunk routes over a relatively short period of time, roughly from the late 1950s to the early 1960s.  However, more evolutionary changes in the nature of jet aircraft have not led to wholesale replacement of the entire fleet.  The introduction of jumbo jets did not lead to the retirement of smaller planes, and even the improved efficiencies of newer models have not resulted in wholesale replacements of vintage aircraft.  In fact, individual airplanes with as much as twenty years of service are still flying; in some cases, when the "major" airlines decide to replace older planes, they are sold to start-up carriers who continue to use them in revenue-producing service.  And propeller airplanes are still being manufactured and flown in commercial service, albeit in specific (typically commuter) market segments.  Clearly, Dr. Vanston's portrayal of technological substitution as somehow being inevitable is both overblown and oversimplified.  We don't see rapid adoption of new technology in the education sector, in mass transit, in air traffic control, or other government functions.  We do see it in health care.  It occurs at different rates in different manufacturing and service industries.  (Significantly, and without exception, all of the specific instances of the use of "technology substitution analysis" cited by Dr. Vanston in US West's response to STF-05-451 occurred in the telecommunications industry.  This response is included as Schedule 2 of my Exhibit 161.)  The pace of substitution will be heavily influenced by the economics of the plant replacement decision.  It will occur when the incremental benefits outweigh the incremental costs of replacement, and it will not occur when this condition is not present.

Q.  You have suggested that Dr. Vanston's rebuttal testimony is irrelevant to the question of cost allocation and, specifically, with respect to the assignment of depreciation costs as between Title 61 and Title 62 services.  Why do you consider his testimony to be irrelevant?

A.  To the extent that Dr. Vanston's testimony is relevant at all in this proceeding, it goes to the collection of technological and market conditions that are driving US West to replace older technology plant with feature-rich vintages; Dr. Vanston fails entirely to tie his theory of technology substitution specifically to the Title 61 services that are at issue in this proceeding or, for that matter, to the demand for any particular US West service.  See US West response to STF-05-453(a), (b) and (c) (Schedule 3 of Exhibit 161).  Dr. Vanston (and, by reference, Mr. Easton) portray technology substitution as something of an autonomous process that exists indepen­dently of the underlying economics of the capital investment process.  Like death and taxes, in their view the replacement of older technology with new, modern plant is inevitable, apparently both as to the absoluteness of its occurrence as well as with respect to the pace at which it takes place.  While Dr. Vanston's "multiple substitution analysis" may well be an interesting academic exercise in the abstract (although it is noteworthy that Dr. Vanston could not cite even a single refereed article in any academic journal in which it had been discussed, see US West response to STF-05-450(c), attached as Schedule 4 of Exhibit 161), the "theory" is plainly at odds with the reality of how businesses actually make investment decisions and, for that matter, how new technologies are created and introduced onto the market.

Q.  Please explain.

A.  Businesses make capital investment decisions where the net present value (NPV) of the expected cash flow is positive.  When considering replacement of existing plant, a firm evaluates the differential cash flow as between retaining the existing plant vs. replacing it with new facilities.  Such a replacement typically involves the expenditure of a relatively large up-front amount to acquire the new asset, which is then offset by a combination of cost savings due to the increased efficiency of the new equipment relative to the old (e.g., lower ongoing mainte­nance costs, lower costs for accommodating growth), and additional revenues that may result from the increased capabilities and/or capacities of the new equipment (e.g., from the provision of new services that could not be supported with the older plant).

Q.  Does US West distinguish between Title 61 and Title 62 services when making capital investment (acquisition or replacement) decisions?

A.  No, it does not.  According to Mr. Easton (at 12-13), because these assets are to be used jointly to provide Title 61 and Title 62 services, US West makes no distinction in the evaluation of the capital acquisition or replacement decision between the two groups.  Instead, the cost savings and revenue gains associated with each of the two service categories are lumped together, and a replacement decision is made without specifically identifying or, apparently, even being concerned with, which of the two categories is actually driving the decision.

Q.  Is it appropriate for the Company to consider the economic merit of its capital spending decisions across Title 61 and Title 62 services combined?

A.  It may well be entirely appropriate for US West as a corporation to make decisions in this manner.  However, it is inappropriate and, in my view, inconsistent with the statutory requirement for cost allocation, for costs that are driven by Title 62 services to be shifted to Title 61 customers via the joint capital decision-making process.

Q.  How might that occur?

A.  Let me respond to that question by way of the following example.  Suppose that US West is considering spending $10-million to replace an existing analog electronic switch with a new digital central office switch that is expected to have an economic life of ten years.  The new switch will be used jointly to provide Title 61 and Title 62 services.  The switch will serve a total of 25,000 access lines, of which 20,000 are in the residential/small business Title 61 category.  The other 5,000 lines serve Title 62 Centrex customers whom, US West expects, will discontinue the US West service and switch to a PBX unless the Company can offer them the advanced features that the new digital switch will provide.  US West currently receives an average of $200 per year in Title 61 revenues from each of the 20,000 residential/small business Title 61 service customers ($4-million total), and $1.5-million in Title 62 revenues from the 5,000 Centrex lines.  Assume that the ongoing annual maintenance cost for the existing switch is $600,000, and that the present switch is physically capable of remaining in service for at least ten more years.  The annual maintenance cost for the new, more efficient switch is $400,000, representing $200,000 in annual savings.  Finally, assume that if the existing switch is not replaced, US West will lose the entire $1.5-million in Centrex revenues, but that if it is replaced Centrex revenues will rise to $1.7-million (due to the additional features that Centrex customers will purchase), and the 20,000 existing residential/small business customers will each spend an average of $10 annually on new optional vertical features, all of which are classified under Title 62, adding another $200,000 of Title 62 revenues.  For purposes of this simplified example, we will assume that there are no other costs associated with the various services that are provided out of the switch, such that all revenues can go toward recovery of the initial $10-million investment.

