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

A.My name is Terri Carlock.  My business address is 472 West Washington Street, Boise, Idaho.

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

A.I am employed by the Idaho Public Utilities Commission as the Accounting Section Supervisor.

Q.Please outline your educational background and experience.

A.I graduated from Boise State University in May 1980, with a B.B.A. Degree in Accounting and in Finance.  I have attended the annual regulatory studies program sponsored by the National Association of Regulatory Utilities Commissioners (NARUC) at Michigan State University.  I chaired the NARUC Staff Subcommittee on Economics and Finance and the Ad Hoc Committee on Diversification.  I have also attended various finance conferences, including the Public Utilities Finance/Advance Regulation Course at the University of Texas at Dallas, the National Society of Rate of Return Analysts' Financial Forums, the Regulatory Economics and Cost of Capital Conference in Utah, and a Standard & Poor's Corporation Telecommunications Ratings Seminar.  Since joining the Commission Staff in May 1980, I have participated in several audits, performed financial analysis on various companies and have previously presented testimony before this Commission.

Q.What is the purpose of your testimony in this proceeding?

A.The purpose of my testimony is to present Staff’s recommendation in this proceeding for U S WEST Communications, Inc. (U S WEST, USWC) related to U S WEST Direct Directory (Directory) revenue and the cost of capital.  In connection with the cost of capital, I will address the appropriate capital structure, the cost of debt, the cost of equity and the overall rate of return.  I am sponsoring Staff Exhibit Nos. 127 and 128 in my testimony.

Q.Please summarize your recommendations.

A.I am recommending an adjustment of $8,645,032 for Directory.  I am also recommending an overall rate of return of 8.66% based on a return on equity of 11.0%.

U S WEST DIRECT DIRECTORY (DIRECTORY) ADJUSTMENT

Q.Are you proposing an adjustment for the Directory revenue?

A.Yes, I am proposing an Idaho Intrastate net income adjustment of $8,645,032 for Directory.

Q.Did U S WEST include revenues from Directory advertising or yellow pages in this case?

A.No.  In response to Production Request ATT01-023, U S WEST stated “U S WEST Communications position is that there are no Yellow Pages Directory revenues that are imputable, which is why there is no test period adjustment.”

Q.Please provide the history of Directory revenues.

A.Directory operations have traditionally been a source of revenues contributing to the Company’s revenue requirement to maintain basic exchange service at reasonable rates and to support universal service.  This directory contribution has existed since well before the Bell system breakup in 1984.  The basic information required to develop a telephone directory continues to be readily available to the local telephone company.  The incumbent local exchange carrier (LEC) will maintain unique access to names, addresses and telephone numbers of all residents and businesses.  This information that constitutes the white page listings are now available to any directory provider for a fee.

The proposed Modified Final Judgement (MFJ) initially assigned directory operations to AT&T.  Following comments argued by the Bell Operating Companies (BOCs), the National Association of Regulatory Utility Commissioners, and many state commissions for the BOCs to retain the directory business, Judge Greene determined directory operations and revenues should be retained by the BOCs.  In the MFJ decision issued August 24, 1982, Judge Greene concluded that directory operations provide a significant revenue source to offset local telephone revenue requirements.

Q.Please explain why you believe an adjustment for Directory revenues is appropriate.

A.Prior to divestiture, combined “Yellow Pages” and “White Pages” directories were prepared and distributed by the local phone company, in this case

U S WEST’s predecessor (Mountain States Telephone and Telegraph Company).  The directory publishing assets were included in the rate base of Mountain Bell from which significant profits were available to satisfy the Company’s revenue requirement.  These profits were obtained as a result of the interrelationship among the phone company, the telephone directory and its customers.  The telephone directory was and is considered by customers as a telephone company service they receive as a customer of the company.

The use of Directory revenues as a component of local revenue requirement was clearly recognized by Judge Greene in the MFJ.  The MFJ court held that AT&T was not entitled to the publishing assets upon divestiture and concluded the Bell Operating Companies (BOCs) would retain those assets.  The Directory revenues were reserved to the BOCs (including U S WEST) specifically because it is in the public interest for Directory revenues to be available to defray some of the cost of local service.

In prior rate cases, this Commission has consistently included Directory revenues to satisfy revenue requirement in setting local rates (General Telephone Company of the Northwest, Inc., Case No.

U-1002-67; Mountain States Telephone and Telegraph Company (now U S WEST), Case No. U-1000-63).  More recently, the Revenue Sharing Plan also included actual southern Idaho Directory revenues for each year.  No evidence has been presented to support changing this method of including Directory revenues to reduce revenue requirement from local services.

Q.Do transactions between USWC and its affiliates raise any special regulatory concerns?

