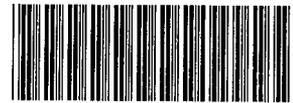


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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF QWEST  
CORPORATION'S FILING OF RENEWED  
PRICE REGULATION PLAN.

Docket No. T-01051B-03-0454

**RUCO's RESPONSE TO QWEST'S MOTION TO REVISE PRODUCTIVITY FACTOR**

Qwest's Motion to Revise Productivity Factor ("Motion") requests a modification of the productivity factor to be used in its upcoming price index adjustment from the current level of 4.2% to zero. Resetting the productivity factor to zero violates the requirement that fair value be determined when rates are set and is inconsistent with the Commission's intention in adopting the price cap plan in the first place and in its recent decision clarifying the plan. In addition, any change to a productivity factor should be based on industry-wide expectations of productivity, not the results of a single carrier. The Commission should deny Qwest's Motion.

**BACKGROUND**

In Decision No. 63487 (March 30, 2001), the Arizona Corporation Commission ("Commission") adopted, with modifications, a Settlement Agreement between Qwest Corporation ("Qwest") and the Commission's Utilities Division ("Staff"). The Settlement Agreement included the terms for a Price Cap Plan ("Plan") agreed to by the settling

1 parties. The Plan ultimately adopted by the Commission is to be for an initial period of  
2 three years. It divides Qwest's services into three baskets. Basket 1, the only basket  
3 affected by the Motion, is for Basic/Essential Non-Competitive Services, and includes an  
4 annual index mechanism that allows total revenue from the Basket 1 services to adjust  
5 downward to the extent the agreed-to productivity factor of 4.2% exceeds inflation. If  
6 inflation for a particular year exceeds the productivity factor, no adjustment would be made  
7 to the overall Basket 1 revenues, as the indexing mechanism is capped at zero.

8 In November 2003, Qwest filed a Motion to Clarify, or In the Alternative, to  
9 Terminate the Price Cap Plan ("Motion to Clarify"). In the Motion to Clarify, Qwest  
10 requested that the Commission clarify, among other things, that no further index  
11 adjustments to Basket 1 revenues were required after March 31, 2004. The Commission  
12 denied Qwest's requested clarification, and on February 10, 2004 issued Decision No.  
13 66772, indicating that an additional price index adjustment is required on April 1, 2004.

14 Qwest's current Motion requests that the productivity factor that is part of the annual  
15 index mechanism be reset from its current level of 4.2%. Though Qwest attaches an  
16 affidavit suggesting that the productivity factor would be -1.2% if calculated in the same  
17 manner as the original productivity factor, it only requests that the productivity factor be set  
18 at zero. Motion at 2. Qwest's Motion should be denied for a number of reasons.

19 **CHANGING THE PRODUCTIVITY FACTOR REQUIRES A FAIR VALUE FINDING**

20 The Commission should not grant Qwest's Motion because the productivity factor  
21 can only be changed along with a finding of fair value.

22 Generally, the Commission is required to make a finding of fair value when it  
23 changes a utility's rates. *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 294  
24 P.2d 378 (1956); *US West Comm. v. Ariz. Corp. Comm'n*, 201 Ariz. 242, 34 P.3d 351

1 (2001); *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 578 P.2d 612 (App. 1978). There are  
2 two exceptions where rate changes are permitted without a concurrent fair value finding:  
3 emergency interim rates, and rate changes that result from the operation of an automatic  
4 adjustor mechanism that was adopted based on a fair value finding. *Scates*; *RUCO v.*  
5 *Ariz. Corp. Comm'n*, 199 Ariz. 588, 20 P.3d 1169 (App. 2001).

6 The price cap index mechanism, of which the productivity factor is one component,  
7 is essentially an automatic adjustor mechanism. While prices are permitted to change as a  
8 result of the implementation of the index mechanism, a change to the composition of the  
9 mechanism itself amounts to the creation of a new adjustor mechanism. A new adjustor  
10 mechanism cannot be implemented without a concurrent finding of the fair value of  
11 Qwest's property. See *RUCO*, 199 Ariz. 588 at 593 ¶ 12, 20 P.3d 1169 at 1174.

12 After the Commission fully considers the matters to be addressed in this docket, the  
13 Commission may determine that a new productivity factor, or other modifications to the  
14 price cap index mechanism, is appropriate. However, the Commission cannot change the  
15 productivity factor, either up or down, to zero or any other number, based merely on a  
16 motion without making a finding of fair value at the same time. Qwest's request to change  
17 the productivity factor is premature and should not be granted apart from a finding of fair  
18 value.

