ORIGINAL 32

BEFORE THE ARIZONA CORPORATION COMMISSION

CARL J. KUNASEK
CHAIRMAN
JAMES M. IRVIN
COMMISSIONER
WILLIAM A. MUNDELL
COMMISSIONER

IN THE MATTER OF THE APPLICATION OF U S WEST COMMUNICATIONS, INC. A COLORADO CORPORATION, FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY, THE FAIR VALUE OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN.

DOCKET NO. T-01051B-99-0105

STAFF'S NOTICE OF FILING

Staff of the Arizona Corporation hereby files the summaries of Michael L. Brosch, William Dunkel and Harry M. Shooshan III, ACC Consultants, in the above-referenced matter.

RESPECTFULLY SUBMITTED this 29th day of November, 2000.

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SUMMARY OF DIRECT AND REBUTTAL TESTIMONY
MICHAEL L. BROSCH ON BEHALF OF
ARIZONA CORPORATION COMMISSION STAFF

SETTLEMENT AGREEMENT ISSUES
U S WEST COMMUNICATIONS DOCKET NO. T-01051B-99-0105

My direct and rebuttal testimony is supportive of the Settlement Agreement that would resolve revenue requirement issues in the pending rate case. In Supplemental Testimony, I explain the process through which I provided advice and assistance to Staff in negotiation of the Settlement Agreement and why the resulting $42.9 million revenue increase to be granted the Company is reasonable and consistent with the public interest. The Settlement Agreement was not negotiated on an issue-by-issue basis, but was based upon judgments associated with the litigation risk of presenting and arguing the many issues set forth in Staff's and other parties' prefiled evidence. Thus, the Settlement Agreement should not be viewed as an agreement regarding any ratemaking theories or positions that are at issue, but rather as a compromise of all of the issues between Staff and the Company.

The maximum revenue increase that can be implemented by the Company under the Settlement Agreement is $42.9 million. However, only $17.6 million is to be implemented as an immediate revenue increase, with the other $25.3 million authorized for increases in a basket of competitive services under the Price Cap Plan. To arrive at the $42.9 million revenue requirement, the Settlement Agreement employs Staff's recommended rate base and rate of return. Thus, no compromise of any of Staff's rate base or rate of return positions is implied by the settlement. In Supplemental Testimony, I identify four specific operating income adjustments proposed by Staff and opposed by the Company that involved considerable litigation risk because of the nature of the issues and the absence of supporting ACC precedent. A compromise of only these adjustments indicates the reasonableness of the settlement revenue requirement, particularly since the many other Staff adjustments and positions are resolved favorably for Staff in the Settlement Agreement.

My Rebuttal Testimony responds to allegations of RUCO witness Mr. Smith and AT&T witness Ms. Gately that the settlement process was arbitrary and that the positive $42.9 revenue requirement included in the Settlement Agreement is excessive. There is nothing arbitrary about a vigorously negotiated compromise of the revenue requirement that is not burdened with detailed issue-by-issue findings in favor of specific parties on each of the dozens of adjustments proposed in this proceeding. In fact, any attempt to reach a settlement by specific resolution of each proposed adjustment would likely have required detailed concessions that the parties would have been unwilling to make. Additionally, such an approach virtually guarantees full litigation of each of the various issues so that any non-signatories could contest the various concessions made or not made in such a settlement.

RUCO's witness, Mr. Smith, is critical of the Settlement Agreement because of his view that RUCO's adjustments were not factored into the settlement negotiations. My Rebuttal testimony explains that several of RUCO's adjustments correspond directly to similar positions taken by Staff that actually were implicitly considered and compromised because of the litigation risks associated with the issues. Two of RUCO's adjustments to reverse the Company's toll revenue loss annualization and to credit estimated gains on exchange sales to customers differ from Staff's positions and are inappropriate. In addition, Staff was careful to post adjustments that were required to reflect known corrections to the Company's prefiled case, even if making such adjustments increased the revenue requirement. The RUCO filing does not reflect any of these corrections. The revenue requirement advocated by RUCO should be increased by at least$12.2 million to recognize the combined effect of these needed correction adjustments that were not made by RUCO. These omissions in RUCO's filing, along with the Toll Loss and Gain on Sale items mentioned above and RUCO's lower return on equity recommendation, explain most of the difference between Staff's and RUCO's recommended revenue requirements.