From these "facts," we can construct a DCF analysis as follows:

YearCapitalCost savingsRevenueNet Cash

gainFlow

0-10,000,000-10,000,000

1200,0001,900,000+ 2,100,000

2200,0001,900,000+ 2,100,000

3200,0001,900,000+ 2,100,000

4200,0001,900,000+ 2,100,000

5200,0001,900,000+ 2,100,000

6200,0001,900,000+ 2,100,000

7200,0001,900,000+ 2,100,000

8200,0001,900,000+ 2,100,000

9200,0001,900,000+ 2,100,000

10200,0001,900,000+ 2,100,000

NPV @ 12%+ 1,865,468

In this example, the overall project is projected to produce a positive NPV of $1.87-million at a 12% discount rate.  On that basis, the undertaking is profitable and should be pursued.  The question before us, however, is not whether it should be pursued (it should), but how much of the $10-million in capital cost and its associated cost of money and depreciation accruals should be booked to the Title 61 category.  To answer that question, it is useful to examine how, if at all, the undertaking specifically benefits the core Title 61 services.  Remember that there will be a $200,000 per year in cost savings, but also that the additional revenues arising from the sale of vertical features to the present Title 61 customers will themselves be carried "below the line" under the Title 62 classification.  In the table below, we examine the same project, but this time exclusively with respect to the Title 61 category.  For the purpose of this example, we will assign the entire $200,000 in annual cost savings to Title 61.  In fact, since 20% (i.e., 5,000 out of the 25,000) access lines to be served by the new switch will be regulated under Title 62, we could limit the Title 61 benefit to only $160,000 per year.  However, if (absent the new switch) all of the Title 62 customers were to go away, the full $200,000 in savings would be available to the Title 61 subscribers (assuming, of course, that the new switch is still purchased).  Accordingly, and to be highly conservative in this illustration, we will assign the entire cost savings to Title 61.

YearCapitalCost savingsRevenue gainNet Cash

Flow

0-10,000,000- 10,000,000

1200,0000+   200,000

2200,0000+   200,000

3200,0000+   200,000

4200,0000+   200,000

5200,0000+   200,000

6200,0000+   200,000

7200,0000+   200,000

8200,0000+   200,000

9200,0000+   200,000

10200,0000+   200,000

NPV @ 12%- 8,869,955

Without the Title 62 revenues, the modest $200,000 in annual cost savings would not even come remotely close to justifying an up-front outlay of $10-million.  If limited solely to Title 61 services, this undertaking would result in an NPV of nearly negative $8.9-million, and the project would not be pursued.

Q.  What happens when the project is examined solely on a Title 62 basis, i.e., looking solely at the incremental Title 62 revenues, and excluding the annual cost savings?

A.  If we look at the undertaking strictly from the Title 62 revenue enhancement perspective, and assume no cost savings at all, the project would still produce substantial positive returns.  This situation is presented in the following table:

YearCapitalCostRevenue gainNet Cash Flow

savings

0-10,000,000- 10,000,000

101,900,000+ 1,900,000

201,900,000+ 1,900,000

301,900,000+ 1,900,000

401,900,000+ 1,900,000

501,900,000+ 1,900,000

601,900,000+ 1,900,000

701,900,000+ 1,900,000

801,900,000+ 1,900,000

901,900,000+ 1,900,000

1001,900,000+ 1,900,000

NPV @ 12%+ 735,424

Without the $200,000 in annual cost savings but with the significant revenue enhancement associated with retaining and expanding the Centrex market while also generating additional vertical services revenues from the residential/small business subscribers, the $10-million in capital outlay is still easily justified by the Title 62 services alone.

Q.  How would the $10-million in up-front capital spending and the associated depreciation and other capital-related costs be assigned, under US West's approach, as between the Title 61 and Title 62 service categories?

A.  Although a slight simplification, in general the capital-related costs would be assigned on the basis of relative use of the jointly-used asset.  In the present case, since 20,000 out of the 25,000 total access lines (i.e., 80%) are subject to Title 61 regulation, US West would include $8-million of the total cost of the switch in the Title 61 rate base, and assign the remaining $2-million to Title 62.

Q.  Inasmuch as the investment would not be economically justified solely for the Title 61 services, is it appropriate that any portion of the $10-million be assigned to and recovered from this category?

A.  Perhaps, but only an extremely small fraction of the total outlay.  If the project is pursued, the Title 61 services will receive some positive benefit in the form of cost savings.  On this basis, it might arguably be appropriate to assign at least some portion of the total cost of the new switch to Title 61.  The NPV (at 12%) of the $200,000 in annual cost savings over a ten-year period is approximately $1.1-million.  Hence, that amount — $1.1-million — is the maximum share of the total $10-million in capital cost that should be borne by Title 61 customers; any amount in excess of $1.1-million would make those customers worse off with the new switch than had the old one remained in place, and would constitute a cross-subsidy of the Title 62 services by Title 61 customers, which is expressly forbidden by the Idaho statute.  (Idaho Code, at § 62-613.)

Q.  Is it then reasonable to assign the full $1.1-million to Title 61?

A.  No, it isn't.  Doing that would produce no net gain for the Title 61 customers, and there is no reason why they should bear the risks attendant to any capital investment unless there is something to be gained therefrom.  Moreover, if US West were to assign the full $1.1-million in capital cost to Title 61, then the Title 62 services would have received 100% of the total gains available from the new switch while bearing only 89% of its total cost.

Q.  Under these circumstances, what is the appropriate method for assigning the joint investment cost as between the Title 61 and Title 62 service categories?

A.  While this is admittedly a simplified example, it does serve to highlight the central issue regarding capital cost allocation.  In fact, there are two distinct, but highly interrelated, capital cost allocation issues that the Commission needs to confront.

(1)To the extent that plant replacements ("technology substitutions" in Dr. Vanston's terminology) that are driven by Title 62 demands work to shrink service lives and thereby to increase depreciation rates on embedded plant, the allocation of any increased depreciation accruals attributable to such "substitutions" should be confined to Title 62 services.

(2)The forward-looking costs of the new plant whose acquisition is driven by Title 62 demands should be allocated primarily to Title 62 services; the maximum amount of any allocation of such plant to Title 61 services should be that which would make the Title 61 customers no worse off with the new plant than without it.

In fact, the allocation of the joint capital-related costs to Title 61 should be based upon the share of total benefits that is expected to flow to Title 61 services.  In the above example, $200,000 in cost savings is to flow to Title 61, while $1.9-million in new or protected revenues will flow to Title 62.  On that basis, the appropriate share of the $10-million in initial capital outlays and ongoing depreciation and cost of money should be based upon the portion of the $2.1-million in total benefit that is represented by the $200,000 that is to flow to Title 61 services, i.e., 2/21, or $952,000.

Q.  Mr. Easton argues (at 70) that Staff's adherence to "historic" or "empirical" depreciation rates is like driving a car by looking through the rear-view mirror.  Do you agree?