A.Yes.  The distinction between affiliate and non-affiliate transactions is significant.  Normally, transactions between non-affiliates are presumed to be reasonable when the utility demonstrates that it actually incurred the expenditure.  Parties challenging such non-affiliate transactions carry the burden to show that the expenditures were unreasonable or imprudent.  In contrast, transactions between affiliated companies are subjected to close scrutiny and the regulated utility has the burden of proving the reasonableness of its affiliate transactions.  In this instance U S WEST Communications transferred the Directory to an affiliate and therefore has the burden of proving the removal of directory advertising revenues was reasonable.  U S WEST cannot simply rely on the fact that a transfer of operations to an unregulated affiliate occurred.  If the Company fails to produce substantial evidence of the reasonableness of its affiliate transaction, then adjustments for ratemaking purposes to maintain customer neutrality are reasonable.  This Commission and Idaho courts have consistently followed this approach.  Order Nos. 24443, 16945, 16829; General Telephone Co. v. Idaho PUC, 109 Idaho 942, 712 P.2d 651 (1986), Boise Water Corp. v. Idaho PUC, 97 Idaho 832, 555 P.2d 163 (1976).

Q.Please explain the change in organizational structure related to Directory services at U S WEST.

A.In 1984, the Directory assets were transferred to U S WEST DIRECT (USWD), an unregulated affiliate, and then included with U S WEST Media Group in 1995.  As shown on Staff witness Faunce’s Exhibit No. 102 the Directory services, including yellow pages, are organized as U S WEST Marketing Resources Group (USWMRG) under U S WEST Media Group as a unit of U S WEST, Inc.  Although Directory services are now under USWMRG, I will continue to refer to it as U S WEST Direct since this is the way the accounting records are identified.

Q.Please explain Staff’s position regarding the transfer of an asset to an unregulated affiliate.

A.It is Staff’s position that the effect on customers should be neutral as to the transfer of any asset when it is for the convenience of the Company that the asset is transferred.  This means that no rate changes or revenue impact should result from the transfer.  To assure customer neutrality, revenues need to be credited to USWC even though the assets were transferred.  The revenue adjustment amount should be based on the difference between the revenues received from the publication venture and the reasonable cost of publication.  Such an adjustment is necessary to prevent utilities from removing profitable portions of the business to an unregulated entity and leaving captive utility customers with higher expenses of operations but with no revenue source to satisfy the revenue requirement.

Q.Please summarize the reasons for your adjustment.

A.The reasons for the Directory adjustment can be classified in three areas:

1.The Directory revenue stream was granted to the BOC to support local revenue requirement.  There is no supportable evidence to change this treatment.

2.USWD is an affiliate where the reasonableness of all transactions must be justified by the Company.  U S WEST must demonstrate that the removal of this revenue source from the regulated revenue requirement is reasonable.

3.The Staff’s Directory adjustment continues to recognize the inherent goodwill value of name and logo  recognition with U S WEST.  Based on USWD market research in Idaho, the U S WEST Direct telephone directory continues to be the primary directory referenced by customers and advertised in by advertisers.

Q.With various areas of the telecommunications business being classified as Title 62, or not rate regulated, in southern Idaho, please explain why Directory revenues should continue to support the local Title 61 revenue requirement.

A.Even though U S WEST elected to deregulate all of its services except basic local exchange services under Idaho’s Telecommunications Act of 1988, directory revenues continued to benefit local exchange customers in the Revenue Sharing Plan process that was adopted in lieu of a more formal and complicated cost allocation methodology.  The Commission stated:

The staff recommended language to

ensure that the Idaho jurisdiction

receives all Idaho-generated

directory advertising revenues plus

an allocation of national directory

advertising revenues.  The Commission

finds that this is an appropriate

change to the plan.  While U S WEST

has removed all of its directory

operation to a separate subsidiary,

the benefit of the directory revenues

themselves must continue to flow to

the regulated services of the

telephone operations.  Bell operating

companies were allowed to retain

publishing functions and assets upon

divestiture from AT&T specifically

for the purpose of supporting local

exchange rates.  U.S. v. AT&T, 552

F. Supp. 131 (D.D.C. 1982), Aff’d

Mem. Sub. nom. Maryland v. U.S., 460

U.S. 1001 (1983).  The Commission

finds that the inclusion of Idaho

directory revenues is essential for

the fair operation of the sharing plan.

Order No. 22738 at 10-11, Order No. 22738, dated September 20, 1989, emphasis added.

Q.Please explain how you calculated your proposed adjustment for Directory revenues.

A.I calculated the Staff recommended adjustment by starting with the 1995 Southern Idaho Directory Revenue used for Revenue Sharing.  To reflect operating costs including interest and taxes, I utilized the USWD 1995 Net Income to Revenue ratio.  This net income to revenue ratio was calculated from the Income Statement for USWD allocated to the southern Idaho jurisdiction in the answer to Confidential Staff Audit Response No. 63, Attachment A.  I have also made a reduction to allow USWD to retain a reasonable return on its investment.  These calculations are shown on Confidential Staff Exhibit No. 127.  My Directory adjustment is $8,645,032.

