Q.Please state your name and business address for the record.

A.My name is Madonna Faunce.  My business address is 472 West Washington Street, Boise, Idaho.

Q.By whom are you employed and in what capacity?

A.I have been employed by the Idaho Public Utilities Commission (IPUC) as an auditor since 1989.  I am licensed as a Certified Public Accountant in the State of Idaho.

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 October 26, 1996.

Q.What is the purpose of this surrebuttal testimony?

A.The purpose is to sponsor the Company and Staff settlement regarding affiliate interest except Advanced Technologies (AT) and Bellcore.  I respond to the rebuttal testimony of U S WEST Communications, Inc. witnesses regarding the affiliate expenditure from AT and Bellcore (BC).  I also discuss employee compensation.

AFFILIATED TRANSACTION SETTLEMENT AGREEMENT

Q.Has the Company and Staff reached a Settlement and Stipulation on affiliated transactions excluding Advanced Technologies (AT) and Bellcore affiliates?

A.Yes.  Following notice to all parties in the rate case, a settlement conference was held on February 12, 1997.  Following additional negotiations, the Staff and the Company reached a settlement on affiliated expenses on February 21, 1997.  See Exhibit No. 153.

Q.What is the result of the settlement?

A.Based upon my analysis of the affiliated transaction issues (excluding AT and Bellcore), I found that the Company had allocated $3.127 million to Title 61 customers.  I believed that Title 61 customers should have been directly charged and allocated only $1.207 million of the affiliated transaction costs.  We agreed that the difference between the Company’s and my calculation was approximately $1.920 million.  The Company and Staff agreed to split the difference and reduce the Company’s allocated Title 61 costs by $960,000.  This would result in the Company lowering its revenue requirement associated with its operating expenses by approximately the $960,000 and the Staff increasing its revenue requirement associated with operating expenses by the same amount.

Q.Why do you believe the Settlement is reasonable?

A.Excluding AT and Bellcore, I looked at five affiliated companies and addressed approximately 20 issues.  Given the complicated issues, the approximately $1.920 million difference between my Title 61 direct and allocated amount and the Company’s allocated amount, and the likelihood that neither the Staff nor the Company would fully prevail in their affiliated transactions arguments, I believe the settlement represents a reasonable resolution of these disputed issues.

GENERAL CONCERNS REGARDING AFFILIATED TRANSACTIONS

Q.What are your general concerns regarding affiliated transactions?

A.Transactions between U S WEST Communications and its affiliates (e.g., AT and Bellcore) raise two related concerns.  First, expenditures charged to USWC by affiliates should be subject to close regulatory scrutiny, and USWC has the burden of showing that such expenditures are reasonable.  Merely showing that expenditures were incurred and charged to the utility is not sufficient to meet this burden.  Second, USW employs a series of cost allocation systems at several levels which, ultimately, result in costs being assigned to Title 61 regulated services in Idaho. U S WEST asks us to rely simply on the integrity of the whole cost allocation system in determining the reasonableness of affiliate costs assigned to Title 61 services (Ms. Barrington, page 3, lines 3-4; page 10, line 18 through page 11, line 20; page 12, lines 1-19).

Q.Why should the Commission require U S WEST to prove the reasonableness of affiliate costs to Title 61?

A.I have addressed the reasons in my direct testimony page 9, lines 22-25 through page 10, lines

1-16.  Basically the courts have ruled transactions between affiliate companies are to be subject to close scrutiny, and the regulated utility has the burden of proving the reasonableness of its affiliate transactions.

Q.Margaret J. Wright in her rebuttal testimony on page 58, lines 14-17, claims that you do not challenge the reasonableness of USWC’s transactions with affiliates.  Are you suggesting that these affiliate expenses are unreasonable?

A.I addressed this concern on page 15, lines 16-20, stating “While the costs may have been prudently incurred for the Part 64 and Title 62 services I believe that the costs were not prudently incurred for southern Idaho Title 61 customers.”  I cannot and would not keep the affiliates from doing work for services or functions other than Title 61 and charging those costs to USWC.  The problem is that once costs lose their identity at the affiliate level as they do under the Company’s cost allocation system, I have no confidence that they can be correctly allocated several allocation processes later at the Title 61/62, or CAAS, level.