19 **A DECREASE IN THE PRODUCTIVITY FACTOR IS INCONSISTENT WITH THE**  
20 **COMMISSION'S INTENTION IN ADOPTING THE PRICE CAP PLAN**

21 The Commission should deny the Motion because it is inconsistent with the  
22 intention of the Commission in adopting the Price Cap Plan in the first instance.

23 First, the intention in adopting the Plan was that Qwest would improve its efficiency.  
24 Staff and the Company cited improved efficiency as one of the major advantages of the

1 Plan. Decision No. 63487 at 4 and at Exh. A pg. 1. Further, despite arguments that the  
2 productivity factor in the Plan was too low, the Commission concluded that a productivity  
3 factor in excess of 4.2% was not necessary for the initial term of the Plan, but that the Plan  
4 could be modified after its initial term to reflect any increased productivity resulting from  
5 Qwest's merger with U S West. *Id.* at 10-11. In light of the Commission's expectation that  
6 productivity could likely increase, it should not decrease the existing productivity factor  
7 based merely on Qwest's Motion and affidavit, without undertaking a full analysis of the  
8 matter. Further, in light of the goal to create an incentive for efficiency, the Commission  
9 should not reward Qwest's alleged decrease in productivity over the past three years,  
10 especially without undertaking a full analysis of the Plan's results.

11 Second, when it adopted the Plan the Commission intended that all the terms of the  
12 Plan would continue until such time as the Commission analyzed the results of the Plan  
13 and made any necessary modifications or terminated the Plan. The Plan requires that,  
14 nine months before end of its initial three-year term, Qwest file certain information to permit  
15 the Commission to review the Plan. The Plan as originally proposed by Staff and Qwest  
16 provided that the Plan would continue in effect, even beyond its initial three-year term, until  
17 such time as the Commission acted to renew, modify or terminate the Plan. See Decision  
18 No. 63487, Exh. A at 6. In light of evidence put forward at the hearing, the proponents of  
19 the Plan subsequently updated the language regarding the continuation of the Plan during  
20 any gap period between the end of the three years and the Commission's action to renew,  
21 modify or terminate the Plan. *Id.* The Plan also included language that the terms of any  
22 renewal would first be the subject of negotiations between affected parties, and if those  
23 were unsuccessful, could be subjected to a hearing. Decision No. 63487, Attachment A to  
24 Exh. A, at 6. The Commission has held several procedural conferences recently, and is

1 expected to issue a Procedural Order soon scheduling a hearing to consider the renewal,  
2 modification or termination of the Plan.

3       Clearly the Commission intended that it would act to renew, modify or terminate the  
4 Plan only after the affected parties had analyzed the information Qwest was required to file  
5 prior to the Plan's expiration, and that if those parties were not able to reach agreement on  
6 a renewal plan, a hearing would be held. Modifying the Plan's productivity factor at this  
7 time, prior to the analysis of the information Qwest was required to file (and which in fact it  
8 filed in its final form only in January 2004), and prior to either agreement between affected  
9 parties or a hearing, is premature and inconsistent with the Commission's earlier  
10 intentions.

11 **THE REQUEST IS INCONSISTENT WITH THIS COMMISSION'S RECENT ACTION**  
12 **CLARIFYING THE PRICE CAP PLAN**

13       Barely one month ago, the Commission issued Decision No. 66772, in which it  
14 denied Qwest's Motion to Clarify that it was not required to implement the annual price  
15 index adjustment on April 1, 2004. Granting Qwest's current Motion would undermine the  
16 effect of that Decision.

17       The Price Index Adjustment provides that the overall revenues from Basket 1  
18 services are adjusted downward by the percentage that the productivity factor (currently  
19 4.2%) exceeds inflation. If inflation is 4.2% or greater, there is no change to the Basket 1  
20 revenues. Qwest's current Motion asks that the Productivity Factor be reset to zero. The  
21 result of such a change would be that Basket 1 revenues would be decreased only to the  
22 extent that the percentage of the new productivity factor (zero) exceeds inflation. Thus,  
23 unless there were deflation, Basket 1 revenues would not change.

1 Inflation from 2002 to 2003, as measured by the method required in the Plan, was  
2 1.68%.<sup>1</sup> Therefore, granting Qwest's Motion would result in no adjustment to Basket 1  
3 revenues on April 1, 2004. Such a result is inconsistent with the Commission's  
4 requirement that "the annual Price Index adjustment for the third year of the Plan from  
5 April, 2003 to April 2004, is required to be made on April 1, 2004." Decision No. 66772 at  
6 5-6.

7 **PRODUCTIVITY FACTOR SHOULD BE BASED ON INDUSTRY-WIDE PRODUCTIVITY**  
8 **EXPECTATIONS, NOT A SINGLE COMPANY'S PAST RESULTS**

9 The purpose of a productivity offset in a price cap plan is to pass a carrier's  
10 reasonably anticipated increase in productivity on to consumers through rates. Decision  
11 No. 63487 at 9-10. Qwest's purported productivity improvements of -1.2% from 1999 to  
12 2002 is an inappropriate basis for setting a forward-looking productivity factor.

