BEFORE THE ARIZONA CORPORATION COMMISSION

MARC SPITZER
Chairman
WILLIAM A. MUNDELL
Commissioner
JEFF HATCH-MILLER
Commissioner
MIKE GLEASON
Commissioner
KRISTIN MAYES
Commissioner

IN THE MATTER OF QWEST CORPORATION'S FILING AMENDED RENEWED PRICE REGULATION PLAN	)))	DOCKET NO. T-01051B-03-0454
IN THE MATTER OF THE INVESTIGATION OF THE COST OF TELECOMMUNICATIONS ACCESS	)))	DOCKET NO. T-00000D-00-0672

DIRECT

TESTIMONY

OF

ALEJANDRO RAMIREZ

PUBLIC UTILITIES ANALYST I

UTILITIES DIVISION

ARIZONA CORPORATION COMMISSION

NOVEMBER 18, 2004

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EXECUTIVE SUMMARY

The direct testimony of Staff witness Alejandro Ramirez addresses the following issues:

Capital Structure – Staff recommends that the Commission adopt Qwest Corporation's actual end of test year 2003 capital structure consisting of 75.2 percent debt and 24.8 percent equity.

Cost of debt – Staff recommends that the Commission adopt Qwest Corporation's actual end of test year 2003 cost of outstanding debt of 7.81 percent.

Overall Rate of Return - Staff recommends that the Commission adopt 9.5 percent for the overall rate of return ("ROR") to establish the revenue requirement for Qwest Corporation.

INTRODUCTION

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

A. My name is Alejandro Ramirez. I am a Public Utilities Analyst employed by the Arizona Corporation Commission ("ACC" or "Commission") in the Utilities Division ("Staff"). My business address is 1200 West Washington Street, Phoenix, Arizona 85007.

Q. Briefly describe your responsibilities as a Public Utilities Analyst.

A. In my position as a Public Utilities Analyst, I perform studies to estimate the cost of capital component of the revenue requirement in rate proceedings. I also perform other financial analyses.

Q. Please describe your educational background and professional experience.

A. In 2002, I graduated summa cum laude from Arizona State University, receiving a Bachelor of Science degree in Global Business with a specialization in finance. While attending Arizona State University, I successfully completed the Barrett Honors College curriculum. My course of studies included classes in corporate and international finance, investments, accounting, statistics, and economics. I began employment as a Staff Public Utilities Analyst in 2003. Since that time, I have provided recommendations to the Commission on financings and prepared various studies in the field of cost of capital and econometrics. I have also attended seminars related to general regulatory and business issues.

Q. What is the scope of your testimony in this case?

A. I provide Staff's recommended capital structure, cost of debt and rate of return in this proceeding. I discuss the appropriate overall rate of return ("ROR") for establishing the revenue requirement for Qwest Corporation. ("QC" or "Applicant").

SUMMARY OF TESTIMONY AND RECOMMENDATIONS

Q. Briefly summarize how Staff's cost of capital testimony is organized.

A. Staff's cost of capital testimony is organized in four sections. Section I discusses the concept of weighted average cost of capital ("WACC"). Section II presents the concept of capital structure and Staff's recommended capital structure for QC in this proceeding. Section III presents Staff's recommended cost of debt for the Applicant. Finally, Section IV presents Staff's overall rate of return recommendation for the Applicant.

Q. Have you prepared any exhibits to your testimony?

A. Yes. I prepared five schedules (AXR-1 to AXR-5) that support Staff's cost of capital analysis.

Q. What is Staff's recommended overall rate of return for Qwest Corporation?

A. Staff recommends a 9.5 percent ROR. Staff's recommendation is based on its cost of equity estimate of 14.6 percent and the Applicant's actual end of test year cost of debt of 7.81 percent. The ROR calculation is presented on Schedule AXR-1.

I. THE WEIGHTED AVERAGE COST OF CAPITAL

Q. Please define the cost of capital concept.

A. The cost of capital is the opportunity cost of the funds employed as the result of an investment decision. The cost of capital represents the returns that could be expected to be earned in other investments with equivalent risk. In other words, the cost of capital is the return that stakeholders expect for committing their resources in a determined business enterprise. The cost of capital is calculated as the weighted average cost of capital("WACC").

Q. How is the WACC for utilities calculated?

A. The WACC is calculated by adding the weighted expected return on equity and the weighted embedded cost of debt.

The following equation shows how the WACC is calculated:

Equation 1.

$$WACC = W_{debt} * r_{debt} + W_{equity} r_{equity}$$

Where W_{debt} and W_{equity} are the weights given to the Applicant's securities (the proportion of the each security relative to the portfolio), r_{debt} is the embedded cost of debt and r_{equity} is the expected return on equity.

