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December 4, 2000

Arizona Corporation Commission
DOCKETED

DEC 0 5 2000

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Arizona Corporation Commission
Docket Control-Utilities Division
1200 West Washington
Phoenix, AZ 85007

Re: ACC Docket No. T-01051B-99-0105

Dear Docket Control:

Enclosed for filing are the original and 10 copies of the summaries of the Testimony of Susan Gately, Lee L. Selwyn and Arleen M. Starr, on behalf of AT&T Communications of the Mountain States, Inc. A paper copy, as well as an electronic copy, of this filing was mailed to the service list on Friday, December 1, 2000.

Very truly yours,

Davis Wright Tremaine LLP

Larry J. Weathers
Paralegal

Enclosures
cc: Robert Tanner
Mary Steele

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Seattle

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1200 West Washington
Phoenix, Arizona 85007

COPY of the foregoing sent by mail and/or e-mail
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SUMMARY OF TESTIMONY AND SURREBUTTAL TESTIMONY

The purpose of my testimony is to demonstrate that the $42.9-million revenue increase that would be allowed by the Settlement Agreement is neither reasonable nor in the public interest. Despite protestations to the contrary, the Settlement Agreement ignores the ample evidence that was presented by Parties other than Qwest and Staff in this proceeding that Qwest should be subjected to a substantial revenue requirement *decrease*, not an increase. If, and to the extent the Commission decides to adopt a decision based upon the settlement approach used by Staff and Qwest (a "split the baby" approach for several contested issues), that same "split the baby" treatment must be accorded to the proposed adjustments of other interested parties as well.

Moreover, the impact of the Settlement Agreement's failure to properly reduce rates is compounded by the coupling of the *negotiated* $42.9-million revenue increase with the institution of a price cap form of regulation. Central to any *price regulation* plan is the presumption that the going-in price levels are just and reasonable. Implementing a price regulation plan while ignoring evidence that the present price levels result in *overearnings* for Qwest does a disservice to all of Arizona's ratepayers, both end users as well as competitive service providers that must purchase Qwest's wholesale offerings in order to offer their own competing services. Getting the "going-in" price levels right is every bit as important as properly specifying the components of the price caps plan.

In Direct Testimony filed in support of the settlement both Qwest and Staff witnesses provided very little documentation relative to the genesis of the recommendation for a $42.9-million rate increase for Qwest. Neither the specific discussions of issues settled nor the description of the methodology employed make any mention of an evaluation of the *merits* of the various adjustments that had been proposed by Staff in the pre-settlement phases of this proceeding. Rather than basing the settlement of the issues on the merits of the relative to proposed adjustments, the parties evaluated the *litigation risk*[1] of the various arguments. While in a perfect world the *merits* and *litigation risk* would likely be identical, in this imperfect world in which we live, they are not. Moreover, little mention was made of the inclusion of adjustments recommended by other parties in the evaluation, and none of the specific adjustments that had been proposed by other parties that had been disputed by Qwest were identified in the discussions.

Staff and Qwest appear to have reviewed the differences between the numbers underlying Qwest's initial submission of data revealing a $201-million revenue shortfall and any adjustments to the data in that initial Qwest submission that were proposed by Staff in its Direct Testimony, agreeing to incorporate Staff proposals that directly mirrored issues decided by this Commission in the immediately previous rate case proceeding, and agreeing to split the difference between Staff and Qwest on other more contentious issues.

In my Direct Testimony filed prior to the settlement discussions, I proposed and quantified adjustments to Qwest's results that would have required a substantial rate reduction. Based upon my review of the initial round of testimony filed in support of the settlement, I believe that the "negotiated" revenue requirement level produced as a result of the Settlement Agreement ignored seven of the overstatements and legitimate corrections

1. "My advice to Staff 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. It is my understanding that Qwest engaged in its own assessment of such risks and presented settlement offers reflective of possible outcomes if the issues were litigated." Brosch Supplemental at 1-2.

identified in my Direct Testimony.[2] The failure to account for most of the rate base and operating expenses identified in my Direct Testimony results in a Settlement Agreement that allows Qwest not only to continue overearning, but to increase the extent of that overearning. In total, those seven unaccounted for adjustments would lower Qwest's rate base by over $200-million and would result in a revenue requirement *reduction* that dwarfs the "negotiated" *increase* in revenue included in the settlement.