A.  No.  While no one would want to do that, there clearly are differences in the expectations of what the future holds based upon the nature of the business activity at issue.  To extend Mr. Easton's "driving" analogy, it is one thing to be driving along a smooth, wide, familiar highway with the sun shining vs. driving along a narrow, winding, unpaved country road at night for the first time.  While caution is required in both cases, one's driving strategy over the familiar road is obviously influenced by prior experience gained from past use of the road.  In the case of core, basic Title 61 dial tone services that US West has been providing in Idaho for nearly a century, that history and experience can be extrapolated to teach important lessons for the future, and cannot be discarded or dismissed as Mr. Easton would suggest.

Reliance upon historical experience is less appropriate for uncharted territory, such as new and competitive Title 62 services.  The Idaho legislature clearly recognized this distinction and undertook to create a correspondence between risks and returns.  For the relatively low-risk, highly stable, predictable and highly noncompetitive Title 61 services, US West is afforded all of the protection of classic rate of return regulation and is subject to strict limits on its earnings.  For the new, potentially competitive and relatively risky Title 62 services, US West is expected to accept those risks, and for so doing it is permitted to set prices as it sees fit, without regulatory involvement, justification, or approval, and to earn profits at whatever level its own management skills and risk-taking produce.  In seeking to shift risks and costs back to Title 61, Mr. Easton is subverting the very basis of the current paradigm and in so doing is forcing the captive Idaho residential and small business customers of the Title 61 services to shoulder the costs and risks of US West's competitive services and ventures.

Q.  Why do you characterize this as "forcing" captive customers of monopoly services to "shoulder the costs and risks of US West's competitive services and ventures"?

A.  Mr. Easton would use selective and inconsistent reliance upon broadly averaged costs to effectively shift costs and risks arising from competitive and discretionary Title 62 services back to captive Title 61 customers but without giving those customers any opportunity to benefit from having taken those risks.  The use of such devices to enhance the Company's overall earnings would not be possible if all of the Company's services (i.e., those classified under both Titles 61 and 62) were collectively subject to some form of rate of return regulation under a common, company-wide revenue requirement.  In that case, if the Company managed to generate significant new revenues from new services (as in our illustration above), those revenues would be used to reduce the residual revenue requirement and correspondingly produce lower rates for basic noncompetitive services.  But that can't happen here because of the brick wall that the Idaho legislation has created.  From the perspective of its Title 62 business, whatever "trash" US West can toss over that wall into its neighbor's yard (Title 61), so much the better for it.  That is not how the new law was supposed to operate, and US West should not be permitted to behave as if it were.

Q.  Dr. Selwyn, Mr. Easton attempts to justify the periodic revisions to its depreciation rates and lives on the basis of the changes that have occurred in the telecommunications industry in the nine years since 1988 and the changes that are expected to occur in future years" (Easton rebuttal at 6).  Doesn't the volatility of telecommunications technology and market conditions require these periodic revisits?

Q.  Yes, but with several important caveats.  First, different technology and market conditions apply as between Title 61 and Title 62 services, so different factors (and outcomes) must be considered when represcribing depreciation rates and service lives for each of these two groups.  Second, the existence of these rapidly changing conditions and the applicability of forward-looking technology substitution to the setting of service lives needs to be factored into the investment decisions themselves, and not be limited to an after-the-fact application to ongoing depreciation rates.

To the extent that forward-looking technology substitution concepts are relevant for setting depreciation rates, they are even more relevant and important in estimating the economic lives that are used in capital budgeting DCF analyses.  The fact that US West is continually making downward adjustments in its service life estimates for depreciation purposes provides compelling evidence that the Company has failed to adequately consider the potential impacts of technology, competition, and the various other "forces" to which Mr. Easton and Dr. Vanston refer in making their plant replacement decisions.  The importance of this can be seen by returning to our previous example, except that now we will consider the merit of our switch replacement project where the service life of the new switch turns out to be less than the ten years that was used in the original analysis.  Suppose, for example, that the life turned out to be only six years.

YearCapitalCostRevenue gainNet Cash Flow

savings

0-10,000,000-10,000,000

1200,0001,900,000+ 2,100,000

2200,0001,900,000+ 2,100,000

3200,0001,900,000+ 2,100,000

4200,0001,900,000+ 2,100,000

5200,0001,900,000+ 2,100,000

6200,0001,900,000+ 2,100,000

NPV @ 12%- 1,366,045

Now, even the combined cost savings and revenue enhancements aren't sufficient to over­come the $10-million up-front cost, and result in an NPV of negative $1.36-million.  Thus, if this investment had been pursued based upon a 10-year life that ultimately turned out to be four years too long, the effect would be a net loss to US West, most of which would be borne by customers of Title 61 services under the cost allocation scheme that US West supports.

This would occur in several ways.  First, the early retirement (due to the shorter-than-expected life) of the switch would have the effect of increasing depreciation rates for this plant account overall, and could also produce a reserve deficiency.  To the extent that (in our example) 80% of the total cost of the switch had been assigned to Title 61 customers and (under US West's methodology) a uniform, company-wide set of depreciation rates would apply to both Title 61 and Title 62 services, Title 61 customers would be forced to pay the lion's share of the costs engendered by the premature retirement.  Second, whatever new switch is then acquired (to replace our 6-year-old machine) would similarly be charged primarily to Title 61 customers.  Indeed, it is probable that the premature retirement is itself stimulated by yet another attempt to protect and/or acquire additional Title 62 revenues, so like our original example, the subsequent premature replacement of the asset may well be driven by Title 62 demands, yet be largely paid for by Title 61 subscribers.

Q.  Is such cost shifting permissible under the Idaho Telecommunications Act?

A.  No, the Idaho legislation expressly prohibits such cost shifting and cross-subsidization.  (SeeIdaho Code, at § 62-613.)  When the Company makes a downward revision in the service life of plant for the purpose of increasing rates for Title 61 services, it is directly shifting the costs of its original mis-assessment of the service life to its captive Title 61 customers.  And to the extent that the plant acquisition was driven heavily, primarily, or perhaps even solely by services that are now regulated under Title 62, or is being replaced prematurely so as to accommodate the needs of future Title 62 services, this cost- and risk-shifting has the effect of forcing captive Title 61 customers to cross-subsidize the Company's Title 62 activities.

Whether or not Mr. Easton may have difficulty in understanding the require­ments of the statute to correctly assign shared costs and risks as between the two service categories, it is critical that the Commission apply the correct principles to prevent US West from shifting economic burdens to its captive customers without a corresponding shift of economic benefits.  If the Commission concludes that it is simply not possible to apply the kind of allocations that are needed, it should consider seeking statutory authority to re-combine the Title 61 and 62 services into a single revenue requirement, and deal with the cost recovery issues through rate structure rather than through accounting separation.