Q.Is this just an allocation problem?

A.No.  Contrary to what the Company would have us believe, it is not just an allocation problem but ultimately the failure of the Company to meet its burden of proof with respect to the reasonableness of its affiliated transactions.  Any expense that comes from an affiliate and is to be included in costs charged to Title 61 services must clearly be demonstrated to be necessary in the provision of Title 61 services.  Once costs are aggregated and then allocated at the affiliate level, it becomes impossible for the Company to meet this burden of proof.

Q.The Company claims it is unreasonable to expect unregulated affiliates to assign or allocate the costs of their products to the various telephone services provided by USWC.  Do you think this is a valid reason to relieve the Company of its burden of proof?

A.No, I do not.  USWC is a regulated utility that understands or should understand what its legal obligations are.  It is its responsibility to arrange with affiliates to provide adequate documentation of expenditures for regulatory purposes or to do so itself.  While, technically speaking, the Company should maintain such documentation on a regular basis, at a minimum it should be prepared to file it in support of a rate case.  The Company should have anticipated when it filed this case that it would be called upon to support the reasonableness of its expenses and been prepared to provide analyses supporting the reasonableness of amounts paid to affiliates.

Q.Has U S WEST provided any analyses supporting the reasonableness of it’s affiliated expenditures?

A.Yes, but only in rebuttal.  U S WEST witness Barrington provided workpapers showing what she would consider as Title 61, Title 62 and common.  While I do not agree 100% with her classifications, it certainly is closer to what I would have expected to see in this rate case.  Also in examining billings from affiliates, I found that some of the billings do contain enough information to at least divide the cost among Title 62, Title 61, and common Title 61/62 costs.

ADVANCE TECHNOLOGY (AT) AND BELLCORE (BC)

Q.Company witness Barrington on page 3, lines 12-15, claims that you supplied just one example of a project misallocated to Title 61.  Can you explain why you only supplied one project as an example?

A.Yes.  The Company asserts that the AT and BC projects are highly confidential.  Rather than pick several projects that would be very descriptive and have to provide these as confidential exhibits, I chose to use just one project that was more generic than specific.

Q.On page 3, lines 16-18, Company witness Barrington states that you directed all of the Modeling Applied Research Project’s costs to Title 62.  Is this correct?

A.No.  My direct assignment of this project was to Applied Research.  I also note that Ms. Barrington classified this project as Applied Research.

Q.What is the difference between basic and applied research?

A.Basic Research is a studious inquiry or examination, investigation on experimentation aimed at the discovery and interpretation of facts, revision of accepted theories or laws in light of new facts.

Applied Research is applying general principles to solve definite problems.  Which in AT’s case can be for any affiliated company and/or class of services at U S WEST.  In BC’s case it can be applied to any number of companies and for U S WEST it can be for any of the affiliated companies and any class of services at U S WEST.

Q.Has this Commission ever addressed the issue of research costs?

A.Yes.  In Order No. 24443 issued in GTE Case No. U-1002-67, the Commission found that 100% of basic research and 66% of applied research should be disallowed.  The Commission also found that GTE had failed to carry its burden of proving its affiliated transactions were reasonable because, “The Company did not present substantial and competent evidence that the costs for research projects were reasonable.”

Q.What is your position on Basic and Applied Research projects?

A.Starting on page 24, line 20 through page 26, line 15 of my direct testimony, I have pointed out that the Company should prove that a research project has developed or enhanced a product, that the product is both economically and functionally useful, and that the product benefits southern Idaho Title 61.  The Company should also prove what portion of that product benefits southern Idaho Title 61, and what portion benefits Title 62.  This is important because not all of the research projects are related to Title 61.  Also, Title 61 customers do not have a say in AT’s or BC’s basic or applied research agenda as research is driven by market opportunities.  These opportunities may not benefit Title 61 customers.

Q.Does Project 12112AC-Modeling Applied Research meet the above criteria?