If, and to the extent that, the Commission determines that it is appropriate to determine the outcome of this case through Settlement negotiations rather than fully litigating the issues in dispute, then any revenue adjustment flowing out of a Settlement must treat equally proposed adjustments of all of the parties to the proceeding. Meaning that any corrections to Qwest's revenue requirement estimate made by other parties that are not duplicative of adjustments proposed by Staff should be accorded the same treatment as was used for the Staff and Qwest estimates. The adjustments to Qwest's initial $201-million revenue requirement shortfall estimate proposed by AT&T should be treated in the same manner as the Staff-identified adjustments.

In Rebuttal to my evaluation of the Settlement and my recommendations for changes to the $42.9-million revenue increase included as part of that settlement, both Staff witness Brosch and Qwest witness Redding indicate that I have misinterpreted the manner in which that number was developed, indicating that I inappropriately "assumed" that the adjustments proposed in my Direct Testimony were not taken into account when developing the settlement amount. Staff and Qwest both now *appear* to be saying that the adjustments that were

2. Based upon Staff's rebuttal it appears that one of those seven adjustments related to "deregulated services" may in fact have been incorporated into the settlement.

initially proposed in my Direct testimony were evaluated, but were rejected on the merits of those adjustments.[3] As I indicated above, it is necessary to consistently address the positions of all parties participating in this proceeding, and Staff has provided no evidence that assigns my proposed adjustments a higher "litigation risk" (using Mr. Brosch's terminology). Qwest, on the hand, states that it reviewed adjustments proposed by both RUCO and AT&T and accorded those proposals "the weight they deserved" which at least according to Qwest, seems to have been none.[4] Between the Direct and Rebuttal testimony filed by myself and Dr. Selwyn, there were probably close to two hundred pages of testimony and evidence filed in support of just these adjustments. At no point during the pre-settlement portion of this proceeding did Staff file any testimony disputing those adjustments, nor, to the best of my knowledge, did it serve any data requests on AT&T requesting additional documentation on the proposed adjustments. Qwest, not unexpectedly, vigorously disputed AT&T's adjustments (as it did Staff's).

In defense of this position, Mr. Redding indicates that I have "has no reason to assume that Qwest of Staff overlooked any adjustments", referencing "numerous interrogatories and on-site visits by Staff's experts" and concluding that "it is highly unlikely that anything of a significant nature was missed." This suggestion belittles the involvement of those participating in the regulatory process in Arizona, and the contributions of those other parties to the records that are developed. The ACC has many times in the past, including the last rate case, adopted positions and/or adjustments advocated by parties other than Staff or the Company,[5] it should not allow their positions to be so lightly discounted in this proceeding.

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3. Brosch Rebuttal at 4 - 6, Redding Rebuttal at 5 - 11.

4. Redding Rebuttal at 3 - 4.

5. See, for example, ACC Decision No. 58927 in Docket E-1051-93-183 at page 30.

LEE L. SELWYN — SUMMARY AND SURREBUTTAL

In my supplemental testimony, I expressed concern about the proposed settlement's treatment of "Basket 2" services. I noted that the proposed settlement would create a mechanism under which a retail/wholesale "price squeeze" could occur because *retail* prices would be decreasing for noncompetitive Basket 1 services and for some "competitive" services in Basket 3, while at the same time Basket 2 *wholesale* rates remained unchanged. In his responsive testimony, Mr. McIntyre for Qwest and Mr. Dunkel for the Staff dismiss this possibility, arguing that Basket 2 rates would be set or changed pursuant to pricing rules established in the federal *Telecommunications Act of 1996* ("Act") and by the FCC.[1] However, neither witness has elected to even address, let alone rebut, the price squeeze issue with respect to *UNE rates*, which will also be classified in Basket 2. The settlement would freeze UNE rates, denying them the same productivity benefit being afforded retail Basket 1 services. UNE rates are supposed to be based upon *cost*, and neither the Company nor the Staff has explained why the *costs* of providing UNEs would not also experience the same productivity-based reductions as would the cost of providing retail Basket 1 services. Accordingly, Basket 2 UNE rates should receive exactly the same X-factor/PCI treatment as applies for the retail Basket 1 services *of which the UNEs are components*. Moreover, UNE *rates*, not Qwest's costs, should be imputed into the price floor for all Basket 3 services.