Q.Are any adjustments required to reflect payments received by USWC from USWD?

A.No adjustments are required for the payments USWC received from U S WEST DIRECT for white page listings and yellow pages billing and collection.  These payments are reflected in the revenues of USWC and shown as an expense for USWD.  The adjustment I have made is reflected at the net income level so no double counting has occurred and no adjustment is required.

Q.How should this adjustment be assigned to southern Idaho intrastate Title 61?

A.Directory Revenues would be reflected in Revenue Account 5230.  As shown in response to Staff Audit Request No. 6, Directory Revenues are assigned 100% intrastate.  This is consistent with the revenue sharing practice.  Since the benefit of directory revenues should apply to basic local service rates, it should be assigned 100% to Title 61.  Allocating a portion of the directory revenues to Title 62 would provide an unfair advantage to U S WEST over alternative providers of Title 62 services.

Q.Please explain why an allocation to Title 61 services doesn’t provide an unfair advantage to U S WEST since local services may be more competitive in the future.

A.Title 61 services can become more competitive.  However, the directory revenue benefit can be passed on to the local service customer no matter who the local service provider is as long as U S WEST facilities are resold.  This should be addressed in a separate and distinct case addressing unbundled rates.

This issue may be revisited when a strong percentage of local service is not provided by facilities owned by USWC or leased from USWC.

Q.Do other state regulatory jurisdictions adjust Directory revenue?

A.Yes, in addition to Idaho, the following states with U S WEST jurisdiction have adjusted Directory revenues at some level:   Washington, Oregon, Arizona, Utah, New Mexico, Colorado and Iowa.  Directory revenues have also been adjusted for other telephone companies in other jurisdictions.  Some additional states that have adjusted Directory revenues include California, Missouri, Arkansas, Vermont, Kentucky, District of Columbia, Florida, Wisconsin, Illinois and Louisiana.

In U S WEST’s recent rate case in Washington, the Utilities and Transportation Commission recently concluded that:

Utilities, operating as natural

monopolies, may have the power

to operate for their own

corporate, interests, adversely

to the interests of ratepayers.

The Commission is charged with

protecting the ratepaying public.

One of the Commission’s functions

has been to protect customers of

noncompetitive services from

utilities’ self-dealing.  Utilities

may have the power to subdivide the

integrated utility operations and

divest for their own organizational

goals or profit objectives any

discrete, divisible, and potentially

profitable aspect of that operation.

Imputation is entirely consistent

with the purpose of regulation as

a tool to minimize adverse effects

on such division and divestiture

when those circumstances occur.

WUTC Fifteenth Supplemental Order, at 37-38

(April 11, 1996) Docket No. UT-95-0200).

COST OF CAPITAL

Q.What legal standards have been established for determining a fair and reasonable rate of return?

A.The legal test of a fair rate of return for a utility company was established in the Bluefield Water Works decision of the United States Supreme Court and is repeated specifically in Hope Natural Gas.

In Bluefield Water Works and Improvement Co.  v. West Virginia Public Service Commission, 262 U. S. 679, 692, 43 S.Ct. 675, 67 L.Ed. 1176 (1923), the Supreme Court stated:

A public utility is entitled to such

rates as will permit it to earn a return

on the value of the property which it

employs for the convenience of the

public equal to that generally being

made at the same time and in the same

general part of the country on

investments in other business

undertakings which are attended by

corresponding risks and uncertainties;

but it has no constitutional right to

profits such as are realized or

anticipated in highly profitable

enterprises or speculative ventures.

The return should be reasonably

sufficient to assure confidence in the

financial soundness of the utility and

should be adequate, under efficient and

economical management, to maintain and

support its credit and enable it to

raise the money necessary for the proper

discharge of its public duties.  A rate

of return may be reasonable at one time

and become too high or too low by

changes affecting opportunities for

investment, the money market and

business conditions generally.

The Court stated in FPC v. Hope Natural Gas Company, 320

U. S. 591, 603, 64 S.Ct. 281, 88 L.Ed. 333 (1944):

From the investor or company point of

view it is important that there be

enough revenue not only for operating

expenses but also for the capital costs

of the business.  These include service

on the debt and dividends on the stock.

... By that standard the return to the

equity owner should be commensurate with

returns on investments in other

enterprises having corresponding risks.

That return, moreover, should be

sufficient to assure confidence in the

financial integrity of the enterprise,

so as to maintain its credit and to

attract capital.  (Citations omitted.)