Q.  Has Dr. Vanston's technology substitution theory been raised elsewhere by US West in support of its efforts to gain higher depreciation rates?

A.  Yes.  The Company sponsored Dr. Vanston's testimony in a recent Utah proceeding, Docket No. 95-049-22.

Q.  What conclusion did the Utah Public Service Commission reach with respect to US West's arguments?

The of Utah Commission rejected US West's request for approval of increased depreciation expenses:

Notwithstanding unresolved technology and economic issues, this case

compels us to decide the important policy issue of risk distribution

between current and future consumers and between current ratepayers and

shareholders.  We acknowledge a process of technology substitution

which results not only in the premature retirement of existing assets, but

in an opportunity for the Company to enter non-traditional media

distribution and content businesses in entirely new, and likely unregulated,

service markets.  This shift in technology and in service markets compels

recognition of the risk and obligation of current and future consumers of

voice service to fund Company investments in a broadband network

providing video and multimedia services for which there is uncertain

demand.

Public Service Commission of Utah, Docket No. 95-049-22, In the Matter of the Request of US West Communications, Inc. for Approval of Changed Depreciation Rates, issued April 4, 1996, at 22.  The Utah Commission went on to conclude that there was no record of demand for new services (i.e., what consumers would consume under realistic assumptions of price), and that US West had failed to provide an economic analysis of the cost of constructing a broadband or wideband network.  The Utah Commission determined that it could not "justify burdening current ratepayers further with the costs caused by premature retirement of assets replaced to offer competitive services in the future" and also concluded that "[a]s with other competitive companies, the potential revenues and returns from new competitive services will have to provide USWC management and shareholders with the confidence and incentive to invest."  Id., at 23.

Q.  In his response to STF-05-453 (see Schedule 3 of Exhibit 161), Dr. Vanston disputes the applicability of the types of DCF analyses that you have been using in the above example as a basis for technology substitution decisions.  Please comment on his response.

A.  Dr. Vanston appears to agree in principle with the use of DCF analysis as a basis for capital decisionmaking, and further agrees that where the Net Present Value (NPV) is negative the proposed expenditure should in general not be pursued.  However, he qualifies his response by suggesting that the assumptions that underlie such analyses typically change over time, and that in particular such changes would generally favor the acquisition/technology substitution decision.

Significantly, the specific factors that Dr. Vanston suggests may change — costs, for example, would be expected typically to decline over time — while favoring the substitution of new technology for old, also work to shorten the economic life of the new.  Such S-shaped technology curves as Dr. Vanston describes (and which apparently influence his technology substitution theory) can also be forecasted and considered in individual DCF technology substitution decisions themselves.  It makes no sense — and is arguably bad management — to ignore these issues when deciding upon the expenditure of capital and then to afford them great weight when it comes to crafting a regulatory strategy for escalating the rate of post-expenditure capital recovery.  To the extent that Dr. Vanston's counsel may be of value to US West, it should be incorporated into before-the-fact capital spending decisions, and not be limited strictly to after-the-fact regulatory gaming.

US West has failed to justify any departure from the established precedent of imputing yellow pages revenues in support of universal basic local telephone service.

Q.  Dr. Selwyn, please summarize your understanding of US West's position with regard to the imputation of Yellow Pages revenues in the present proceeding.

A.  US West rejects the proposed imputation of $8.645-million in Yellow Pages revenues to reduce the Title 61 revenue requirement, which is supported by myself and by Staff Witness Carlock in direct testimony in this proceeding.  US West's rebuttal witness Ann Koehler-Christensen addresses this issue, making four main arguments against the continued imputation of Yellow Pages revenues.

Q.  Do any of the US West arguments provide a persuasive rationale for the Commission to abandon its practice of imputing Yellow Pages revenues?

A.  No, they do not.

Q.  Please explain.

A.  First, US West argues that the substantial precedents cited by Staff in direct testimony (see, e.g., Selwyn Direct, at 59-63, and Carlock Direct, at 3-7) no longer apply (Koehler-Christensen Rebuttal, at 5).  US West seems to believe that the imputation of some $63-million in Yellow Pages revenues since 1984 (Koehler-Christensen Rebuttal, at 6) satisfies the mandate that those revenues support basic local exchange service, and that, as a result, there is no further need to impute Yellow Pages revenues in the future.  US West has not, however, cited any authority in either Judge Greene's comments at the divestiture of AT&T or in past Orders of the Idaho Commission, that in any way limits the support of universal service by Yellow Pages revenues to a defined period of time.  Rather, the precedents cited all strongly indicate that such support should continue for as long as universal service remains a policy goal, and for as long as the BOCs continue to publish Yellow Pages directories.

Second, US West also speculates that the imputation of Yellow Pages revenues will hinder the development of facilities-based local competition in southern Idaho.  (Koehler-Christensen Rebuttal, at 7-10.)  The Company fails to point out, however, that no consequential amount of facilities-based competition presently exists and that none is likely to develop in southern Idaho in the near future.  Moreover, even if the Commission were concerned about such an imputation where a service faces competition, there is no reason why a yellow pages imputation cannot be applied to services and service elements that are entirely noncompetitive.  Moreover, US West acknowledges that the Yellow Pages imputation might actually promote the development of resale-based competition, which is the form that local competition is most likely to take in the near future.

Third, US West further argues that the imputation of Yellow Pages revenues is inappropriate since, as a Title 62 service, it is exempt from all regulation in southern Idaho.  (Koehler-Christensen Rebuttal, at 6-7)  Yellow Pages are not subject to rate regulation, in that US West is free to charge what it likes for Yellow Pages advertising and to earn whatever profit the market will bear from that service.  However, the present issue has nothing to do with the regulatory status of Yellow Pages per se.  Rather, it involves only the allocation of costs to Title 61, regulated services.  In imputing a portion of the substantial proceeds that US West earns on its Yellow Pages operations, the Commission is not in any way affecting the profitability of Yellow Pages.  Rather, it is applying a portion of those profits toward offsetting the cost to ratepayers of Title 61 services.

Finally, US West attempts to show that its Yellow Pages operation is a competitive business.  (Koehler-Christensen Rebuttal, at 17-20.)  It does not, however, provide any evidence that its directory publishing business in Southern Idaho faces any consequential competition from other publications or media, or that it possesses anything less than complete market saturation (i.e, that regardless of where else they advertise, every business in southern Idaho also has an advertisement in a US West Yellow Pages.)  This ubiquity is unmatched by any competitor.  And it is not likely to be matched by any competitor any time soon.