Q. Can you explain Equation 1?

A. Let's assume that a firm has a capital structure composed of 75 percent debt and 25 percent equity. Let's also assume that the embedded cost of debt is 7.8 percent and the expected return on equity (cost of equity) is 10.5 percent. The WACC calculation is as follows:

WACC = (75% * 7.8%) + (25% * 10.5%)

WACC = 5.85% + 2.63%

WACC = 8.48%

The weighted average cost of capital in this example is 8.48 percent. Given the example firm's capital structure, the company would have to earn an overall rate of return of 8.48 percent to cover its cost of capital.

II. CAPITAL STRUCTURE

Background

Q. Please briefly explain the capital structure concept.

A. The capital structure of a firm shows how its assets are financed over the long-run. The capital structure of a firm is the mix of capital leases, long-term debt, preferred stock and common stock that are used to finance the firm's assets.

Q. How is the capital structure calculated?

A. The capital structure of a company is calculated by finding the percentage of each component of the capital structure (capital leases, long-term debt, preferred stock and common stock) relative to the total capital (the total sum of all the components of the capital structure).

For illustrative purposes, let's suppose that company A is financed by $15,000 of capital leases, $80,000 of long-term debt, $5,000 of preferred stock and $35,000 of common stock. Company A's capital structure would be calculated as follows:

Table 1.

Component			%
Capital Leases	$15,000	($15,000/$135,000)	11.1%
Long-Term Debt	$80,000	($80,000/$135,000)	59.3%
Preferred Stock	$5,000	($5,000/$135,000)	3.7%
Common Stock	$35,000	($35,000/$135,000)	25.9%
Total	$135,000		100%

In this example, Company A's capital structure is composed of 11.1 percent capital leases, 59.3 percent long-term debt, 3.7 percent preferred stock and 25.9 percent common stock.

Qwest Corporation Capital Structure

Q. What capital structure does the Applicant propose for its Arizona operations?

A. QC proposes in this proceeding a capital structure composed of 75.17 percent debt and 24.83 percent common equity. Schedule AXR-1 shows QC's proposed capital structure in this proceeding.

Q. How did the Applicant calculate the proposed capital structure?

A. The Applicant calculated the value of components of its Arizona capital structure based on regulatory and accounting records prescribed by the Federal Communication Commission ("FCC") allocated among jurisdictions on the basis of net plant in service.

Q. Would the Applicant's proposed capital structure change if the net plant in service for Arizona versus other jurisdictions changes?

A. No**.** A change in the relative percentage of net plant in the Arizona jurisdiction would change the dollar value of the capital components; however, the proportion of each component would remain the same.

For illustrative purposes, let's go back to the example of Company A, which as previously stated, is financed by $15,000 of capital leases, $80,000 of long-term debt, $5,000 of preferred stock and $35,000 of common stock. Assuming two net plant scenarios (10 percent and 16 percent) for Company A's operations in a region. Table 2 summarizes the results:

Table 2.

	10 % Allocation Factor		16 % Allocation Factor	
Component	Dollar Amount	%	Dollar Amount	%
Capital Leases	$1,500	11.1%	$2,400	11.1%
Long-Term Debt	$8,000	59.3%	$12,800	59.3%
Preferred Stock	$500	3.7%	$800	3.7%
Common Stock	$3,500	25.9%	$5,600	25.9%
Total	$13,500	100%	$21,600	100%

As shown in Table 2, changes in the allocation factor (net plant) do not change the proportion of the financial instruments included in the capital structure.

Q. How does QC's capital structure compare to other telephone companies?

A. Schedule AXR-2 shows a comparison between a Sample of Telecos (the sample used by Staff witness Mr. Reiker), QC and Qwest International (Holding Company of QC). The average capital structure for the sample Telecos is composed of 47.8 percent debt and 52.2 percent equity. In contrast, QC's capital structure is composed of 75.2 percent debt and 24.8 percent equity. QC's capital structure is more leveraged than the average capital structure of the sample Telecos. Qwest International, QC's holding company, currently has negative equity.

Q. Does Staff have any concerns regarding QC's capital structure?

A. Yes. Staff is concerned with QC's current capital structure and its implication for the future. As stated above, QC's current capital structure is more leveraged than the sample telecos. Moreover, Staff is concerned with QC's new dividend policy that was established in July 2004.