The Supreme Court decisions in Bluefield Water Works and Hope Natural Gas have been affirmed in In re Permian Basin Area Rate Case, 390 U. S. 747, 88 S.Ct 1344, 20 L.Ed 2d 312 (1968), and Duquesne Light Co. v. Barasch, 488 U. S. 299, 109 S.Ct. 609, 102 L.Ed.2d. 646 (1989).  The Idaho Supreme Court has also adopted the principles established in Bluefield Water Works and Hope Natural Gas.  See In re Mountain States Tel. & Tel. Co. 76 Idaho 474, 284 P.2d 681 (1955); Hayden Pines Water Company v. IPUC, 122 ID 356, 834 P.2d 873 (1992); General Telephone Co. v. IPUC, 109 Idaho 942, 712 P.2d 643 (1986).

As a result of these United States and Idaho Supreme Court decisions, three standards have evolved for determining a fair and reasonable rate of return:  (1) the Financial Integrity or Credit Maintenance Standard; (2) the Capital Attraction Standard; and, (3) the Comparable Earnings Standard.  If the Comparable Earnings Standard is met, the Financial Integrity or Credit Maintenance Standard and the Capital Attraction Standard will also be met, as they are an integral part of the Comparable Earnings Standard.

Q.Have you considered these standards in your recommendation?

A.Yes.  These criteria have been seriously considered in the analysis upon which my recommendations are based.  It is also important to recognize that the fair rate of return that allows the utility company to maintain its financial integrity and to attract capital is established assuming efficient and economic management, as specified by the Supreme Court in Bluefield Water Works.

Q.What approach have you used to determine the cost of equity for U S WEST specifically?

A.I have presented two methods:  the Discounted Cash Flow (DCF) method and the Comparable Earnings method for industrial companies and utilities.

Q.Please explain the Comparable Earnings method and how the cost of equity is determined using this approach.

A.The Comparable Earnings method for determining the cost of equity is based upon the premise that a given investment should earn its opportunity cost.  In competitive markets, if the return earned by a firm is not equal to the return being earned on other investments of similar risk, the flow of funds will be toward those investments earning the higher returns.  Therefore, for a utility to be competitive in the financial markets, it should be allowed to earn a return on equity equal to the average return earned by other firms of similar risk.  The Comparable Earnings approach is supported by the Bluefield Water Works and Hope Natural Gas decisions as a basis for determining those average returns.

I have analyzed the returns for utilities

and industrial companies in order to determine a fair return for U S WEST.  When determining the comparable earnings rate, it is important that a cross-section of various companies and industries be utilized in the sample so that any possible effects of unusual occurrences or monopoly powers are limited.  It is also important that any risk differentials between the comparable earnings sample and U S WEST be resolved.

In my comparable earnings analysis, the rates of return on common equity historically earned by industrial firms were examined.  The historical returns earned by electric, gas and telephone utilities were also studied.  Then, based upon current economic conditions, the current cost of equity capital for industrial firms on the average was estimated.  Taking into consideration the risk differentials between industrial companies and utilities and those differentials as they specifically relate to U S WEST, I estimated the current cost of equity range utilizing the Comparable Earnings approach.

Q.Please explain your schedules reflecting the historical rate of return earned for industrial firms.

A.Schedules 1 through 4 of Staff Exhibit No. 128 show the returns on common equity for the Business Week Corporate Scoreboard over the last 10 years.  The industry category classifications were changed beginning the first quarter of 1988.  The current classifications are reflected on each schedule.

Industrial returns tend to fluctuate with business cycles, increasing as the economy improves and decreasing as the economy declines.  I have utilized a three-year moving average to smooth the business cycle effects and yearly fluctuations in the industrial rate of return.  Utility returns are not as sensitive to fluctuations in the business cycle because the demand for utility services generally tends to be more stable and predictable.  Schedule 1 reflects the returns earned for periods ending the First Quarter of each year; Schedule 2 reflects the returns for periods ending the Second Quarter; Schedule 3 reflects the returns for periods ending the Third Quarter; and Schedule 4 reflects the returns for periods ending the Fourth Quarter of each year.  The returns for 1995 and 1996 reflect the effects of the economic recovery and the adequate economic conditions that continue.

For years ending the First Quarter (Schedule 1 of Staff Exhibit No. 128), the five-year average return from 1992 through 1996 was 13.2%, and the three-year average from 1994 through 1996 was 15.2%.  The three-year moving average for 1996 of 15.2% is greater than the three-year moving average of 13.6% in 1995.

For years ending the Second Quarter (Schedule 2 of Staff Exhibit No. 128), the five-year average of 13.6% for 1996 is higher than the five-year average of 12.4% for 1995.  The three-year moving average increases from 14.0% in 1995 to 15.6% in 1996.

For years ending the Third Quarter (Schedule 3 of Staff Exhibit No. 128), the five-year average from 1992 through 1996 was 13.9%, increasing from 12.6% in 1995.  The three-year moving average from 1994 through 1996 was 15.8%, reflecting an increase from 14.5% in 1995.