AT&T's witness, Ms. Gately, claims that the Settlement Agreement revenue requirement "can only be described as arbitrary and began from an unreasonably inflated revenue requirement base". She then characterizes the $42.9 million amount as a "split the baby" treatment that must be "accorded to the proposed adjustments of other interested parties as well". My Rebuttal explains that this characterization is inaccurate since the Settlement Agreement did not begin with the Company's asserted revenue requirement, but instead used Staff's rate base and rate of return outright. The settlement also used Staff's adjusted operating income rather than the Company's, with upward adjustment to recognize that Staff would likely not prevail on every one of its many adjustments. More importantly, it does not follow from her mischaracterization that every unsubstantiated adjustment proposed by every non-signatory party must now be used to reduce the revenue requirement in a 50/50 factoring process. This is particularly true for the seven inappropriate adjustments listed in Ms. Gately's testimony, which are not "corrections" at all, but are instead improper disallowances and imputation adjustments that are based upon incorrect assumptions, misunderstandings of Staff's case, improper ratemaking policies and are inconsistent with prior ACC Decisions. My rebuttal testimony addresses each of the seven issues listed by Ms. Gately and why they should not now be used to further reduce the negotiated settlement revenue requirement.

EXECUTIVE SUMMARY OF THE TESTIMONIES OF WILLIAM DUNKEL PERTAINING TO SETTLEMENT AGREEMENT

The primary purpose of my Supplemental testimonies is to explain the rate design portions of the Settlement Agreement between Staff and Qwest. I have not addressed issues regarding revenue requirement or the general structure of the Plan under the Settlement Agreement. Issues regarding revenue requirement and the general structure of the Plan are addressed in the testimonies of Staff witnesses Brosch and Shooshan, respectively. Although I did not directly participate in the actual negotiations between Staff and Qwest, I did provide assistance and advice to Staff during such negotiations. The Settlement Agreement is a compromise of issues between Staff and Qwest.

DIRECT TESTIMONY REGARDING SETTLEMENT AGREEMENT

Under the Settlement Agreement, the residential and business basic exchange service rates have a "hard cap", such that the prices for those services cannot increase during the term of this plan. The services that are hard capped include flat rate residential; flat rate business; 2 and 4 party service; exchange zone increment charges; low use option service; service stations service; telephone assistance programs; individual PBX trunks, including features; Caller ID block; toll blocking; 900/967 blocking; and basic listing service. Under the Settlement Agreement, the non-recurring residential charge would be reduced from its current rate of $46.50 to $35. In addition, the Settlement Agreement includes an elimination of the residential and business zone connection charges; an expansion of the base rate in certain areas; and the elimination of multi-party services.

The Company will be allowed to immediately increase the current DA rate of 47 cents to 85 cents. The one-call allowance that currently exists would be eliminated. At the 85 cent rate, customers will also receive "call completion" service at no additional charge. After the first year, the Company could increase that rate further, subject to the overall price cap restraints that apply to Basket 3.

The switched access charges applicable to the carriers would be changed so as to reduce revenues by $5 million in the first year, an additional $5 million in the second year, and an additional $5 million in the third year. In total, over the life of the plan, the switched access rates would be reduced by $15 million per year.

Evidence in this case indicates that private line service rates are below cost. The Settlement Agreement includes a $13.7 million annual increase in private line revenues.

Recognizing that this is a compromise, I believe the proposed rate changes included in the Settlement Agreement are a reasonable compromise. The reduction of the non-recurring charges, the expansion of the base rate areas, and the "hard cap" on basic exchange and related rates, are beneficial to universal service. In addition, the Settlement Agreement includes an "inflation minus productivity" indexing mechanism, which has the effect of sharing the industry wide productivity gains with the ratepayers, and may result in a further reduction of rates in Basket 1.

Basket 3 services include flexibly priced, competitive services. These include services that the Commission has determined to be competitive under ACCR14-2-1108, as well as new services and service packages offered by Qwest. Services that are in the non-competitive Basket 1 can be components of a "new" package that would be offered in Basket 3. In an attempt to limit the use of this mechanism to transfer non-competitive Basket 1 services into Basket 3, the Agreement does require Qwest to inform customers that the services in Basket 1 remain available as separate offerings.

