

1 **Financial Analysis**

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3 **Q. You mentioned that Qwest and US West have requested approval pursuant to Article 8**
4 **of the Commission's Rules. What does this Article provide?**

5 A. This article applies to the organization or reorganization of public utility holding companies and
6 sets forth notice, filing and procedural requirements. Additionally, Article 8 provides a list of
7 some of the conditions under which the Commission may reject proposed holding company
8 organizations or reorganizations. [R14-2-803(C)]. Specifically, Rule R14-2-803(C) provides
9 that the Commission may reject the proposal if it would: 1) impair the financial status of the
10 utility; 2) otherwise prevent the utility from attracting capital at fair and reasonable terms; or, 3)
11 impair the utility's ability to provide service that is safe, reasonable and adequate.

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13 **Q. Have the companies addressed the provisions of Rule R14-2-803(C)?**

14 A. Qwest witness Paul Gallant briefly discusses portions of this rule. Mr. Gallant used pro forma
15 combined financials for the six months ending June 30, 1999 to compute two ratios. These
16 ratios, according to Mr. Gallant, show that the combined company will be in "a solid financial
17 position", and have "a strong ability to service [its] existing debt". [Gallant, p. 7].

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19 **Q. What are the two ratios computed by Mr. Gallant?**

20 A. First, Mr. Gallant calculated a "leverage" ratio by dividing long term debt and capital lease
21 obligations less cash and cash equivalents by earnings before interest, taxes, depreciation and
22 amortization (EBITDA). Based upon his June 30, 1999 financials, this ratio would be 1.45 for
23 the combined company. [Id.]. Mr. Gallant then calculated an interest coverage ratio by dividing
24 EBITDA by net interest expenses. Mr. Gallant states that this ratio would be 8.18 for the
25 combined company. However, Mr. Gallant used only 6 months of earnings. If he had used
26 annualized earnings, as he apparently intended, the ratio would have been 16.36.

1 **Q. Have you computed these 2 ratios for Qwest and US West individually?**

2 A. Yes. First, using the data presented in Mr. Gallant's Exhibit 1, I computed the same "leverage"
3 ratio for the two companies. These ratios are 1.31 and 1.48 for Qwest and US West,
4 respectively. Mr. Gallant's "leverage" ratio is somewhat unusual, in several ways, including its
5 treatment of cash. First, on June 30, 1999 Qwest held approximately \$1.4 billion in cash. This
6 helps increase its ratio, and thus the comparison indicates a slightly stronger financial position
7 for Qwest relative to US West. Second, using Mr. Gallant's interest coverage ratio formula, I
8 computed a ratio of 9.63 and 17.87 for Qwest and US West, respectively. This indicates that
9 both companies have ample funds available to cover interest expense, although US West is in
10 the stronger position.

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12 **Q. Are these the only ratios which can be used to compare the relative financial strength**
13 **of the two companies?**

14 A. No. There are a variety of different ratios available to measure different aspects of a company's
15 financial strength. In fact, there are several ratios which in my experience are more traditionally
16 relied upon than those cited by Mr. Gallant. For example, traditional leverage ratios include
17 "total debt" ratios, which focus on the total amount of debt relative to the total amount of assets,
18 "debt to equity" ratios, which compare total debt (or long term debt) to the amount of equity.
19 Similarly, there are other ratios which are traditionally used to evaluate a firm's ability to cover
20 its interest obligations.