For years ending the Fourth Quarter (Schedule 4 of Staff Exhibit No. 128) the five-year average return of 12.6% for 1996 is an increase from 11.7% in 1992.  The three-year average in 1996 of 14.7% increased from 12.6% in 1995.

This is a significant improvement in reported returns causing large increases in the industry composite compared to prior years.

Schedule 5 of Staff Exhibit No. 128 depicts the returns for the years ending each quarter from 1987 through the Third Quarter of 1996 for the Corporate Scoreboard composite returns, the three-year moving average industrial returns, the utilities returns and the telecommunications returns as reflected in Schedules 1 through 4.  This graph shows the increase and decrease of industrial returns through good and bad economic times of business cycles.

Q.What is your estimate of the current and near-future equity returns for industrial companies?

A.Based upon the three-year moving average trend in industrial earnings and actual earnings reflected on Schedules 1 through 5, Staff Exhibit No. 128 along with current economic conditions, I believe industrial returns will be stable or decrease in 1997.

The 1995 inflation rate is 2.5% for the consumer price index and 2.3% for the producer price index.  The change in the inflation rate can be seen by looking at the consumer and producer price indexes as shown in Schedule 6 of Staff Exhibit No. 128.  The change in bond rates is illustrated in Schedule 7 of Staff Exhibit No. 128, Moody's Average for Public Utility Bond Yields.  The yields are shown for "Aa", "A" and "Baa" bonds from 1977 through October 1996.  Prime interest rates as shown in Schedule 8 of Staff Exhibit No. 128 have been stable at 8.25% since February 1, 1996.  The Federal Funds Reserve Rate is currently at 5.5%.

The Dow Jones Industrial Average Index (DJIA) has fluctuated widely between the 1982 low of 776.92 on August 12, to a closing record of 6430.02 on November 20, 1996.  The Dow Jones Utility Average (DJUA) reached a record high of 247.68 on April 16, 1993 and closed at 234.63 on November 20, 1996.

I made a review of the actual earned returns on equity for industrial companies, the decline and improvement in the economy, changing inflation

and stock market conditions.  Based upon these considerations my estimate of the near future equity capital returns for industrial companies is in the range of 13.5% - 15.0%.

Q.How does the trend in utility returns compare with the trend in industrial returns?

A.Schedule 9 of Staff Exhibit No. 128 shows the returns for the Moody's Electric Utilities since 1970.  The returns in individual years may increase or decrease from the prior year, but the three-year moving averages show general movements in earned returns.  There has been a general downward trend in average electric utility returns since 1986 as reflected in the three-year moving average returns.  In 1995, the three-year moving average return is 9.8% while the five-year average return is 10.4%.

The return on common equity for the Moody's Gas Distribution Companies is shown in Schedule 10 of Staff Exhibit No. 128.  For the period ending 1995, the annual return is 10.1% while the three-year average return for the gas utilities is 11.3%.

The booked earned returns for the Telecommunications Services Industry has increased from 15.0% in 1992 to 25.0% in 1996 (Value Line Investment Survey, October 11, 1996).  The average market to book ratio for this industry is 3.4x.  When the market to book ratio is above 1, booked earned returns are greater than the required cost of capital.  Therefore the required market realized return is significantly less than the reported earned returns.  If the relationship between the returns and the market to book rate was directly proportional, the required cost of capital would be 7.4% (25.0% ÷ 3.4).

A review of electric, gas and telephone utility returns provides a record of actual utility returns earned in the past.  The required return for telephone utilities, and U S WEST specifically, can then be estimated by reviewing current market changes and considering any risk differentials between the different types of utilities.

Q.Please explain the risk differentials between industrial companies and utilities.

A.Risk is a degree of uncertainty relative to a company.  The lower risk level associated with utilities is attributable to many factors.  Utilities continue to have limited competition for distribution of utility services within the certificated area.  With limited competition for regulated services, there is less chance of losses related to pricing practices, marketing strategy and advertising policies.  The market share may decline as competition increases in various markets but the probability of losses in regulated markets remains small compared to industrial companies.

The competitive risks for telephone companies continue to change with The Telecommunications Act of 1996.  Even with the removal of legal barriers to local competition, telephone companies maintain substantial market power from the existing network.  This market power limits the competitive risks for the incumbent LECs.  While U S WEST may have increased competition in select local markets, the existing market power advantages retained by U S WEST will limit competition for several years.  The competitive risks for gas and electric utilities have also changed with the increase in non-utility generation and open transmission access.

Competitive risks are less for U S WEST than for many telephone companies, partially due to the rural nature of the service area and also the market power advantages.  The demand for utility services of

U S WEST and other BOCs is relatively stable compared to that of unregulated firms and even non BOC telephone service providers.