I have also expressed the concern that the pricing rules that the proposed settlement would establish for Basket 3 services may be anticompetitive because Qwest could reduce prices *selectively* where a service faced actual competition while increasing it where no current competition is present. This would be possible because, in determining that a given service satisfied A.A.C. R14-2-1108, the Commission was required to apply this standard *statewide* rather than limiting it to those geographical areas where competition is actually present. I note with some interest that the Company and Staff appear to have different understandings as to what services are eligible for Basket 3 treatment. According to Mr.

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1. McIntyre (Qwest) rebuttal at 9, Dunkel (Staff), rebuttal at 11-12. If rates for bundled wholesale services offered for resale will be maintained pursuant to Sec. 252(d)(3) of the *Act* and will be adjusted proportionately with changes in the *retail* prices as these witnesses contend, my concern at least with respect to bundled wholesale rates would be resolved.

Teitzel for Qwest, "services in [Basket 3] are competitive *or non-essential.*[2] However, "non-essential" services that do not confront effective competition have not been found by the Commission to satisfy A.A.C. R14-2-1108. Mr. Shooshan for the Staff, by contrast, appears to believe that only those services that the Commission has found to have satisfied A.A.C. R14-2-1108 are eligible for Basket 3 treatment:

> Simply put, Qwest will find it very difficult – at least in the long run — to sustain price increases on Basket 3 services *that are out of line with marketplace conditions*, unless it wants to lose customers. In its classification decisions, the Commission has, in effect, *determined that competitive marketplace forces are sufficiently strong for these services to provide a reasonable check on Qwest's pricing.*[3]

Mr. Shooshan is, of course, in error, because noncompetitive "non-essential" services, including those vertical features that can have no existence independent of the monopoly basic exchange access line, as well as all "new" services, are to be afforded Basket 3 pricing treatment. For these services, competitive marketplace forces are nonexistent, and thus cannot be relied upon "to provide a reasonable check on Qwest's pricing."

Mr. Teitzel appears to contend that Qwest would not be able to apply geographic pricing to Basket 3 services, citing a series of "restrictions" including, *inter alia*, A.A.C. R14-2-1109. *Nothing in any of the "restrictions" he cites or in A.A.C. R14-2-1109 would preclude Qwest from increasing its prices in, for example, rural areas while reducing them in the Phoenix and Tucson metros.* Additionally, I note that one of the specific restrictions he cites, contained at Section 4(k) of the proposed settlement, would "prohibit[] cross-subsidization of competitive services by non-competitive services." By Mr. Teitzel's own admission — i.e., that Basket 3 includes "non-essential" services for which no A.A.C. R14-2-1108 finding has been made — within Basket 3 are both competitive and non-competitive services and, as long as the *Basket cap* is not exceeded, there is nothing in the price cap plan that would prevent Qwest from raising prices of non-competitive "non-essential" services while setting rates for its truly competitive services at the TSLRIC floor. As Mr. Dunkel would appear to agree, this tactic would relieve the competitive service of making any contribution toward the common/joint/shared costs of the Company's operations.

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2. Teitzel (Qwest), rebuttal at 2, emphasis supplied.

3. Shooshan (Staff), rebuttal at 7, emphasis supplied.

Moreover, while both Mr. Shooshan for the Staff and Mr. Teitzel for Qwest contend that the "price floor at TSLRIC" requirement forecloses the possibility of anticompetitive pricing,[4] it would appear that Mr. Dunkel for the Staff would disagree with that position. According to Mr. Dunkel, "the TSLRIC floor excludes all joint and common costs," and so "[t]he reasonable, proper, *and subsidy-free price* for a service is a price that is between the TSLRIC floor and the SAC [stand-alone cost] ceiling."[5] Mr. Dunkel goes on to observe that "[p]ricing above the direct cost or TSLRIC of a service is how the common/joint/shared costs of a company are recovered."[6] If Basket 3 services are priced *at* TSLRIC, then no contribution toward the common/joint/shared costs will be made, and these "competitive" services will get a "free ride" on the common/joint/shared costs that are being charged to and recovered from *monopoly* basic services. Staff has offered no basis upon which different standards should be applied to competitive and access services — i.e., TSLRIC for competitive services, and TSLRIC-plus-common/joint/shared costs for access services.