A.No.  The project description states “This project funds general mathematical modeling work in advance of specific project requirements.  Under this project, modeling experts will meet with prospective clients within the Company to determine possible matches between the modeling group’s capabilities and specific business needs.”  The project description also states that it contemplates that “much of the work done under this project will result in client-funded projects.”  This project could be used for multi-media, international, other affiliates, Title 62 or Title 61.  The description given to Staff is vague; it does not provide enough information to allow determination of any benefits to Title 61.

Q.Do Title 61 customers support 100% of the costs for this project?

A.No.  But I have no way of knowing exactly how much of the cost for this project may have been charged to multi-media, international or other affiliates.  Therefore, I cannot determine how this project benefitted all affiliated entities and if the allocation to USWC and Title 61 customers is reasonable.  I can determine that of the costs to Idaho Intrastate (per production request answer-STF03-194, attachment A,) $1,907 or 49.7986% of the total cost to Idaho intrastate was charged to Title 61 in this rate case.

Q.Is there any question that this is the amount that should have been charged to Title 61?

A.Yes.  In Company rebuttal witness Barrington’s workpapers, she shows only that $245 or 6.399% of the total Idaho intrastate cost of this project should go to Title 61.   I believe, given the questions surrounding research projects, the nature of the work preformed in research projects, and U S WEST’s move into multi-media, international and Title 62 services, that without proper cost benefit analysis or complete access to records that prove the benefit to Idaho Title 61 service the costs should be disallowed.

Q.On page 4, lines 7-21 of Ms. Barrington’s rebuttal testimony, Ms. Barrington uses project 12049AD as an example of the use of algorithms that benefits Idaho customers.  Do you agree?

A.Project 12049AD-Demand Forecasting Center Algorithms is a project classified by Ms. Barrington as Applied Research.  This project states its purpose as assisting USWC Demand Forecasting Center in developing a forecasting model of work force demand and the associated databases and systems.

Q.Has the Company provided proof that 12049AD is used to serve Idaho Title 61 customers?

A.No.  What has been provided shows the related projects have only questionable benefits for Title 61 customers, and in light of service quality problems, the Company has not provided information showing Title 61 customers receive any benefit.  The Company still has the burden of proof that an affiliate’s costs are both reasonable and proper.  If this model is used by Idaho technicians the Company should show that customer service has been improved as the scheduling of appointments and lack of technicians is one of the service quality problems addressed by Staff witness Hart.

Q.Ms. Barrington in rebuttal testimony page 4, line 24 through page 5, line 15, claims that modeling has been applied to solve other business problems.  Please comment.

A.First, Ms. Barrington uses an example of an AT model to optimize investment in the interoffice fiber network.  Interoffice fiber could be used for Title 62 toll services.  The Company has not identified what this model has been used for in southern Idaho.  Staff witness Lansing in his testimony shows that only 10.355% of the fiber in Idaho is lit, or used and useful.  That could mean that the AT model to optimize investment is not working and should be disallowed along with the excess capacity.  At any rate, it does not appear to be beneficial to the Title 61 customers.

Second, Ms. Barrington uses an example of a model developed by AT in 1994 and 1995 for Business Resources Inc. (BRI).  BRI is a non-regulated affiliate of USW that services USWC as well as other affiliates.  While Ms. Barrington makes it sound like this model is used exclusively for USWC, the Company has provided no proof that this is used exclusively for USWC, and even if it is, the cost of this system was charged to BRI.

Q.Why is USWC being asked to subsidize AT for a project for BRI?

A.The Company has not provided a good answer as to why AT would ask Title 61 customers to subsidize a project for BRI. I believe the Company has not sustained its burden to show that these costs are reasonable and useful for Title 61 customers, therefore the Commission should disallow this cost.

Q.In Ms. Barrington’s testimony on page 6, lines 4-16, Ms. Barrington states that U S WEST received the Operations Research Society of America (ORSA) prize for its outstanding applications of operating research managing business.  Should the Commission base its decision to allow research cost to be paid by Title 61 customers on the fact that AT has been recognized for its valuable impact to the business from its modeling efforts?

A.No.  The Commission should base its decision on whether the cost is reasonable for southern Idaho Title 61 services.  The reasonableness of the cost can only be determined if it shows that it has a direct relation to southern Idaho Title 61 service and that southern Idaho Title 61 customers have received a benefit in direct relation to the cost.