Under regulation, utilities are generally

allowed to recover, through rates, reasonable, prudent and justifiable cost expenditures related to regulated services.  Unregulated firms have no such assurance.  Utilities in general are sheltered by regulation for cost recovery risks on regulated services, making the average utility less risky than the average unregulated industrial firm.

Q.Please explain the targeted stock issue for  U S WEST, Inc.

A.This transaction is explained best by Value Line in the October 11, 1996 Value Line Investment Survey.

On November 1, 1995, each share of

U S WEST, Inc.’s stock was divided

into one share of U S WEST Communi-

cations Group Common Stock and one

share of U S WEST Media Group Common Stock....  These two classes of stock

were established in order to allow investors to “track” the performance

of each group’s operations.

I have utilized the data for U S WEST Communications Group for Company specific data in my cost of capital evaluation.  Although I have used data specific to U S WEST Communications Group, the risk analysis and market data continue to reflect some impact from U S WEST Media Group since “[t]here is no legal separation between the assets and liabilities of the two groups, and it is possible for events affecting one to carry over to the other.”  (Value Line Investment Survey, October 11, 1996)

Q.Have you compared U S WEST directly with other telephone utility companies?

A.Yes.  Schedule 11 of Staff Exhibit No. 128 shows U S WEST and other telephone companies that meet the following Value Line Investment Survey criteria:

1.  Industry code for Telecom Services.

2.  Safety of 1,2 or 3 where 1 is the highest rank and 3 is average (U S WEST's safety rank is 1).

3.  Beta of .50 - 1.10 where the market equals 1.00 (U S WEST's Beta was .75 before the targeted stock issue).

Of the 20 companies besides U S WEST meeting these criteria, 10 companies have a safety rating of 1 and only 3 companies in the group have Betas less than or equal to .75.  Higher Betas reflect more risk.  Therefore, U S WEST is less risky than the sample group.

The financial statistics shown on page 2 of Staff Exhibit No. 128, Schedule 11, include the price/earnings ratio for the last 12 months, average annual dividend yield, common equity ratio, booked percent earned on common equity, percent payout ratio and market to book ratio.  These financial statistics shown on page 2 of Staff Exhibit No. 128, Schedule 11, show the Telecom Services group average compared to U S WEST.

Q.Based upon your analysis of industrial returns, utility returns, and current economic conditions, what is your estimate of the cost of equity capital for U S WEST based upon the Comparable Earnings method?

A.When utilizing the Comparable Earnings method, the risk differentials between industrial companies, utilities and telecommunication service providers, particularly U S WEST, must be considered.  Utility returns, in comparison to industrial returns, may be ranked by classifying the utility services according to risk levels.  Utility groups are less risky than industrial companies.  Because an average utility company is less risky than an average industrial company, its cost of equity capital range would be less.

U S WEST is less risky than an average telephone utility company partially due to lower competitive risks and regulatory risks as discussed previously.  These lower risks produce a lower business risk for U S WEST than for other telephone services companies.  Therefore, the cost of equity capital would be less for U S WEST than that of both an average telephone services utility and that of an industrial company.

Using the Comparable Earnings approach, my estimate of the current cost of equity capital for

U S WEST is in the range of 11.0% - 12.0%.  This range is developed by reviewing the most recent utility and telecommunication services returns as shown in the Corporate Scoreboard for 1996 (Ex. 128, Sch. 1-5); current market to book ratios; the three-year average returns of 9.8% ending 1996 for the Moody's Electric Utilities (Ex. 128, Sch. 9); and three-year average returns of 11.3% ending 1996 for the Moody's Gas Distribution Utilities (Ex. 128, Sch. 10).  The safety ratings and Betas for the comparable telephone companies (Ex. 128, Sch. 11, pg. 1); comparable telephone earnings shown on page 2 of Schedule 11, the market indicators (Schedules 6 - 8 of Ex. 128) and the industrial returns (Schedules 1 - 5 of Ex. 128) were utilized to predict the reasonable required return.

Q.You indicated that the Discounted Cash Flow method is utilized in your analysis.  Please explain this method.

A.The Discounted Cash Flow (DCF) method is based upon the theory that (1) stocks are bought for the income they provide (i.e., both dividends and/or gains from the sale of the stock), and (2) the market price of stocks equals the discounted value of all future incomes.  The discount rate, or cost of equity, equates the present value of the stream of income to the current market price of the stock.  The formula to accomplish this goal is:

           D1         D2           DN        PN

Po = PV = ------- + ------- +...+ ------ + ------

         (1+ks)1    (l+ks)2       (1+ks)N   (1+ks)N

Po =Current Price-

D =Dividend

ks =Capitalization Rate, Discount Rate, or Required Rate of Return

N =Latest Year Considered

The pattern of the future income stream is the key factor that must be estimated in this approach.  Some simplifying assumptions for ratesetting purposes can be made without sacrificing the validity of the results.  Two such assumptions are:  (1) dividends per share grow at a constant rate in perpetuity; and,

(2) prices track earnings.  These assumptions lead to the simplified DCF formula, where the required return is the dividend yield plus the growth rate (g):

                 D

            ks = -- + g

                 Po

Q.What is your estimate of the current cost of capital for U S WEST using the Discounted Cash Flow method?