Q.  Please address in greater detail Ms. Koehler-Christensen's assertion that the continued imputation of Yellow Pages revenues will hinder the growth of local competition in southern Idaho.

A.  US West's fear that Yellow Pages will give it an unfair advantage vis-a-vis its (presently nonexistent) facilities-based competitors in the local telephone service market is misplaced and is certainly premature.  Competition in southern Idaho, as I have already observed, is still in its earliest stages.  There is no meaningful local competition in Southern Idaho at this time.  Although US West's altruistic concern for the well-being of its hypothetical future competitors is heartwarming, there is no particular linkage between the yellow pages imputation and nascent competition, since there is nothing to prevent the imputation from being limited solely to noncompetitive US West Title 61 services.  In fact, AT&T, perhaps US West's largest potential competitor, has submitted testimony in this case explicitly in favor of maintaining the yellow pages subsidy.  Competition itself, then, does not provide any justification for discontinuing the imputation of Yellow Pages revenues.

Q.  Does Ms. Koehler-Christensen address the fact that AT&T supports the continuation of Yellow Pages imputation?

A.  Yes.  She makes two assertions in this regard.  First, she argues that competitors that intend to enter the market through resale will gain an advantage, since Yellow Pages imputation will result in a reduction of the wholesale prices they pay to US West.  (Koehler-Christensen (US West) Rebuttal, at 10-11)  Oddly, she then goes on to state that "[s]ome competitors understand that if US West is forced to sell local service below cost, it will weaken the company and hence diminish its ability to compete effectively."  (Koehler-Christensen (US West) Rebuttal, at 12)  In fact, it is the retention of all Yellow Pages profits by US West that will afford it a substantial competitive advantage vis-a-vis its rivals, since US West alone will have the use of these revenues to support and potentially cross-subsidize its competitive services.

Q.  Does the reduction in wholesale prices cited by Ms. Koehler-Christensen represent an "advantage" for resellers?

A.  Only in a very indirect way.  Extending the Yellow Pages subsidy to wholesale rates would make those rates lower than they would otherwise be.  However, the reduced wholesale rates do not give new entrants any sort of advantage over US West, because US West's own retail rates will be similarly and correspondingly reduced as well.  To the extent that the demand for service at the retail level (whether supplied by US West or by a reseller) is other than perfectly price-inelastic, the lower wholesale and retail prices will result in increased overall consumption and hence in a slightly increased total market volume.

Q.  What is your understanding of Ms. Koehler-Christensen's characterization of the market for Yellow Pages advertising in southern Idaho?

A.  Ms. Koehler-Christensen makes several points about the level of competition for US West's Yellow Pages; however, none of them provide any evidence as to the actual state of competition that US West's Yellow Pages faces in Idaho.  Her claim that "Yellow Pages advertising is a part of the overall advertising market in the United States" (Koehler-Christensen Rebuttal, at 17) has no bearing upon the question of whether or not Yellow Pages itself, as a classified listing of businesses by category in a single reference book, is a monopoly.  A more appropriate measure of the level of competition for Yellow Pages advertising in Southern Idaho would be the percentage of businesses in Southern Idaho that currently advertise in the Yellow Pages.

Koehler-Christensen also observes that "at least ten other publishers ... publish seventeen directories that compete" with US West's publishing operation.  (Koehler-Christensen Rebuttal, at 18, lines 16-17).  The mere presence of other directories that serve the same function as US West's Yellow Pages provides no evidence as to the state of competition among them.

Q.  Ms. Koehler-Christensen contends that because the yellow pages directory business has become competitive, it is no longer appropriate for yellow pages profits to be included within the Company's Title 61 revenue requirement.  Does this claim have merit?

A.  No, it does not.  First, I strongly disagree with Ms. Koehler-Christensen's contention that the yellow pages directory business now faces actual competition.  The yellow pages directory is a unique publication that has come to be dominated by only one provider in any given market area.  I have discussed the economic theory underlying this consistent outcome at considerable length in my direct testimony (at 63-67), and will not repeat it here.  Ms. Koehler-Christensen argues that the yellow pages directory is simply one of many types of advertising media, and in that context represents a small fraction of the aggregate advertising market.  By offering any overly broad market definition (i.e., all advertising media), Ms. Koehler-Christensen crafts a strawman argument in which she seeks to minimize the unique nature of the yellow pages directory.  In fact, the market for yellow pages directory advertising is the relevant market for purposes of this discussion, and inclusion of spurious "other advertising media" within that market definition serves only to obscure the significant market dominance enjoyed by US West.

Unlike newspapers, magazines, catalogues, and radio and television adver­tising, the yellow pages is the only static advertising medium that users retain and use as a reference throughout its publishing cycle.  When a pipe bursts at three o'clock in the morning, you don't get the name of an all-night plumber by watching television or looking in yesterday's newspaper.  When someone throws a rock through your windshield, you don't find the name of a local auto glass dealer by listening to the radio or reading a magazine.  When you want the names and addresses of all sporting goods stores, florists, optometrists, travel agents, all-night drug stores, appliance repair shops, or video rental stores in your community, the US West Yellow Pages is likely the only readily-available source.

The ubiquitous distribution and widespread acceptance of the US West Yellow Pages as the source for this kind of information makes advertisers willing to pay significantly more for a given amount of space in the Yellow Pages than they would pay, for example, for a comparably sized insertion in a local newspaper:

Idaho Newspaper and Yellow Pages Advertising Rates Per Insertion

NewspaperUS West Yellow Pages

2"X 4"4"X 5"2.5" X 4"4" X 5"

(1/8 Page)(1/4 Page)

Mountain Home News:$23.80$59.50

Weekly publication

(Circ. 4,000)

Mountain Home Yel. Pgs$1,368.00$3,228.00

Post Register

Sunday (Circ. 30,000)$58.88$147.20

Daily (Circ. 27,000)$58.08$145.20

Idaho Falls Yel. Pgs.$2,158.80$5,514.00

Idaho Statesman

Sunday (Circ. 88,000)$187.24$468.10

Daily (Circ. 66,000)$140.48$351.00

Boise Yellow Pages$4,512.00$11,736.00

And unlike newspapers, many of which are struggling to remain financially afloat, the Yellow Pages business is highly profitable, frequently generating revenues that are multiples of the costs associated with producing the publication.

Q.  That may well be, but what is the specific linkage between US West's Yellow Pages directory business and the telephone services that are subject to Title 61 regulation?