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22 **Q. Did Mr. Gallant present any of the more traditional leverage ratios for the two**
23 **individual companies or the combined entity?**

24 A. No. The more traditional leverage ratios all include an equity component, and allow an analyst
25 to evaluate the size of a firm's debt relative to its equity. In contrast, Mr. Gallant only discussed
26 the relationship of long term debt less cash to earnings. US West's situation with booked equity

1 after the separation from MediaOne may have been a factor in Mr. Gallant's choice of leverage
2 ratios. On June 12, 1998 US West separated into US West, Inc. and MediaOne Group, Inc.
3 As part of this transaction, nearly all of US West's book equity was attributed to MediaOne for
4 accounting purposes. This accounting treatment left very little equity on the books of US West.
5 For example, as of June 30, 1999, US West had total equity of \$1.1 billion, compared to \$8.4
6 billion in long term debt. [Gallant, Exhibit 1, p. II-11]. However, this accounting treatment does
7 not mean that US West is highly leveraged. Its debt remains relatively modest in comparison
8 with the value of its assets and the market value of its equity.
9

10 **Q. Is the financial data for US West Communications, Inc. useful in this situation?**

11 A. To a degree. The vast majority of US West's business is conducted through US West
12 Communications, Inc. (USWCI) For example, in 1998, USWCI reported revenues of \$10.7
13 billion, compared to \$12.4 billion for US West as a whole during the same period. Accordingly,
14 one can look at financial data for USWCI, as submitted to the FCC to gain an alternative view
15 of US West. This data is not distorted by the effects of the recent separation from MediaOne to
16 the same degree as the parent company's books. However, the USWCI data has a problem of
17 its own; as a wholly owned subsidiary of US West, its retained earnings (and thus its book
18 equity) is controlled by the parent, and may not be representative of its underlying financial
19 strength. More specifically, it appears that USWCI has maintained a dividend policy in which it
20 routinely passes nearly all of its earnings up to the parent, which is then free to use the funds as
21 it sees fit. Provided the parent-subsidiary relationship is kept in mind, it can be helpful to
22 compute various USWCI ratios and compare them with the analogous ratios for Qwest. For
23 this purpose, I have relied upon data published by the FCC for 1998, which is the most recent
24 financial data for USWCI which was readily available.

25 Table 1 below presents three leverage ratios for USWCI, Qwest and the combined
26 companies. In each case, lower numbers indicate more financial strength than higher numbers.

1 As shown, all three measures indicate that USWCI is more leveraged than Qwest, because US
2 West has not allowed USWCI to retain its earnings. For example, in 1998, USWCI realized
3 income of \$1.1 billion, and declared dividends of \$1.3 billion. If more earnings were retained by
4 USWCI, then its total book equity would be greater, and the calculated leverage ratios would
5 be lower.

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7 **Table 1**

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Ratios	USWCI	Qwest	Combined
Total Debt	.64	.35	.47
Debt/Equity	1.75	.55	.90
Long Term Debt	.24	.23	.20

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15 **Q. Have you computed any other financial ratios for USWCI and Qwest?**

16 A. Yes. I computed two liquidity ratios which measure a firm's ability to meet short term
17 obligations. First I calculated a "current" ratio by dividing current assets by current liabilities.
18 Second, I computed a "cash" ratio by dividing cash by current liabilities. In each case, higher
19 numbers indicate more financial strength than lower numbers. The results of these calculations
20 for USWCI, Qwest and the combined Company are presented in the following table.

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22 **Table 2**

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Ratios	USWCI	Qwest	Combined
Current	.56	2.48	.54
Cash	.02	1.52	.17

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1 Both of these ratios are heavily influenced by the two firms' disparate policies with regard to
2 cash. Qwest currently maintains a very heavy cash position, amounting to more than 41% of its
3 revenues. USWCI follows essentially the opposite policy—it maintains very low cash balances,
4 amounting to less than 1% of its revenues. This contributes to the much stronger liquidity ratios
5 which Qwest enjoys compared to USWCI.

6 Finally, I computed several profitability ratios. First I computed profit margins by dividing
7 annualized net income by annualized revenue. Second I calculated the companies' return on
8 assets (ROA) by dividing annualized net income by total assets. Third, I computed the
9 companies' return on equity (ROE) by dividing annualized net income by total equity. These
10 results are presented in the following table. In each case, higher numbers indicate more financial
11 strength than lower numbers. As shown, USWCI's profit margin, return on assets, and return
12 on equity are all significantly greater than the same ratios for Qwest, because it is currently
13 generating much higher profits than Qwest.