A.The current cost of equity capital for

U S WEST using the Discounted Cash Flow method is between 9.33% - 12.03% during various time intervals over a 52-week range, as shown on Schedule 12, page 1 of 2, Staff Exhibit No. 128.  I believe the six-month average price (May 1996 - October 1996) is the most appropriate time interval to use.  This average price reflects current investor expectations without being subject to daily market fluctuations, as would be the case if the price on a specific date were used.  The average price of $31.21 results in the 10.15% to 11.02% range.  The price of $30.375 on November 20, 1996 results in a DCF return of 10.32% to 11.21%.  I have used an 11.0% to 12.0% range as the most appropriate estimate under the Discounted Cash Flow method for use in this case.  This is the upper end of the range of reasonableness for the DCF method.

Q.How is the growth rate (g) determined?

A.The growth rate is the factor that requires the most extensive analysis in the DCF method.  It is important that the growth rate used in the model be consistent with the dividend yield so that investor expectations are accurately reflected and the growth rate is not too large or too small.

I have used an expected growth rate of

3.5% - 4.0%.  This expected growth rate was derived from an analysis of various historical and projected growth indicators, including growth in earnings per share, growth in cash dividends per share, and growth in book value per share for U S WEST (Staff Exhibit No. 128, Schedule 12, page 2).

The targeted stock issue limits the historical data to proforma estimates for 1994 and 1995.  The historical growth factors are significantly lower than the projected growth factors for earnings per share and book value per share.  I have placed more weight on the projected growth factors in this case.  Therefore, I believe the 3.5% - 4.0% growth factor will be high in the near future but reasonable for time periods over five years.

Q.You have utilized an adjusted dividend yield to determine the required return with the DCF method.  Please explain.

A.The adjustments I have made to arrive at the adjusted dividend yield for the DCF method recognize the quarterly compounding of dividend growth in the growth factor and direct issuance or flotation costs for stock issuances.  Market pressure should not be reflected in the flotation cost adjustment.  I have used a 2.0% flotation cost rate based on past Company issuances as a reasonable flotation cost over time to be included in the DCF analysis.  This 2% flotation cost is derived from Cummings Exhibit 15.

Q.Please explain the quarterly compounding.

A.The Commission has allowed for quarterly compounding in prior cases (originally adopted in Order No. 23420, Case No. BOI-W-90-1).  I have adjusted the growth rate in this case to reflect the impact of quarterly compounding of the dividend.  The dividend growth rate, compounded for quarterly payments, is used to calculate the required return in the DCF method.  Staff Exhibit No. 128, Schedule 12, page 1 shows the 3.5% - 4.0% growth rate compounded to reflect quarterly dividend payments resulting in an annual effective growth rate of 3.513% - 4.015%.

Although it is true that dividends are paid quarterly and not annually, I do not believe that the quarterly adjustment is necessary for the DCF method.    The quarterly adjustment I made increases the DCF return by .013% - .015%.  Quarterly DCF models basically compound the dividend yield for timing differences of quarterly payments then add the incremental growth rate.  The compounded rate assumes that the Company is responsible for reinvestment payments the investor will receive by reinvesting his/her dividends.  The investor has the option to reinvest the dividends in U S WEST Communications Group stock or in some other security.

Q.Please explain the adjustment to reflect a 2.0% issuance expense or flotation cost factor to calculate the dividend yield in the DCF calculation?

A.The 2.0% is based on the issuance expenses incurred by U S WEST as shown on U S WEST witness Cummings Exhibit 15, page 1.  Issuance costs are relevant expenditures to consider in the cost of equity determination for new issuances.  Direct issuance or flotation costs impact the actual price received by the Company for stock sold.  The funds received amount to the stock price less the issuance costs.  To reflect these costs, the dividend yield is adjusted in the DCF method.

A specific allowance for market pressure is not appropriate.  Investors determine the price they are willing to pay for stock at the time of issuance.  I do not believe it is appropriate to make an allowance

for price fluctuations as a result of this competitive process.  I have used the 2.0% allowance as reasonable over time.

Q.What capital structure have you used for

U S WEST to determine the overall cost of capital?

A.I have utilized the actual capital structure at December 31, 1995 consisting of 62% long-term debt and 38% common equity as shown on Schedule 14 of Staff Exhibit No. 128.  This capital structure is appropriate to use for ratemaking purposes in this case and is the same capital structure as reflected on financial statements used by investors and rating agencies.