A.  As I explained in my direct testimony (at 64), the yellow pages business is characterized by what economists refer to as "network externalities" in which the relative value of the product to any one consumer (advertiser or end-user) is heavily influenced by the number of other consumers who utilize the directory.  Once such a publication has achieved a critical mass — i.e., when it has amassed a degree of market penetration that could not be readily duplicated by another supplier, such as a market share well in excess of 50% (by definition, you can't have two suppliers each one of which has a market share in excess of 50%) — entry by a new supplier becomes virtually impossible, and essentially permanent market dominance is established.  US West's directory publishing activity was conducted for decades as an adjunct to its local telephone business.  By virtue of its monopoly position in the local telephone market and its near-universal coverage of the entire residential and business customer base in the areas in which it holds a franchise, US West was handed an uncontested opportunity to develop its directory business.  By the time that competition became a factor in the directory publishing business, US West's market dominance was so overwhelming that the Company can be expected to be able to preserve its monopoly well into the future.

Moreover, as I discussed at length in my direct testimony (at 62), the specific regulatory linkage between yellow pages profits and local exchange telephone service was recognized and confirmed by the United States District Court for the District of Columbia when, in considering the terms of the break-up of the former Bell System, it accepted BOC and state PUC arguments calling for the yellow pages to be retained by the BOCs and not transferred to AT&T, precisely because yellow pages revenues had been and would continue to be used to offset the costs of basic telephone service.  (U.S. v. AT&T, 552 F. Supp. 131, 193-194 (D.D.C. 1982))

Q.  Is the use of Yellow Pages revenues to reduce the cost of providing basic telephone service unique?

A.  No, it is not.  Although Ms. Koehler-Christensen argues that the imputa­tion of yellow pages revenues is based upon an outdated paradigm that (she claims) has no place in an environment of growing local competition, the sale of adver­tising has long been used by any number of services, even in competitive industries, to contribute to and to support the costs of providing that service.  For example, public mass transit authorities routinely sell advertising space on busses, bus shelters, trains, and transit stations, the revenues from which go toward defraying the overall costs of operation, and without which transit fares and/or municipal subsidies would be higher.  The role of Yellow Pages advertising in supporting universal service is also analogous to the role that commercials play for radio and television broadcasting, or that print advertisements provide for newspapers and magazines.  Television broadcasts and newspapers are furnished to their audiences at prices that are typically well below the actual cost of production and distribution (indeed, radio and television programming is provided to the public free of charge by broadcasters).  This is only possible because these media derive substantial revenues from advertising.  In this sense, what US West is trying to do is like NBC continuing to sell commercial time during its programming, but also scrambling its signal and forcing viewers to pay an additional fee to view its broadcasts.  Indeed, the only reason that US West can, as an economic matter, "get away" with retaining 100% of yellow pages profits for its shareholders is precisely because the Company maintains a de facto absolute monopoly over both the yellow pages directory business and basic local telephone service.

Q.  Who stands to benefit from the discontinuation of the Yellow Pages imputation?

A.  US West and its shareholders will benefit at the expense of Title 61 ratepayers.  US West attempts to justify this transfer of benefits from Title 61 ratepayers to shareholders by arguing that "[t]he fact that US West no longer has a legislated monopoly means the business now presents greater risk for investors than in the past."  (Koehler-Christensen Rebuttal, at 14-15.)  However, the fact that the local telephone market remains (and is likely to remain) a de facto monopoly means that investors' risk is nowhere near as high as this statement implies.

Barring the continued imputation of Yellow Pages revenues, the law requires that US West reimburse Title 61 ratepayers for the full market value of the asset (the Yellow Pages business) it is removing from the rate base.

Q.  Suppose that, notwithstanding the various points you raised in your direct testimony and that you have just been discussing, the Commission determines that the US West yellow pages should be shifted to Title 62 and thereby removed from the Title 61 revenue requirement.  Can such a transfer be made without providing some compensation to Title 61 ratepayers?

A.  No, it cannot.  A rule established by the United States Circuit Court of Appeals for the District of Columbia Circuit in Democratic Central Committee of the District of Columbia v. Washington Metropolitan Transit Commission (DCC) requires that any gain on the sale or disposition of utility assets acquired with ratepayer funds go to ratepayers under the principle of "reward follows risk and benefits follow burdens."  485 F.2d 786, 810 (D.C. Cir. 1973), cert. denied, 415 U.S. 934 (1974).  Counsel advises, and I agree, that the DCC principle would apply to any transfer of US West's directory publishing assets out of the Title 61 rate base and associated revenue requirement.  The yellow pages business is a valuable asset whose "going business" market value is far in excess of the nominal "net book value" of the modest physical asset base that supports this business activity.  When the yellow pages business is transferred to Title 62 treatment, the effect is to remove the going business value of the yellow pages asset from the Title 61 asset base (where that going business value is effectively used to support the costs of basic service and does not flow to US West shareholders) over to Title 62, where the value of the yellow pages business and the stream of future earnings to be derived therefrom will flow entirely to the Company's owners.

Q.  Please explain your understanding of the holding in Democratic Central Committee and how it establishes a ratepayer entitlement to the going business value of US West's yellow pages business, given the facts associated with the acquisition and proposed disposition, via transfer to Title 62 treatment, of US West's directory publishing business.

A.  In Democratic Central Committee, the D.C. Circuit Court of Appeals articulated the principle that "reward follows risk and benefits follow burdens" (at 818).  The Court explained this principle as follows:

In situations where consumers have shouldered these burdens on an asset

which produces a gain, the equities clearly preponderate in their favor.  ...

it is eminently just that consumers, whose payments for service reimburse

investors for the ravages of wear and waste occurring in service, should

benefit in instances where gain eventuates — to the full extent of the gain.

Id.  Emphasis supplied.  The Court reasoned that:

The ratemaking process involves fundamentally "a balancing of the

investor and the consumer interest."  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 government 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 should also reap the benefit

resulting therefrom.

Id., at 806.  The Court went on:

[T]he cases ... generally agree that consumers have the superior claim to

capital gains achieved on depreciable assets while in operation.

Id., at 811.

Q.  Have any state PUCs applied the "reward follows risk" principle in decisions involving the transfer of utility assets from regulated to "below-the-line" status?