Q.Of the other modeling projects that Ms. Barrington refers to in rebuttal testimony on page 6, line 20 through page 21, line 2, do you have a comment?

A.Yes.  Ms. Barrington in her rebuttal work papers classifies all of these projects as applied research.  This agrees with my classification.  However, I believe these projects should require the same proof of reasonableness as I have previously described.  When I find descriptions that state “will push the state of the art in this area as necessary, and will create tools which will lead to solutions with measurable impact for clients in all business entities of U S WEST...” (emphasis added) and “explore trade-offs between customer service levels and costs” I believe the Company has not adequately demonstrated that these project costs are reasonable.  Title 61 customers should not pay for projects without proof of Title 61 benefits.

Q.Ms. Barrington in rebuttal testimony page 7, lines 8-22, discusses project 11278BC-Fixed Wireless Architecture as being a Title 61 service.  Why did you classify this as not being a Title 61 service?

A.Actually Ms. Barrington identified three projects 2804CC-Fixed Wireless Loop Application, 10925BC-Wireless Local Loop Strategy, and 11278BC-Fixed Wireless Architecture:

Project 2804CC description states:

“may have several applications, both

domestically and internationally.”

Project 10925BC states: “This

technology may eventually be used to

provide basic telephone service.”

Project 11278BC states: “...research,

study and test wireless equipment that

may be used as part of the U S WEST

Communications (USWC) network in the

provisioning of new services and the

resolution of held orders.” and

“Technical tests will be conducted ...”

This shows the Company is experimenting with many wireless applications but has not shown that this is to be used in Idaho and if it is to be used in Idaho when and what services it will provide.

In examining all wireless projects, I found project 2351BD-Wireless Testing & Trials that states that “Selected wireless systems will be placed in the field, tested, and analyzed...” for the efficient distribution of video services.  Video services are clearly not Title 61.  In light of all the wireless technology U S WEST is exploring, I continue to believe that the Company has not given proof to show the reasonableness of these expenses.

Q.Was Ms. Barrington correct in her analysis of the projects classified as Title 62 on page 8, lines 7-17?

A.No.  Two of the AT projects were classified as reengineering and Staff witness Schneider recommends these costs be expensed over the period of expected benefit.  Two more projects were classified as research because the “products” were white papers or had Broadband solutions that were unclear as to southern Idaho Title 61 application.  Of the three BC projects, I classified two as benefiting Title 61/62 service, as did Ms. Barrington, and classified one as not Title 61 because I could not determine the Title 61 benefit.

Q.Earlier you talk about Ms. Barrington’s workpapers that show Title 61, Title 62 and common projects.  Did Ms. Barrington directly assign these costs to the appropriate service?

A.No.  Although Ms. Barrington’s workpapers  show the Company and I agree that $417,497 of AT intrastate costs and $394,253 of BC intrastate costs can be identified as a direct Title 62 cost(Proprietary Exhibit No. 154), the Company did not directly assign these costs to Title 62.  The Company claims that the CAAS allocation provides an accurate allocation between Title 61 and Title 62.  I find that by adding the costs of allocated common Title 62 costs, that Ms. Barrington has identified, to Ms. Barrington’s identified Title 62 project costs and then comparing this to the Company’s actual CAAS allocation, it appears that $223,060 of AT’s Title 62 costs and $227,898 of BC Title 62 cost are charged to Title 61 customers in Idaho.

AT:

Classification per Ms. Barrington’s workpapers:

Title 62Title 61

 Direct Project Costs$417,497$  7,447

 Common Allocated Costs 379,483 445,479

   Total Costs$796,980$452,926

Classification per CAAS:

 Direct Project Costs  0  0

 CAAS Allocated Costs 573,920 675,986

Difference between Direct$223,060    ($223,060)

Assigned and CAAS Allocation

BC:

Classification per Ms. Barrington’s workpapers:

Title 62Title 61

 Direct Project Costs$  394,253$      0

 Common Allocated Costs  620,964  728,957

   Total Costs 1,015,217  728,957

Classification per CAAS:

 Direct Project Costs$    0$   0

 CAAS Allocated Costs   787,319  956,855

Difference between Direct$  227,898    ($ 227,898)

Assigned and CAAS Allocation

Q.Is USWC complying with the Idaho Code if it charges Title 62 costs to Title 61 customers?