Q. What is QC's new dividend policy?

A. QC's new dividend policy allows QC to consistently declare dividends in excess of its earnings. The following is an excerpt found in QC's 10-Q[1] for the period ending June 30, 2004, page 24:

> "In July 2004, we [Qwest Corporation] modified our dividend practice to balance our financial needs, cash position and credit profile with those of our parent. As a result, going forward, we may declare and pay dividends in excess of our earnings."

Q. How could this new dividend policy affect QC's overall financial condition?

A. If QC consistently declares dividends in excess of its earnings, QC's book equity may be further reduced, resulting in an even more leveraged capital structure. QC's bond rating and its cost of debt may be adversely affected by an increase in leverage.

Q. Does staff believe that the Applicant's actual capital structure should be adopted for rate-making purposes in this case?

A. Yes.

III. COST OF DEBT

Q. Are the applicant's debt instruments graded by credit rating agencies?

A. Yes. Schedule AXR-3 shows QC's long-term debt rating from the three main credit rating agencies: Standard & Poor's ("S&P"), Moody's Investors Services (Moody's) and Fitch Ratings ("Fitch") at June 30, 2004 and at December 31, 2003. Investment grade bonds are those whose investment grade is at least BBB- (S&P), Baa3 (Moody's) and BBB- (Fitch). QC's long-term debt grade at December 31, 2003 was B- (S&P), Ba3 (Moody's) and B (Fitch). QC's long-term debt grade at June 30, 2004 was BB- (S&P), Ba3 (Moody's) and

[1] See Exhibit 1: *Note 8: Subsequent Events*. Taken from QC's 10-Q filed on August 06, 2004.

BB (Fitch). Even though QC's long-term debt grade has improved since December 31, 2003, it is still regarded as speculative.

Q. **How does QC's long-term debt rating compare to the sample Telecos previously referred to in this testimony?**

A. Schedule AXR-4 shows S&P and Moody's bond grades for the sample Telecos. With the exception of Citizens Communications, the sample Telecos have an investment grade (At least BBB- in S&P and Baa3 in Moody's) rating.

Q. Is Staff concerned with QC's long-term debt grade?

A. Yes, it is. As shown in Schedule AXR-3, QC's long-term debt grade is still below the investment grade. In addition, QC's credit rating could be negatively affected by Qwest International Communications, Inc. financial position. The following is an excerpt found in QC's 10-Q for the period ending June 30, 2004, page 37:

> **"…**if cash provided by our and QCII's [Qwest Communications International, Inc] operations does not improve, if competitive pressures increase, if revenue and cash provided by operations continue to decline, if economic conditions weaken or if we [Qwest Corporation] or QCII become subject to significant judgments…"
>
> "We or QCII could be required to make significant payments that we do not have the resources to make."
>
> "…QCII's ability to meet its debt service obligations and its financial condition could be materially and adversely affected, potentially adversely affect its credit ratings, its ability to access the capital markets and its compliance with debt covenants."
>
> "*As a wholly owned subsidiary of QCII, our business operations and financial condition could also be affected, potentially impacting our credit ratings and access to capital markets* [emphasis added]."

Q. What is the implication of QC's lower debt rating compared to the sample Telecos?

A. A lower debt rating translates into higher debt costs for new issuances resulting in higher cost of service that may be passed on to ratepayers.

Q. What cost of debt does the Applicant propose?

A. The Applicant proposes 7.81 percent as the cost of debt (for practical purposes, capital leases are included in the long-term portion). Schedule AXR-5 summarizes QC's cost of debt.

Q. Does Staff agree with the cost of debt that QC proposes?

A. Yes, Staff agrees with QC's proposed cost of debt of 7.81 percent.

IV. RATE OF RETURN RECOMMENDATION

Q. What is Staff's overall rate of return recommendation for Qwest Corporation?

A. Based on the cost of equity recommendation of 14.6 percent presented by Staff witness Mr. Reiker, Staff recommends a ROR of 9.5 percent for the Applicant, as shown in Schedule AXR-1 and the following table:

Table 3

	Weight	**Cost**	**Weighted Cost**
Long-term Debt	75.2%	7.81%	5.87%
Common Equity	24.8%	14.6%	3.63%
Cost of Capital/ROR			**9.5%**

CONCLUSION

Q. Please summarize Staff's recommendations.

A. Staff recommends that the Commission adopt an overall rate of return of 9.5 percent. Staff's recommendation is based on a 75.2 percent debt and a 24.8 percent equity capital structure.