Contrary to Mr. Dunkel's claim, reductions in access charges to parity with interstate will not result in rates that fail to recover the common/joint/shared costs associated with the subscriber line. Mr. Dunkel confuses the issue of cost recovery with the manner in which traffic-sensitive and non-traffic-sensitive costs are recovered through usage-based and fixed monthly charges. The Carrier Common Line Charge (CCLC), which has been eliminated in the interstate access rate structure, improperly imposes a usage-sensitive charge to recover a non-usage-sensitive cost. The costs of the subscriber line do not vary with the volume of access usage, and it is economically inefficient for usage-based rates to be inflated to recover loop costs. And contrary to Mr. McIntyre's utterly baseless claim to the contrary,[7] there is

4. Shooshan (Staff), at 9-10, Teitzel (Qwest) at 9-11.

5. Dunkel (Staff), rebuttal at 4, emphasis supplied.

6. *Id.*, at 6.

7. McIntyre (Qwest), rebuttal at 7. The sole basis for Mr. McIntyre's contention that the effect of stimulation should be ignored is his claim that "stimulation modeling is a very inexact science." *Id.* While there has indeed been considerable debate over the years as to the correct quantification of the demand elasticity for intrastate toll, *no credible study has ever contended that toll or access price elasticity is zero*, which is what Mr. McIntyre claims. I would note that the California PUC, in its 1994-95 rate rebalancing proceeding, devoted an (continued...)

ample historical evidence that access charge decreases *will be flowed-through to consumers* in the form of lower toll rates, and the lower toll rates *will stimulate additional and beneficial use of the public switched network*, usage that is currently being *suppressed* as a result of the *excessive* non-cost-based intrastate access charges.

Finally, I feel compelled to address the comments of Ms. Arnold for Qwest and Mr. Shooshan for the Staff on the matter of the X-factor. Both witnesses emphasize the feature of the proposed settlement's price cap formula that would prevent rates from increasing if the annual inflation rate were to exceed 4.2%. Indeed, Ms. Arnold goes so far as to portray this as "a significant concession on [Qwest's] part that it will be prohibited from raising rates in years when inflation exceeds the productivity offset."[8] The US inflation rate has been in the range of about 2%-3% or less for at least the past eight years and is expected to stay there; indeed, the last year in which the change in the GDP-PI exceeded 4.2% was 1982! Qwest's acceptance of this limitation is more of an "empty gesture" than a "significant concession."

As to the 4.2% X-factor itself, which Mr. Redding claims to be "near the top of the range" of X-factors approved by state PUCs,[9] none of the Company or Staff witnesses have addressed the fact that, by limiting the X-factor to Basket 1 and by permitting Basket 3 rates to rise by as much as 10%, the *effective X-factor* applicable across *all* of Qwest's intrastate operations will be perilously close to zero, putting it at the *bottom*, not the top, of the "range." Mr. Redding also mischaracterizes my testimony when he states that I am "not adverse to a jurisdictional productivity factor."[10] What Mr. Redding conveniently omits from his recitation of my testimony is that a jurisdictional productivity factor would be appropriate *so long as both the FCC and the state commissions adopted consistent positions*. Since Qwest is subject to a total company 6.5% X-factor in the federal jurisdiction, it should similarly be subject to this same X-factor for its Arizona intrastate services.

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7. (...continued)
extensive amount of time to this issue and concluded that the price elasticity for *intraLATA* toll was –0.50. California Public Utilities Commission, *Implementation and Rate Design (IRD)* order in *Phase III* of I.87-11-033, D.94-09-065, 56 CPUC 2d 117, 203-206.

8. Arnold (Qwest), rebuttal at 5.

9. Redding (Qwest) at 15-16.

10. *Id.*, at 13.

Summary of Testimony
Arleen M. Starr
AT&T Communications of the Mountain States, Inc.
Docket No. T-01051B-99-0105
December 1, 2000

<u>Access Priced at Forward-Looking Economic Cost</u>

The Settlement Agreement includes a $5 million reduction in intrastate switched access charges for the first year of the agreement. In addition, the Settlement Agreement states that rates for intrastate switched access shall be reduced at the start of the second year of the Price Cap Plan to cause an additional $5 million reduction in revenues from that service, and reduced again at the start of the third year of the Price Cap Plan to cause an additional $5 million reduction in revenues. This is not sufficient. It is well known and generally accepted that intrastate switched access rates in Arizona are priced significantly in excess of the forward-looking economic cost of actually providing the service. Qwest's intrastate switched access rates should be based on forward-looking economic cost, including a reasonable allocation of joint and common costs. As a reasonable approximation of the FLEC forward-looking economic cost ("FLEC") of switched access, AT&T recommended the use of the UNE rates established by the Commission for switching elements and Qwest's interstate transport rates.[1] Consumers will benefit from the resulting competition triggered by access reductions, <u>i.e.</u>, additional toll competition, and access reductions will also limit Qwest's ability to engage in anti-competitive pricing strategies in the toll market, which would impede competition.