A.No.  Idaho Code §62-613 provides that telephone corporations may not subsidize telecommunication services which are offered pursuant to Title 62 by those telecommunication services which are subject to regulation pursuant to Title 61...”

Q.Does U S WEST’s cost allocation method account for the difference between Title 61 and Title 62?

A.After reading the discription of all of these projects and examining Ms. Barrington’s workpapers, the methodology used by USWC CAAS which allocates 54% of the cost to Title 61 appears to be inadequate.  Staff believes that CAAS cannot replace direct assignment.

Q.Do you believe that Ms. Barrington’s workpapers have identified all of the costs that should be directly assigned as Title 62 costs?

A.No.  Ms. Barrington has assigned projects to common cost for things such as AIN service referred to as “do not disturb,” support for business and government services, carrier billing, business customer products, multi media, and advance services.  These costs are clearly Title 62 costs in Idaho.  I also found costs incurred in 1994 booked in 1995, FCC services and other state-specific services that have been allocated to Title 61.

Q.Do you and the Company agree on an intrastate basis what the total amount of AT and BC is to be Title 61?

A.No.  I have prepared Exhibit No. 155 showing how I have classified results and how USWC classified results.  AT is shown on line 1 and BC on line two.  While Ms. Barrington has identified projects as either Title 61, Title 62 or common, she does not make a change in their allocation to Title 61 or Title 62 as a direct assignment.

Q.Ms. Barrington on page 12, lines 4-16 of her rebuttal testimony, provides a table showing that only 34% of the total AT and BC expenses allocated to Idaho are further allocated by CAAS to Title 61.  Does this information prove that the amount allocated to Title 61 is reasonable?

A.This may be correct but what is more important is whether the costs to Title 61 from affiliates are reasonable, not the percentage of total costs allocated by questionable systems at both the affiliate and USWC level.  As shown on my Exhibit No. 155, lines 1-2, I have identified a total of $2,428,804 as not related to Title 61.  I make this adjustment because I do not believe the information I have been able to audit supports the Company’s claim that its allocations are reasonable and therefore I cannot accept the Company’s number of $1,489,729.

Q.Have you eliminated costs as being

reengineering for AT and BC?

A.No.  I have identified costs that are attributable to reengineering for both AT and BC.  Staff witness Schneider and I recommend that this cost be removed from the 1995 expenses and amortized over 15 years.  See testimony and rebuttal testimony of Staff witness Schneider.

Q.Did you rely solely on the Company’s Proxy Statement as proof that AT and BC were correcting restructuring system problems in 1995 as Carl Inouye claims in his rebuttal testimony on page 29, lines 18 through page 30, line 15?

A.No.  In my testimony on page 21, line 12 through page 22, line 3, I point out that in Order No. 25826, dated December 12, 1994, pages 14-15, that this Commission had already found that USWC had installed support systems that were either too slow in development or have not performed up to expectations.  In that Order it also states that USWC also blamed system problems as a cause of service difficulties.

Q.Is Company witness Inouye correct in his claim that you did not examine the negative effects of restructuring when reviewing AT and BC projects?

A.I examined the projects to determine their correct classification to Title 61.  In examining the project descriptions, I found several projects that were charged to “base” cost that in reality were restructuring or reengineering projects.  For example, some project descriptions stated “U S WEST Communications is engaged in a large program to reengineer their business processes.  A key element of this is the redesign of the business systems to support the reengineered business process.” and “...project provides for the resystemization of...” Given the full description of these projects, these projects clearly should be classified as reengineering.

Q.Does AT and BC charge costs other than the project costs to USWC?

A.Yes, there are post-employment benefits, shared space, management services, database management, and training costs that are separate from the projects.  I have allocated these costs in direct relation to the classification of the projects between reengineering, not Title 61, research, and common.