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15 **Table 3**

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Ratios	USWCI	Qwest	Combined
Profit Margin	10.0%	2.6%	7.3%
ROA	10.1%	0.5%	2.2%
ROE	27.8%	0.7%	4.2%

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23 **Q. What conclusions have you drawn from this comparison of ratios?**

24 A. Both firms are financially strong USWCI is currently much more profitable than Qwest. It has
25 historically generated enormous profits, but the parent company has not allowed USWCI to
26 retain these profits. As a result, the leverage ratios indicate that USWCI is more highly

1 leveraged than Qwest. Leverage ratios are difficult to evaluate in this situation. US West's book
2 equity has been reduced by the accounting treatment which was applied at the time of the
3 MediaOne separation, while Qwest's book equity has been increased by goodwill it booked
4 when completing various acquisitions. Similarly, US West's corporate policy of distributing
5 earnings from USWCI to US West, rather than retaining them, has resulted in relatively low
6 levels of book equity and correspondingly high leverage levels.

7 Liquidity ratios indicate that Qwest has more cash and other short term assets available
8 to cover short term obligations, relative to USWCI. However, as I will discuss in more detail
9 later in my testimony, there is no guarantee that Qwest will use this cash to fund operations in
10 Arizona or elsewhere in US West's region. Rather, cash and other assets may be used to
11 further Qwest's operations in other parts of the country and the world.

12 Finally, the ratios presented in Table 3 indicate that USWCI is significantly more
13 profitable than Qwest. This is not surprising, given Qwest's limited operating history compared
14 to USWCI.

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16 **Q. Do you have any concerns regarding the combined company's financial status or its**
17 **ability to raise capital, as provided in Rule R14-2-803(C)?**

18 A. Yes. As demonstrated by these ratios, both companies are financially strong. However, US
19 West has been generating far more profits than Qwest. If the latter firm is not successful in
20 executing its business plan, or if competition in the long haul market continues to intensify, there
21 is no assurance that Qwest will ever be able to generate substantial profits. It has built a
22 modern, nationwide fiber network, but it is not unique in this regard. Unless Qwest is successful
23 in filling this network with profitable traffic, it will never generate profits which are
24 commensurate with the scale of its investment. In the meantime, the combined entity will have to
25 rely upon USWCI to generate nearly all of its profits, and the majority of its discretionary cash
26 flow. US West has used USWCI as a "cash cow." The profits generated by its dominant

1 market position have been distributed to the parent, and subsequently reinvested in whatever
2 ventures top management has felt hold the greatest long term potential. There is every reason to
3 believe that this policy will continue after the merger. The difference is that the emphasis may
4 shift even farther away from the 14 state region, because of Qwest's focus on nationwide
5 markets. It is reasonable to assume that the cash and profits generated by USWCI will tend to
6 flow where management believes they will be most beneficial to the merged entity's
7 stockholders. Stated differently, USWCI's role as a subservient cash cow will probably be
8 intensified, as the merged companies shift their concentration even more heavily towards growth
9 opportunities outside the 14 state region.

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11 **Q. Have the companies addressed the extent to which the merger might impair US West's**
12 **ability to provide "safe, reasonable and adequate service"?**

13 A. Not specifically. Throughout their testimony and other filings, the companies have discussed the
14 various public benefits that Qwest and US West believe will result from the proposed merger.
15 Their direct testimony concerning the financial implications of the merger is very limited, and it
16 fails to address head-on the extent to which management's focus may shift further away from
17 Arizona and the rest of the 14 state region, as well as the possibility that USWCI's role as a
18 cash cow may be intensified. There is clearly a risk that the merger might result in a weakening
19 of USWCI's ability to provide safe, reasonable and adequate service, however, the companies
20 direct testimony fails to really address this risk.