Q. Does this conclude your direct testimony?

A. Yes, it does.

NOTE 8: SUBSEQUENT EVENTS[2]

Note 8: Subsequent Events

During the second quarter of 2004, we declared cash dividends of $253 million and paid cash dividends of $910 million. We have historically declared and paid regular dividends to our parent, QSC, based on the earnings of our wireline operations. In July 2004, we modified our dividend practice to balance our financial needs, cash position and credit profile with those of our parent. As a result, going forward, we may declare and pay dividends in excess of our earnings. In addition, during July 2004, we declared dividends of $400 million.

[2] Taken from QC's 10-Q filed on August 06, 2004, page 24.

Qwest Corporation
Capital Structure
And Weighted Cost of Capital

Line No.	[A]	[B] Weight (%)	[C] Cost	[D] Weighted Cost
1	**Long-term Debt**	75.2%	7.81%	5.87%
2	**Common Equity**	24.8%	14.6%	3.63%
3				
4	**Weighted Average Cost of Capital/ROR**			9.5%
5				
6				
7				
8				
9				
10	Supporting Schedules: Schedule AXR-5			
	Staff Witness Mr. Reiker Direct			

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Schedule AXR-2

Capital Structure of Sample Telecos

Company	Debt Percentage[1]	Equity Percentage[1]
BellSouth	36.8%	63.2%
CenturyTel, Inc.	47.2%	52.8%
Citizens Communications	74.8%	25.2%
ALLTel	44.3%	55.7%
SBC Communications	29.6%	70.4%
Verizon	54.1%	45.9%
Average	47.8%	52.2%
Qwest Intl.	106.9%	-6.9%
Qwest Corporation	75.2%	24.8%

Sources: Applicant's Filing & Hoover's Online
[1] For the Year 2003

Qwest Corporation Long-term Debt Rating

Credit Agency	June 30, 2004	December 31, 2003
Standard & Poor's	BB-	B-
Moody's	Ba3	Ba3
Fitch Ratings	BB	B

Source: Qwest Corporation 10-Q filed for ending period June 30, 2004

Summary of Rating Agency Categories

	Credit Agency		
Standard & Poor's	**Moody's**	**Fitch Ratings**	**Description**
AAA	Aaa	AAA	Extremely strong capacity to meet financial commitments
AAA-	Aaa	AAA-	
AA+	Aa1	AA+	
AA	Aa2	AA	Very strong capacity to meet financial commitments
AA-	Aa3	AA-	
A+	A1	A+	
A	A2	A	Strong capacity to meet financial commitments
A-	A3	A-	
BBB+	Baa1	BBB+	
BBB	Baa2	BBB	Adequate capacity to meet financial commitments
BBB-	Baa3	BBB-	
BB+	Ba1	BB+	
BB	Ba2	BB	
BB-	Ba3	BB-	
B+	B1	B+	
B	B2	B	
B-	B3	B-	Speculative characteristics
CCC+	-	CCC+	
CCC	-	CCC	
CCC-	-	CCC-	
CC+	-	CC+	
CC	-	CC	
CC-	-	CC-	
D	-	D	Default has occurred

Bond Ratings for the Sample Telecos

Company	S&P	Moody's
BellSouth	A+	Aa3
CenturyTel, Inc.	BBB+	Baa2
Citizens Communications	BB+	Ba3
ALLTel	A	A2
SBC Communications	A+	Aa3
Verizon	A+	A1

Source: C.A. Turner Utility Reports, August 2004

Qwest Corporation Cost of Debt Allocated to Arizona

Description	Total Capital	------Interest------ Total	Cost of Debt
Short Term Borrowings	$0	$0	
Current Maturities - LT Debt	$142,865,764	$10,026,105	
Premium	$0	$0	
Discount	$83,927	$94,568	
Debt Iss.	$156,862	$176,583	
Net Funded Debt	$142,624,975	$10,297,256	7.22%
Current Maturities - Capital Leases	$1,576,704	$135,804	8.61%
Total ST Debt	$144,201,678	$10,433,060	7.24%
Funded Debt	$1,147,851,781	$84,497,330	
Premium on LT Debt	$109	$77	
Discount on LT Debt	$25,649,989	$464,554	
Debt Issuance Expenses	$27,201,468	$1,452,999	
Net Funded Debt	$1,095,000,433	$86,414,805	7.89%
Obligations Under Capital Leases	$1,190,246	$111,715	9.39%
Other Long Term Debt	$2,609,385	$170,132	6.52%
Total LT Debt	$1,098,800,065	$86,696,652	7.89%
Total ST + LT Debt	$1,243,001,744	$97,129,713	7.81%