COMPENSATION

Q.In Ms. Wright’s rebuttal page 91, lines 19, through page 99, line 12, Ms. Wright basically states that the costs for bonuses should follow the cost of payroll and that incentives based on the achievement of financial goals benefit Title 61 customers.  Do you agree?

A.No.  First, bonuses do not have to follow payroll.  Like all costs, they should be charged to the cause of the bonus.  When a bonus is paid because the recipient has increased the Company’s income, I question whether the Company’s Title 61 customers benefit.  If the recipient increased income by reducing expenses, customers could benefit if the expenses were related to Title 61 services.  However, the Company has provided no proof that such is the case.  In fact, the plan is not based on holding costs down as it easily could be, but rather it is based on increased net income.  This income is then passed on to Inc through dividends and is used to either pay dividends to shareholders or to invest in non-regulated services.

Q.What was the cause of the 1995 bonus?

A. The Team Awards earned in 1994 and paid in 1995 were based on achieving 134% of the financial goals and zero percent (0%) of customer service goals.  It should also be noted that the team award earned in 1995 and paid in 1996 does not appear to have any customer service goals.  (See Exhibit No. 156)

Q.How can USWC claim that Title 61 customers receive a benefit when the one benefit, customer service, that directly benefits Title 61 customers is not achieved?

A.I cannot answer that question unless the answer is the benefits achieved by awarding the bonus is not a Title 61 benefit but a shareholder benefit.  I do note that although the quality of service had deteriorated in 1994 the bonus was paid in 1995.

Q.When was the last year that USWC achieved the customer service target?

A. It appears that it was last achieved in 1992 and the bonus was paid in 1993.  In 1993 only half of the customer service targeted goals were met and the bonus was paid in 1994.  (See Exhibit No. 156)

Q. Can you explain your position on the incentive plans?

A.USWC is proposing that the test year include bonuses that were paid to its management and executive employees in 1995 under three incentive programs: (1) Team Performance Award Plan (“TPA”), (2) Executive Short Term Incentive Plan (“STIP”), and (3) Executive Long Term Incentive Plan (“LTIP”).

Bonuses paid under these plans were based on the achievement of certain financial, business and corporate goals.  The 1995 TPA bonuses were paid for meeting or exceeding goals regarding: (1) Earnings before Interest, Taxes, Depreciation and Amortization (“EBITA”); (2) USWC Net Income; and (3) Business Unit Results & Strategic Measures, and Customer Service.  The 1995 STIP bonuses were paid for meeting or exceeding goals regarding: (1) Financial performance (new product development, net income, EBITA); (2) Reengineering Benefits; and (3) Customer Loyalty.  The 1995 LTIP bonuses were paid for meeting or exceeding goals regarding: (1) increase in the price of USWC stock; and (2) stock dividend growth.  I recommend exclusion of these bonuses from the test year because the financial, business and corporate goals upon which the bonuses were based primarily benefited USWC’s stockholders not Title 61 customers or services.  Therefore, the stockholders should pay for these bonuses.

USWC has not proven that the goals upon which the bonuses were based provide any benefits for Title 61 customers.  As I have pointed out, service quality goals had a zero percentage of achievement, the quality of service has deteriorated and the bonuses were still paid.  Therefore, service quality as a factor had zero impact on the bonuses.  In the past, other states have found that it is not appropriate to include bonuses based on a utility’s financial results in rates for regulated services.  (See E.G., Pacific Northwest Bell Telephone Company, Oregon Docket UT 43.)

Q.If bonuses based on increasing income should not be allowed and the Company did not meet its own service quality goals, why did you include 20% of the bonuses in revenue requirement?

A.My recommendation was made before I learned from production request answer-STF350, attachment B (Exhibit No. 156) that service quality goals had not been met.  Unfortunately, I did not get this information in time to adjust the Staff revenue requirement.  This would lower the Title 61 revenue requirement by $210,248.

Q.Is there ever a time when the inclusion of incentive pay for Idaho Title 61 customers is reasonable?

A.  Yes.  When employee incentive plans have goals that benefit customers and those goals are met.

Q.Does this conclude your surrebuttal testimony in this proceeding?

A.Yes, it does.