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BEFORE THE ARIZONA CORPORATION COMMISSION

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Arizona Corporation Commission

**DOCKETED**

MAR 17 2004

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IN THE MATTER OF QWEST )  
 CORPORATION'S FILING OF 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

AT&T'S RESPONSE TO )  
 QWEST'S MOTION TO REVISE )  
 PRODUCTIVITY FACTOR )

AT&T Communications of the Mountain States, Inc. and TCG Phoenix (collectively, "AT&T") hereby file their response to Qwest's Motion to Revise Productivity Factor.

**I. INTRODUCTION**

AT&T opposes Qwest's Motion to Revise Productivity Factor. Qwest Corporation's ("Qwest") Motion is premature and seeks by motion to change an integral part of the Price Cap Plan. Qwest's claim that no one has challenged its current productivity calculations that were provided to Staff in July 2003 is disingenuous. The calculations were filed as part of its Application pursuant to the terms of the Settlement Agreement and not as a part of Qwest's direct case. No one has challenged Qwest's

current productivity calculations on the record because no party has been procedurally obligated to respond to the calculations. AT&T wishes to make it very clear that it has serious problems with Qwest's calculations and will challenge the calculations and the productivity factor when AT&T files its testimony.

## **II. ARGUMENTS**

It is not appropriate to revise an integral part of the Price Cap Plan by the use of a motion and supporting affidavit. The productivity factor is an integral part of the Plan and should be addressed by Qwest in its direct case. Parties will have an opportunity to serve discovery on Qwest and subsequently file rebuttal testimony. After hearings the Commission will be in a position to adopt a productivity factor based on a complete record.

Qwest's Motion is accompanied by an "Arizona Productivity Analysis" that purports to calculate the rate of total factor productivity ("TFP") growth experienced by Qwest with respect to its Arizona intrastate services over the four-year period from 1999 through 2002. The "analysis" is presented as Attachment B to the Affidavit of Phillip E. Grate. No underlying workpapers or data sources were included with Mr. Grate's affidavit; as such, AT&T has only been able to make a preliminary assessment of the productivity results being claimed by Qwest. However, on the basis of that preliminary assessment, it is abundantly clear that Qwest's showing is woefully insufficient as a basis for Commission approval.

Qwest's current price cap plan was adopted by the Commission in March 2001 by Decision No. 63487 based on a settlement agreement entered into by Qwest and Staff. In that settlement, a productivity offset or "X factor" of 4.2% was adopted, consisting of the

3.7% average productivity growth rate that Qwest claimed to have experienced over the 1995-98 period, plus a “consumer dividend” of 0.5%. In the new 1999-2002 TFP study now being offered by Mr. Grate, Qwest’s Arizona intrastate productivity growth rate for 1999-2002 is put at a *negative* 1.2%. Based thereon, Qwest is seeking a revised X-factor of 0.0%.

On its face, a decrease of this magnitude in Qwest’s productivity growth rate – from a *positive* 3.7% just three years ago to a *negative* 1.2% today – should be a cause for serious concern by the Commission, particularly inasmuch as neither Mr. Grate nor Qwest have provided any explanation or justification for this precipitous drop in the Company’s productivity growth rate. Indeed, there is no *a priori* reason to expect such extreme volatility, except to the extent that some extraordinary event may have occurred that would have produced such a result. The only such “event” that occurred during the time frame embraced by this latest study is the June 2000 merger of U S WEST into Qwest. According to Mr. Grate’s Attachment B, Qwest-Arizona’s Total (intrastate) Expenses increased by an astounding 12.5% from 1999 to 2000, while its Arizona intrastate revenues grew by only 5.3% over that same year-to-year period. The result was a year-over-year productivity growth of *negative* 7.2% for 2000. Confirming the obviously anomalous nature of the 2000 results, Mr. Grate’s “analysis” also indicates that the Company had experienced a *decrease* in Total (intrastate) Expenses of 3.6% for 2001 vs. 2000, resulting in a year-over-year productivity growth rate for 2001 of *positive* 3.3%. Expenses decreased further (by 2.6%) between 2001 and 2002, but Mr. Grate reports a revenue drop of 8.4% for the same year-over-year period, resulting in productivity growth of *negative* 5.8% for 2002.

Mr. Grate provides no explanation for any of these relationships, relying solely upon an entirely *mechanical* spreadsheet calculation of “productivity” changes. Qwest’s Arizona intrastate operating revenues consistently *grew* from 1998 to 2001, declining for the first time in 2002. Expenses, however, show extreme volatility during the study period. The considerable one-time growth in expenses for 2000 makes it likely that the 2000 expense figures (and possibly the 2001 expenses as well) include significant merger-related or merger-driven costs (*e.g.*, one-time costs arising from coordinating various U S WEST and Qwest systems, personnel actions, severance packages, redundant personnel and resources, etc.) that must be excluded from any price cap productivity factor. Inclusion of these expenses without any adjustment results in a *negative* 7.2% productivity growth, which serves to depress the “average productivity 1999-2002” as calculated by Mr. Grate. Had Mr. Grate not included this outlier, the average productivity figure would be positive.