Part 2(c)(v) of the Plan requires that all services in Basket 1 shall be continued statewide at the tariffed rate, unless or until the Commission orders retail geographic rate deaveraging, or unless Qwest demonstrates a cost difference for the new service on which to base the price difference. This requirement is intended to prevent Qwest from cutting the price for a Basket 1 non-competitive service in one area in order to disadvantage competitors or potential competitors in that area without reducing the prices statewide.

The Settlement Agreement allows the Company to change rates in Basket 3 such as to produce $25.3 million in additional annual revenues during the first year. This cap is adjusted upwards an additional $5 million in the second year of the Plan, and an additional $5 million in the third year of the Plan, to reflect the switched access charge reduction in those years.

While the Settlement Agreement does not specify the level of modernization or replacement that is required of Qwest, a review of Qwest's capital investments during the initial three years of the plan is expected to be one of the items reviewed and considered at the time Qwest asks for renewal or revision of the Plan at the end of the three year initial plan period.

REBUTTAL TESTIMONY REGARDING SETTLEMENT AGREEMENT

The primary purpose of my Rebuttal testimony is to respond to the testimonies of other parties pertaining to several rate design issues in the Settlement Agreement between Staff and Qwest.

One issue raised by the parties is imputation requirements. Nothing in the Settlement Agreement changes any of the Commission's existing imputation requirements. Therefore, the Settlement Agreement requires that the imputation requirements that currently exist will continue to exist under the Plan.

I address AT&T witness Ms. Starr's proposal to eliminate the carrier common line charge (CCLC). Ms. Starr's proposal is based upon the flawed conclusion that these charges have no cost basis and are subsidies provided to Qwest by IXCs. The fact is that there are very significant costs involved with Carrier Common Line Access service - the service the carriers receive for paying the CCLC. The carriers, including AT&T, use the loop facilities to terminate calls to premises, and also to originate calls from premises. There is a significant cost to Qwest to provide and maintain those loop facilities. The CCLC is simply the charge whereby the IXCs support a portion of the cost of those loop facilities which they are sharing and utilizing. The CCLC is not a subsidy.

There are two standard costs that must be calculated to properly evaluate whether a price receives or produces a “subsidy”. These are the TSLRIC "floor" and the "stand alone" cost (SAC) "ceiling." Since the loop facility would have to exist for Carrier Common Line Access service even if no other services were provided (stand alone), the loop cost is part of the SAC of Carrier Common Line Access Service. At the other extreme, the cost of the loop facility is excluded from the properly calculated TSLRIC of any service that shares that facility, because the TSLRIC floor excludes all shared costs. The reasonable price is generally above TSLRIC (but below the SAC) to provide a contribution to the shared costs. The reasonable, proper, and subsidy-free price for a service is a price that is between the TSLRIC floor and the SAC ceiling. The switched access rates that will result from the Settlement Agreement are well below the stand alone "ceiling" and well above the TSLRIC floor. Therefore, these rates will be in the subsidy-free range, which is where prices are normally expected to fall.

If the CCLC were eliminated, but the IXCs were still allowed to utilize the loop facilities, that would mean the IXCs would be getting a “free ride” on those loop facilities. The CCLC is not excessive. For most locations, paying the CCLC, and therefore using the shared loop facility, is the lowest cost way for AT&T and other IXCs to connect traffic to and from the premises. In other states, even AT&T has recognized that giving companies a "free ride" on the loop facilities is improper. However, in this proceeding, AT&T violates that concept by effectively proposing that AT&T and other IXCs receive a "free ride" on the loop facilities.

My rebuttal testimony addresses Ms. Starr ‘s objections to the Settlement Agreement switched access reduction as being insufficient, and her objections regarding the increase in the Basket 3 rate cap to offset Basket 2 switched access reductions. Ms. Starr does not appear to recognize that the revenue requirement of Qwest must be recovered somewhere. Ms. Starr wants to see the rates reduced in Basket 2 more than they have been reduced in the Agreement, but she objects to the revenue loss being made up in the other baskets (or at least any other basket that would effect any AT&T rates).