Q.Please explain the difference between the capital structure you recommend and the capital structure utilized by U S WEST witness Cummings.

A.Mr. Cummings adjusts the actual capital structure to eliminate for ratemaking purposes the impact from write-offs taken related to the discontinuance of Financial Accounting Standards Board Statement of Financial Accounting Standards (SFAS) No. 71 “Accounting for the Effects of Certain Types of Regulation.”  The primary write-off relates to SFAS  No. 106, “Employers’ Accounting for Postretirement Benefits Other Than Pensions” and SFAS No. 112, “Employers’ Accounting for Postretirement Benefits.”

The return on equity recommendation is based on market required returns so the capital structure utilized should be based on ratios utilized by investors and rating agencies.

Q.Are you indicating that SFAS Nos. 106 and 112 should not be recognized for ratemaking purposes?

A.No.  The revenue requirement impact of SFAS Nos. 106 and 112 related to the expense and amortization have been reflected in the Staff’s revenue requirement recommendation by Staff witness Schneider.

Inclusion of these expenses in the revenue requirement does not necessitate the adjustment of the capital structure.  To maintain consistency between the market data used to establish the recommended return on equity, the actual capital needs to be utilized to develop the authorized overall rate of return.  Again, this is important since the actual capital structure is utilized by investors to evaluate the price each investor is willing to pay for stock of U S WEST Communication, Inc.  Value Line reports the actual capital structure in the Value Line Investment Survey.

Q.What are the costs related to the capital

structure for debt?

A.The embedded cost of debt is 7.23% as of December 31, 1995.  The 7.23% cost of debt is reflected on Schedule 13, Staff Exhibit No. 128, pages 1 & 2.  This schedule reflects the actual cost of debt for U S WEST Communications, Inc. as of December 31, 1995.  The last line on page 2 of Schedule 13 adjusts the cost of debt for the additional Debt Call Premiums that were wrote off on the books.  These premiums are amortized over the life of the new issue for ratemaking purposes.  The debt cost adjustment (Staff Exhibit 128, Schedule 13) and the amortization (U S WEST witness Wright, Exhibit No. 25, page 9 of 21, adjustment 20) allows U S WEST to recover these costs of refinancing in the revenue requirement.

Q.Why have you used an adjusted debt cost to reflect a write-off for debt call premiums when you used the actual capital structure after the write-offs?

A.Using the adjusted debt cost is consistent with allowing, for ratemaking purposes, the expenses related to SFAS Nos. 106 and 112.  The adjustment allows U S WEST to recover the actual costs.

Q.You indicated the cost of common equity range for U S WEST is 11.0% - 12.0% under the Comparable Earnings method and 10.15% - 11.02% under the Discounted Cash Flow method.  What is the cost of common equity capital you are recommending?

A.The fair and reasonable cost of common equity capital I am recommending for U S WEST is in the range of 11.0% - 12.0%.  Although any point within

this range is reasonable, the return on equity granted would not normally be at either extreme of the fair and reasonable range.

Q.What point estimate are you recommending?

A.Normally I would recommend the midpoint of the range, 11.5%, as the point estimate.  However, I am recommending a point estimate of 11.0% to recognize the service quality problems primarily addressed by Staff witness Hart.  The 11% return on equity point estimate utilized is based on:  (1) a review of the market data and comparables shown on the schedules in Staff Exhibit No. 128; (2) U S WEST's stock price and risk characteristics shown on Staff Exhibit No. 128, Schedule 11 and (3) the service quality problems.

Q.What is the overall weighted cost of capital you are recommending for U S WEST?

A.I am recommending an overall weighted cost of capital in the range of 8.66% - 9.04% as shown on Schedule 14, Staff Exhibit No. 128.  For use in calculating the revenue requirement, a point estimate consisting of a return on equity of 11.0% and a resulting overall rate of return of 8.66% was utilized.

Q.What do you propose that the Commission do to encourage the Company to improve it’s service quality performance?

A.Staff recommends that the return on equity used in the determination of the Company’s revenue requirement be the minimum return within the range of reasonable returns.  This would still allow the Company to obtain a return on their investment that is within the range of reasonableness, but at the lower end of that range.

The reduction in revenue requirement would be in effect until the Company could provide evidence that it has returned service quality to an acceptable level.  The service quality problems are discussed in greater detail in Staff witness Hart’s testimony.

Q.Why are you recommending this approach?

A.The Commission has used this type of approach in the past to recognize the failure of a company to provide adequate service (Case No. U-1002-67, Order No.  21443), as well as recognize superior service (Case No. SOU-W-94-1, Order No. 25785; Case No. U-1025-48, Order No. 19902).

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

A.Yes, it does.