A.  Yes.  For example, in the Pacific Bell Information Services (PBIS) case, the California Public Utilities Commission (CPUC) applied the "reward follows risk" principle in determining that Pacific Bell ratepayers, having funded the development of Pacific Bell's Voice Mail services, were entitled to compensation based upon the "going concern" fair market value of the Voice Mail affiliate.  Re Pacific Bell Information Services, California PUC, Application (A.) 90-12-052, Decision (D.) 92-07-072, 45 CPUC 2d 109, 132.  In that case, the Commission found that:

[R]atepayers were burdened with the responsibility of funding the

development and operation of ISG [Pacific Bell's "Information Services

Group," the predecessor of the separate Pacific Bell Information Services

affiliate] through rates. ...  Shareholders did not bear the financial risks of

funding ISG's expenses to the extent they were expected to.  For these

reasons shareholders should not receive the increase in the value of ISG

that they would otherwise be entitled to.  Therefore, we are directing

Pacific to credit ratepayers with the increase in the value of ISG (i.e., the

difference between its going-concern value and its net book value).

Id., at 131.

Q.  But didn't the California Commission reject the "reward follows risk and benefit follows burden" principles in its decision in the Pacific Telesis cellular/wireless "Spin-Off" Case?  Order Instituting Investigation (I.)93-02-028, D.93-11-011, 51 CPUC 2d 728.

A.  No, it didn't.  In the Spin-Off case, the CPUC recognized the validity of the "reward follows risk" principle.  It held, however, that DCC was not applicable to the specific facts of that case, offering several reasons for this conclusion.  First, the Commission stated that the cellular licenses that Pacific Telesis sought to spin off had been awarded directly by the FCC to PacTel Cellular, an affiliate of Pacific Bell, and had therefore never been part of Pacific Bell's rate base.  Id., at 760.  The CPUC stated further that "the cellular licenses are an asset of PacTel and these assets will remain with PacTel or its successor."  Id.  Since no property was being transferred from Pacific Telesis, the Commission stated, there was no gain to be booked above the line as Pacific Bell operating revenue.  Second, the CPUC distinguished the Spin-Off case from the PBIS decision, stating that the PBIS decision involved the creation of a subsidiary of Pacific Bell and the transfer of assets to that subsidiary, whereas, after divestiture, PacTel Mobile Services (PTMS) was an affiliate, and not a subsidiary, of Pacific Bell.  Id., at 761.  Moreover, the Commission stated that in PBIS the ratepayers were entitled to benefit from the appreciation in value during the time period in which Pacific Bell had improperly included the costs of operating the Information Services Group in Pacific Bell's start-up revenue requirement under the CPUC's "New Regulatory Framework," whereas in the Spin-Off case, the Commission concluded that no significant amount of ratepayer funds had actually been placed "at risk."  (Id., at 761-762.)

On the other hand, where the CPUC had determined that ratepayer funds had in fact been used by Pacific to fund its cellular entry, the company was directed to reimburse ratepayers for those funds, with interest accruing back to their date of incurrence.  Id., at 763.  Specifically, the Commission found that Pacific Bell ratepayers were entitled to monetary reimbursement from PacTel for all preoperational formation and development expenses incurred by Pacific Bell ratepayers prior to divestiture.  Id., at 763.  The CPUC ordered Pacific Telesis to refund to Pacific Bell the principal — $7.9-million dollars — plus interest, and decided to defer for a later decision how this money would be returned to the ratepayers.

Q.  Is there a close parallel between the facts in the PBIS case and those applicable to the US West proposal to shift its Idaho yellow pages operations to an unregulated affiliate?

A.  Yes, and if anything the facts of the proposed transfer of US West's yellow pages business to a below-the-line status argue even more strongly for application of the DCC rule here.  Like Pacific Bell's voice mail business, the long-term development of US West's yellow pages activity was funded entirely by ratepayers and at ratepayer risk.  Unlike Pacific Bell's voice mail business, which had been initiated only a few years prior to the proposal to shift it "below-the-line" and was (arguably) funded by ratepayers primarily because PacBell had disobeyed an explicit Commission order (to carry the development and preoperational costs of the voice mail business below the line), US West's Idaho yellow pages business was unambiguously funded by ratepayers from its inception.  Because both revenues and costs of the yellow pages business were included within the US West revenue requirement (prior to the Company's Title 62 election) and have been included within the Title 61 revenue requirement following that election, every penny of expense that the Company charged to its yellow pages business meant one penny less in contribution available to support other regulated (Title 61) services.  Thus, advertisements promoting the US West Yellow Pages Directories as the preeminent product in its field, promotions that have contributed materially toward its future revenue prospects and hence to its current "going business value," were in each instance paid for by Title 61 ratepayers.  In fact, except for the effects of "regulatory lag" that apply to all services subject to Title 61 regulation, US West shareholders have never been any more "at risk" with respect to the Idaho yellow pages business than with respect to any other service subject to Title 61 regulation.

If US West were, for example, to sell outright its Idaho yellow pages business for cash in an arm's length transaction (whereby the selling price would be expected to reflect the present value of future earnings associated with that business), there would be no question but that the gain on the sale of the yellow pages asset would inure above the line.  If, on the other hand, the Company were permitted to transfer the yellow pages business to Title 62 treatment and then elected immediately to sell it, it would no doubt argue that as a Title 62 asset any gain from such a sale should flow entirely to shareholders.  Clearly, the Commission should not permit or condone such an evasion, yet that is precisely what it would be doing if it permitted the Company to amputate the yellow pages business from the Title 61 rate and revenue base without a compensatory payment to Title 61 ratepayers.  The Company's proposal simply to transfer this asset out of rate base through a book value accounting entry does not alter Title 61 ratepayers' entitlement to exactly the same gain as would arise under an arm's length cash sale.  If the Commission determines that the proposed transfer should be approved — or that it is required under Idaho law — the Commission needs to look past the Company's self-dealing and impute an arm's length market value to the yellow pages business, as it is required to do under the Democratic Central Committee doctrine.

DCC can clearly be interpreted as requiring the transfer to ratepayers of the entire difference between the net book value of US West's Idaho yellow pages assets (representing the acquisition cost less accumulated depreciation) and the market value of the yellow pages business that would be produced through an arm's length cash sale.  DCC would require that this amount be assigned to ratepayers under the "rewards follow risks" principle.

Q.  Would this treatment of US West's yellow pages business be similar to other transfers of regulatory assets that have been undertaken by the Company?