In connection with its forthcoming price cap review proceeding, on January 21, 2003, Qwest provided the Commission’s Staff and some of the parties with its proposed submission pursuant to Arizona Rule R14-2-103. That document indicated Qwest’s intention to make certain adjustments to its cost, revenue and investment data that would, among other things, “remove any U S WEST merger costs (per Decision No. 58972); make an interest synchronization adjustment (per Decision No. 58972); remove any above-the-line cost of the Qwest merger (per conditions 12 and 13 in Decision No. 62672); and include \$72 million of directory imputation (per Decision No. 66230).” Each and all of these (and possibly other) adjustments are just as appropriate for a productivity analysis as they would be for a R14-2-103 filing. However, there is no

indication in Mr. Grate's affidavit or any attachments thereto that any of these (or other) adjustments have in fact been made.

Comparing Mr. Grate's figures with Qwest Arizona intrastate results as reported in ARMIS provides additional support for the conclusion that Qwest's costs and revenue data contain inappropriate expenses that artificially decrease Qwest Arizona's recognized productivity. Although the figures in ARMIS do not exactly match those figures presented in Mr. Grate's Attachments, the aggregate total revenue and total expense figures are of similar magnitude. Using the ARMIS figures (adjusted for Arizona rate increases and decreases), the result is an even more negative productivity growth than that calculated by Mr. Grate – a stunning *negative* 10.33% productivity for the year 2000. In light of the *positive* 2% productivity recognized just one year earlier, such extreme negative productivity is not a “normal” condition, and considering that it appears to have coincided with the Qwest/U S WEST merger makes it highly suspect, to say the least. Indeed, in 2000, Qwest reports an extremely large growth in expenses, much of which is due to almost a 30% year-over-year growth in plant-specific operations expenses and corporate operations expenses. By 2002, both of these accounts reported expenses that actually declined *below* their 1999 levels. Such a drastic, one time increase in expenses suggests strongly that the year 2000 anomalous data, perhaps with carryover effects in 2001 data, requires the Commission's careful scrutiny.

According to Mr. Grate's Attachment B, Qwest also experienced a precipitous drop (8.4%) in its above-the-line Arizona intrastate revenues between 2001 and 2002. It is possible that the *apparent* drop in above-the-line revenues may be explained by customer migration to and use of *other* Qwest services that are recorded below-the-line.

For example, in the 2001 settlement, local Directory Assistance service was eliminated and was merged with Qwest's long distance DA service. The effect of this may have been to shift what had previously been booked as *intrastate* DA revenue out of the intrastate jurisdiction and into the *interstate nonregulated* category, or simply below-the-line. Similarly, customers subscribing to Qwest ADSL service may have discontinued their second residential access line (which they had been using for dial-up Internet access). This would have caused intrastate above-the-line revenues to decrease, offset by a corresponding increase in nonregulated ADSL revenues. Since all such services continued to be provided by Qwest on a fully integrated basis, it is entirely improper to exclude them from a total factor productivity (TFP) analysis that compares changes in total inputs with changes in total outputs.<sup>1</sup>

Looking to the future, it will become even more critical for TFP (and for traditional revenue requirement) calculations to be made comprehensively across the entirety of Qwest's ILEC and affiliate operations, and not be limited solely to above-the-line services. In December 2003, Qwest received authority pursuant to 47 U.S.C. § 271 to provide interLATA services. Although nominally furnished by a separate affiliate (per 47 U.S.C. § 272(a)), Qwest is permitted to provide Qwest's long distance affiliates with an extensive array of marketing, customer care, billing and collection, and various other

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<sup>1</sup> It is equally improper to exclude these revenues and their associated costs from the calculation of Qwest's revenue requirement as determined under traditional rate of return regulation principles. Any and all services that Qwest provides on an integrated (or substantially integrated) basis using its common network infrastructure and common base of corporate assets (which would include, in addition to network assets, such other functions as sales and marketing, customer care, billing and collection, and operations support systems, among other things) should be included within a rate of return analysis, because to do otherwise (e.g., to exclude "nonregulated" services' revenues and costs) would require highly detailed and potentially highly contentious cost allocations, which themselves are likely to involve fundamentally arbitrary (and hence highly debatable) assignments of common plant and associated expenses as between regulated basic telephone service and other lines of business, such as ADSL, voice mail, inside wire maintenance, directory assistance, directory advertising, and any other service that is nominally booked "below-the-line" but which is nonetheless dependent upon "above-the-line" resources.

administrative services and corporate support functions on a fully integrated basis. Moreover, in a decision announced on March 11, 2004, in WC Docket No. 03-228, the FCC will now permit Qwest and the long distance affiliates to integrate their Operations Installation and Maintenance (OI&M) activities, which will likely mean that these functions will be provided by Qwest to the affiliates. Confining a TFP study (or a traditional revenue requirement analysis) only to “above-the-line” Qwest activities would require, at a minimum, extremely detailed cost allocation to separate those costs incurred for the benefit of Qwest regulated activities from those applicable to nonregulated lines of business.