I address the proposal set forth by some of the IXCs that the intrastate switched access charges be set equal to the interstate switched access charges that resulted from the FCC’s CALLS Order. Following the FCC CALLS Order would result in a large increase in fixed monthly charges to Qwest customers in Arizona through a large increase in the End User Common Line (EUCL) charge. It is not in the public interest to impose a similar intrastate EUCL charge on customers.

Dr. Selwyn’s concern that the “avoided cost” discount supposedly would no longer apply to wholesale prices under the Settlement Agreement is incorrect. Part 3(c) of the Agreement requires that wholesale prices be set based on the federal Telecommunications Act of 1996 requirements, and Section 252(d)(3) requires the “avoided cost” discount for the wholesale services.

<u>Summary of Testimony of Harry M. Shooshan</u>
<u>in Support of Settlement Agreement</u>

The structure of the price cap regulation plan in the Agreement ("the Proposed Plan") conforms with the recommendation I made in my Testimony in this proceeding. There are three "baskets" of services: Basic/Essential Non-competitive Services; Wholesale Services; and Flexibly Priced Competitive Services. The most important element of this structure is the creation of a "wholesale" basket. As I stated in my Testimony, placing wholesale services in a separate basket permits the Commission to focus on these important "inputs" that competitors rely on to compete with Qwest. Segregating these services also permits reductions in intrastate carrier access charges to occur without offsetting automatic increases in rates for basic services (such as Qwest had originally proposed in this case). Under the Agreement, the phased reductions in carrier access charges will, instead, be offset by providing Qwest with more "headroom" to adjust the prices of flexibly-priced services in Basket 3.

The Proposed Plan also embodies my recommendation for an "inflation less productivity" cap for Basket 1 and adopts my recommendation of a productivity offset of 4.2 that includes the 0.5 "consumer dividend" I suggested. The Proposed Plan, however, "caps" the cap at zero with no lower bound which means that, if inflation exceeds productivity, the cap itself will not be raised, but, if as is more likely, the productivity offset exceeds the rate of inflation, the overall cap will be reduced forcing aggregate price reductions for the services in Basket 1. This is a significant concession by the company in that it has accepted the risk of inflation for the term of the price cap plan.

The cap for Basket 3 in the Proposed Plan differs from what I suggested in that it is set at the initial weighted average price level of all services in the basket, subject to annual updates in quantities. Basket 3 also includes "headroom" above the initial prices to provide Qwest the opportunity to achieve its full revenue requirement through the pricing of services in this basket. This change, among others, has been made to conform the price cap plan to the constitutional and legal requirements related to a "fair value" rate base and reasonable rate of return.

I still prefer the five-year term I proposed in my earlier Testimony to the three-year term in the Agreement. However, for a state making the important transition from earnings to price cap regulation, I certainly believe an initial three-year term is reasonable.

In addition to the benefits inherent in price cap regulation that I have already noted, the Agreement contains a number of significant benefits to consumers and competitors. The Agreement:

Provides for phased reductions, in both real and nominal terms, in rates for "basic services" over a three-year period; that is, these rates are capped at initial levels and cannot be increased, but will likely be reduced over the life of the plan. The "hard-capped" services include: flat rate residential, 2 & 4 party service, low use option, telephone assistance programs, flat rate business, individual PBX trunks, Caller ID block, and basic listing service. Increases for other services in Basket 1 are limited.

Enables consumers to benefit directly from Qwest's increased productivity by adjusting the price cap in Basket 1. This is in addition to a Consumer Productivity Dividend that is included in the initial price cap;

Subjects Qwest to new penalties *in the form of* bill credits *for failing to meet service* quality standards;

Requires Qwest to provide additional consumer information in its bill inserts, including information about the Commission's complaint process;

Lowers charges made by Qwest to long-distance carriers by $15 million over the three years (and eventually to the interstate level), with the result that long-distance prices for calls within Arizona will be reduced;

Encourages Qwest to offer a variety of new services and service packages that will respond more directly to consumer needs and will have the flexibility to price these new offerings to meet the demands of the market.

Protects competition by preventing Qwest from raising rates for either non-competitive/basic services or wholesale services in order to subsidize its competitive/new service offerings. Establishing a price floor at TSLRIC—coupled with continued application of the Commission's imputation rules--prevents anti-competitive cross-subsidies or a price squeeze by Qwest.