A.  Yes.  In 1995, US West sold eleven of its Idaho exchanges at prices that were substantially in excess of the then-existing book value of those assets.  The Commission's approval of the sale of these exchanges was made contingent upon three actions on the part of US West:  (1) The purchase of switch upgrades in the exchanges to be sold; (2) a refund by US West to the pool of southern Idaho revenue sharing funds; and (3) a contribution by US West to the Idaho universal service fund. (Idaho PUC Order No. 26198, and Order No. 26353.)  These expendi­tures were equivalent to approximately 50% of the $10.1-million that US West had calculated as the intrastate gain from the sales (Idaho PUC, Order No. 26198, at 5).  The Commission found that the requirement of a contribution by US West "spreads a benefit from the sales to a significant number of ratepayers in US West's southern Idaho exchanges..." (IPUC, Order No. 26353, at 17).  Of course, in the case of the rural exchanges, the Commission had the benefit of arm's length sales to establish the current market value of the assets in question.  Since US West is not proposing to sell its yellow pages business, but only to discontinue the imputation of revenues to Title 61, no arm's length sale is involved.

Q.  Inasmuch as US West is not proposing to engage in an arm's length cash sale of its yellow pages business, how should the Commission go about establishing the current market value of the business asset that is proposed to be transferred?

A.  Perhaps the most straightforward approach would be to require that US West put up its Idaho yellow pages business for sale to the highest bidder, and to permit US West itself to bid for the purchase of this asset.  While that would likely result in a price that closely approximates the current market value of the yellow pages business, the outcome could well mean that US West would no longer be the owner.  However, it is not clear that the Commission would have the legal authority to require such a sale, or that it would want to force US West to divest its yellow pages operations even if it did have such authority.

An alternate approach would be to arrange for an independent appraisal of the market value of US West's Idaho yellow pages business.  This is the approach that the California PUC pursued in the case of Pacific Bell Information Services.  The resulting approach would then serve as the basis for the imputation.

Finally, the Commission can develop its own estimate of the market value through a discounted cash flow (DCF) analysis of current and recent yellow pages earnings and projected earnings growth.  I have prepared an illustrative DCF analysis for this purpose, based upon Staff's proposed imputation of yellow pages net revenues.  In this analysis, I consider the test year yellow pages contribution (earnings) of $8.645-million.  With no firm data available on the historic growth rate of yellow pages revenues, I (very conservatively) assumed zero growth, and projected the same annual net contribution forward ten years.  Also, and again to be extremely conservative in this illustrative example, I used the Company's proposed rate of return of 10.55%.  (Cummings Rebuttal, at 31.)  (My use of the Company's proposed rate of return for purposes of this illustration should in no way be interpreted as suggesting that I consider it to be the appropriate rate of return for US West's Title 61 operations.)

Q.  What estimate of market value did your DCF analysis produce?

A.  My analysis produced an estimated current market value of $54.8-million for US West's Idaho yellow pages business.  Assuming the reasonableness of this estimate, this is the amount that the Commission should impute to Title 61 as a one-time offset to rate base in determining the applicable Title 61 revenue requirement.

Q.  What would be the effect on this value if one were to assume, for example, a modest earnings growth rate of, say, 5% per year?

A.  In that case, the net present value of those earnings, taken over a ten-year period, would be $67.4-million.

Q.  Please summarize your recommendation regarding the treatment of Yellow Pages.

A.  Yellow Pages revenues have been used for decades to support universal service, and US West has offered no valid basis for its claim that this historic arrangement should be discontinued at this time.  The imputation of Yellow Pages revenues should continue, and Staff's initial recommendation in the matter should be adopted by the Commission.  Barring that, the DCC principle applies in this case, and the full market value of US West's Yellow Pages business should be captured as an offset to the Title 61 rate base.

The Company's claims of incipient competition in Southern Idaho, which it repeatedly uses to justify its flawed cost allocation proposals, do not stand up to scrutiny.

Q.  Please summarize your understanding of the Company's position regarding the extent of competition in the provision of local telephone service in southern Idaho.

A.  Several of US West's rebuttal witnesses take issue with Staff's position that competition for the provision of basic (i.e., Title 61) services is not imminent in Southern Idaho.

US West witness Ms. Owen contends that if "the Commission and US West do not price the underlying residential access line in a manner indicative of the costs we incur to provide that line, facilities-based competition will be very slow in arriving in Idaho for the general residence customer." (Owen Rebuttal, at 35.)

Ms. Owen also provides examples of the rampant competition in the telecom­muni­cations market in southern Idaho (see, e.g., Owen, at 4-8).  However, the specific examples that she offers, which concentrate primarily upon intraLATA long distance and private line services, are Title 62 services that Idaho law has deemed to be "competitive."

Mr. Wozniak (at 9) contends that US West "remains a company that favors competition and the open market place as long as it has an opportunity to compete and as long as there is a recognition of the fact that US West continues to be price-regulated, is the provider of last resort, and must maintain a ready-to-serve position.  The last two requirements amount to mandated investment obligations."

The Company argues in favor of facilities-based competition on the local level, claiming that such competition will provide a clear benefit for customers.  However, it downplays competition based upon resale or unbundled elements.  (See, e.g., Owen, at 16-17, and 23-24, and Koehler-Christensen, at 7-10.)

Q.  Were any US West witnesses any more specific as to precisely which services the Company considers to be "competitive"?

A.  Yes.  US West has clarified that Ms. Wright's testimony (at 57) specifically referred to the fact that "over 150 companies ... are competing for the same intrastate toll and payphone revenues with USWC."  (Response to AT&T data request ATT02-044.)

Q.  But aren't most if not all of these Title 62 services?

A.  Yes, indeed they are.  In effect, US West is worried about competition in its markets for services that already are, by statute, deemed to be "competitive."  As I stated in my direct testimony in this case, the Company has simply not provided any compelling evidence that it either currently or in the near future confronts actual competition for its Title 61 services.

Q.  Does the theoretical possibility of future competition for some Title 61 services in certain parts of southern Idaho alter the manner in which these services are treated for regulatory purposes at the present time?

A.  Title 61 services were recognized by the Idaho legislature as monopoly US West offerings for which no competitive alternatives are available to Idaho consumers and small businesses.  That condition has not materially changed in the years since enactment of the Idaho statute.  If anything, the prospect of potential competition adds to the need for continued regulation of monopoly services and network elements, because absent such regulation the incumbent local exchange carriers would be capable of frustrating entry and of surgically targeting nascent competitors as soon as they emerge.  The present state and federal legislation provides a framework for such regulation that should be maintained in full force and effect until Idaho consumers have realistic choices of alternative service providers.

Q.  Does this conclude your testimony at this time?

A.  Yes, it does.