In that regard, Mr. Grate’s TFP study is limited to Qwest’s *intrastate* operations, thus excluding both jurisdictionally interstate revenues and costs. This is particularly remarkable, inasmuch as Qwest’s predecessor, U S WEST, had specifically represented to the FCC that such jurisdictional separation was not practical in a TFP analysis. In its Reply Comments in the FCC’s *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, Reply Comments of U S WEST Communications, Inc., filed March 1, 1996, at 28-29, U S WEST stated:

AT&T and Ad Hoc [Telecommunications Users Committee] contend that the Commission is required to select a TFP based solely on interstate inputs. This position is neither technically feasible nor legally mandated by prior precedent. In the *Fourth FNPRM* the Commission determined that interstate and intrastate services are provided largely over common facilities. It further determined that there was no evidence that such facilities could be divided and measured in an economically meaningful manner. The Commission tentatively concluded that TFP should be calculated on a total company basis. Since none of the initial comments to this proceeding presents an approach which would contradict the Commission’s earlier findings, the Commission should affirm its tentative conclusion.

As discussed in the Christensen response attached to USTA’s Reply Comments in this proceeding, no party has presented a meaningful method

for calculating an interstate-only TFP. The proposals presented by AT&T and Ad Hoc suffer from similar infirmities. Both methods attempt to calculate the input growth of interstate services by assuming that inputs grow at the same rate for interstate access service as they do for other regulated telephone services provided by the LECs. As has been previously demonstrated by Christensen, there is no economically meaningful way to partition LEC inputs into separate intrastate and interstate categories. This is true because both services share joint and common inputs. To attempt to calculate productivity for interstate service based on an insupportable assumption necessarily produces results which are arbitrary and capricious.

The AT&T and Ad Hoc submissions in the FCC price cap proceeding demonstrated that TFP calculations based upon interstate-only inputs (costs) and outputs (revenues) produced significantly greater productivity growth estimates than when calculated on an unseparated total company basis.<sup>2</sup> The FCC, however, accepted the arguments presented by U S WEST, USTA and the other RBOCs, and based the interstate X factor (which it had set at 6.5%) upon unseparated, total company (*i.e.*, interstate plus intrastate) TFP.

The practical effect of the FCC's actions is to require that the Arizona Corporation Commission adopt a corresponding total company TFP for intrastate price cap rate adjustment purposes. To do otherwise would provide Qwest with an unjustified windfall, in that it would be using company-wide average TFP to set the X factor in the interstate jurisdiction, while being permitted to utilize the *below-average* intrastate-only TFP result for intrastate price cap purposes. The fact that the current price cap X factor appears to have been based upon intrastate-only TFP should not be dispositive of any revised X factor, since the current plan resulted from a settlement rather than from an adjudicated proceeding.

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<sup>2</sup> *In the Matter of Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, Comments of AT&T, January 11, 1996, at 13-18; Comments of Ad Hoc Telecommunications Users Committee, January 11, 1996, at 6.

Finally, the Commission should take particular note that Mr. Grate's analysis is not limited solely to those regulated Basket 1 services that continue to be subject to X-factor-based annual rate adjustments, but includes services that have been reclassified as competitive and whose prices would not be subject to X factor-based rate adjustments because these services have been effectively deregulated. Much of Qwest's capital spending is directed at services (such as broadband) that are not included within Basket 1 and hence fall outside of the application of the X-factor. It is both entirely possible and, indeed, highly likely that the *apparent* drop in Qwest's overall productivity growth is due to up-front investments and other expenditures incurred for the purpose of supporting services not subject to price regulation, and that if one were to confine the TFP calculation to only Basket 1 services, the results would be dramatically different. If non-Basket 1 services are dragging down Qwest's TFP, their inclusion in Mr. Grate's productivity analysis operates to force Basket 1 regulated services to cross-subsidize these other nonregulated competitive services.<sup>3</sup>

### **III. CONCLUSION**

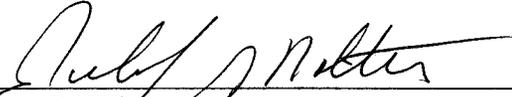
In conclusion, it is clear that a substantial amount of additional analysis will be required before the Commission will have a sufficient basis to consider Qwest's Motion. The issues AT&T raises can be addressed in the forthcoming price cap review proceeding, and any immediate action to grant Qwest's Motion before the record can be fully developed would be premature and potentially unlawful. Qwest's Motion should be denied.

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<sup>3</sup> These issues are also germane to a traditional revenue requirement analysis, in that investments and other costs that had been driven by deregulated services, if not properly excluded from the costs applicable to regulated intrastate services, would result in an apparent revenue shortfall that may well be entirely illusory.

Submitted this 16<sup>th</sup> day of March, 2004.

**AT&T COMMUNICATIONS OF THE  
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**CERTIFICATE OF SERVICE**

(Docket No. T-01051B-03-0454, T-00000D-00-0672)

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