13 While productivity in the telephone industry fluctuates from year to year, it does not  
14 generally fluctuate in a range above and below zero, nor does it average out to zero. To  
15 the contrary, the actual level of industry-wide productivity normally averages well above  
16 zero. On an industry-wide basis (e.g. measured on a composite basis, including data from  
17 multiple states and carriers), productivity tends to be relatively stable, particularly when  
18 productivity patterns are observed on a multi-year basis. The Commission should deny  
19 Qwest's Motion that is based on data that is allegedly contrary to this pattern (e.g. its claim  
20 that productivity has been negative). Qwest's data fails to analyze a reasonable cross-

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22  
23 <sup>1</sup> The Plan provides that the measure of inflation used in the Price Cap Index mechanism will be the  
24 annual percentage change in the Gross Domestic Product Price Index ("GDP-PI"), using a seasonally-  
adjusted, changed price index, as calculated by the Department of Commerce. Decision No. 63487,  
Attachment A to Exhibit A at §2)b)iii). For the 3<sup>rd</sup> Quarter 2003 (the most recent period available), the GDP-  
PI was 105.870, and for the same quarter 2002 it was 104.123, for an annual change of 1.68%.

1 section of data that is representative of normal productivity patterns (e.g. data from  
2 multiple telephone carriers and jurisdictions).

3       Unfortunately, when carrier-specific productivity data is observed in isolation, it can  
4 offer a highly misleading impression—one that is not relevant to the operation of an  
5 appropriate price cap mechanism. Such isolated data can be significantly distorted by  
6 accounting changes, unusual circumstances, non-recurring events, and other factors that  
7 are not representative of future conditions, and that are not appropriate for use in a price  
8 cap regulatory system. While data from individual states and carriers will often be  
9 distorted, the underlying phenomena (e.g. non-recurring events) tend to be insignificant, or  
10 to cancel out, when the data is measured on an industry-wide basis (e.g. using nationwide  
11 composite RBOC data).

12       Furthermore, when productivity is measured on a state-specific, carrier-specific  
13 basis, it can be strongly affected by tactical decisions by management, and other  
14 temporary variables that should not be allowed to influence the calculation of an  
15 appropriate inflation offset for regulatory purposes.

16       For this reason, among others, the data put forward by Qwest in its Motion should  
17 not be relied upon for regulatory purposes. It would be highly inappropriate for the  
18 Commission to consider adopting changes to the price cap plan (e.g. elimination of the  
19 productivity offset) in response to allegations that rest upon such an inherently unreliable  
20 type of data.

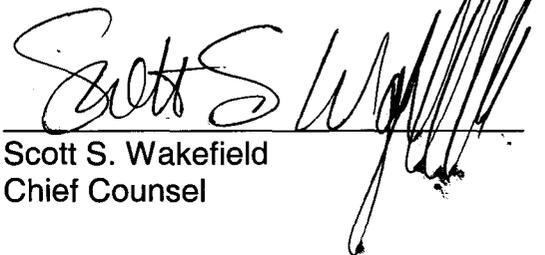
21       Finally, in setting a productivity factor, the Commission should rely upon industry-  
22 wide cost data rather than carrier-specific data because, by focusing on industry-wide  
23 data, the Commission can avoid re-establishing a link between each carrier's costs and  
24 prices. This avoids directly or indirectly diminishing the incentives for management to

1 minimize costs, increase productivity and operate as efficiently as possible. When carrier  
2 specific data is used, particularly in a regulatory proceeding like this, it reduces the  
3 incentive for management to minimize costs and maximize productivity improvements. In  
4 fact, if Qwest were to be allowed to avoid a further reduction in Basket 1 revenues in  
5 response to recent poor productivity data, it would effectively be rewarded for failing to  
6 keep pace with industry-wide productivity improvements.

7 **CONCLUSION**

8 For the numerous reasons set forth above, the Commission should deny Qwest's  
9 Motion. If, as a result of the pending proceeding, the Commission concludes that  
10 continuation of price cap regulation is appropriate, it can determine whether a change to  
11 the productivity factor is appropriate.

12 RESPECTFULLY SUBMITTED this 15<sup>th</sup> day of March, 2004.

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14 \_\_\_\_\_  
15 Scott S. Wakefield  
16 Chief Counsel

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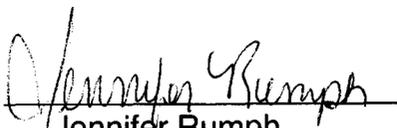
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