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[1] *In the Matter of the Petition of AT&T Communications of the Mountain States, Inc. for Arbitration with U S WEST Communications, Inc. of Interconnection Rates, Terms and Conditions Pursuant to 47 U.S.C. § 252(b) of the Telecommunications Act et al.,* Arizona Corporation Commission Docket No. U-2428-96-448, *et al.*, Opinion and Order, Decision No. 60635, (Arizona Corp. Comm., January 30, 1998) (dis. op. Commissioner Renz D. Jennings) at 13. The UNE rates established by the Commission include an overhead cost factor, including attributed, joint and common costs of 15%.

The proposed Settlement Agreement should be modified to include:

- Intrastate switched access rates set at FLEC, including a reasonable allocation of joint and common costs. The Commission can rely on the equivalent to the UNE rates established by the Commission in the cost proceeding in Arizona for local and tandem switching and equal to Qwest's interstate rates for transport as reasonable approximations of the FLEC of providing intrastate switched access;

- At a minimum, the Settlement Agreement must include reductions that transition Qwest's intrastate switched access rates to its interstate rates over the initial term of the plan, but certainly no longer than five years; and

- Elimination of the Carrier Common Line Charge and the Interconnection Charge, which have no cost basis and are merely subsidies being provided to Qwest by IXCs at the ultimate expense of end users.

Qwest's Interstate Switched Access Rates

Qwest's $15 million reduction in intrastate switched access rates over a three year period falls woefully short of setting its intrastate rates equivalent to its interstate rates. Qwest states that it is not appropriate to set intrastate switched access rates equivalent to its interstate rates, although, it is the "stated goal" for intrastate switched access in the Settlement Proposal and was advocated by Staff in its original proposal. Mr. McIntyre states that interstate switched access revenue is collected through three major rate elements — switching, transport and the End User Common Line charge ("EUCL").[2] It may be correct all three elements provide revenue, significant revenue, to Qwest, but this does not mean all three elements are paid by Interexchange Carriers ("IXCs") for the provision of interstate access services. Only the local switching and transport rate elements are related to the provisioning of access services — interstate or intrastate. The EUCL is collected directly from end users and was established by the FCC with the intention of transitioning interstate access rates toward the cost of providing the service. On the intrastate

[2] Rebuttal Testimony of Scott A. McIntyre at 3.

side, the "cost" of providing switched access is comprised of switching and transport only. Based on the theory of cost causation, the cost of the intrastate portion of the local loop is recovered, or should be, through local exchange rates.

Imputation Requirements

Due to Qwest's monopoly position in the switched access market, imputation requirements are necessary and Qwest apparently agrees. The issue is Qwest is using an inappropriate definition of essential services and does not intend to include the price of originating access in the price floor for intraLATA toll services. In response to RUCO data request #5.2 Qwest states, "Nothing in this Price Cap Plan is intended to change or modify in any way the imputation requirements contained in ACC R-14-2-1310. In addition, the data request listed ACC Rule 14-2-1310(C), the imputation rule and Rule 14-2-1302, defining essential facility or service. Mr. Teitzel states Rule 14-2-1307 (C) defines essential services and facilities as 1) termination of local calls, 2) termination of long distance calls, 3) interconnection of E911 and 911 services, 4) access to numbering resources, 5) dedicated channel network connections and 6) unbundled loops. Moreover, Mr. Teitzel states that since Rule R-14-2-1307 classifies *termination* of long distance calls as essential, *origination* of long distance calls is excluded from the category of essential services and can no longer be considered essential.[3] Rule 14-2-1307(C) is included in the broader category of R-14-2-1307 titled, Unbundling. This indicates the list of "essential" services is related to unbundling requirements, not the calculation of a price floor for intraLATA toll services. Rule 14-2-1302 (8) provides definitions and includes a definition of "essential facility or service" which states:

[3] Rebuttal Testimony of David L. Teitzel at 19.

> Essential facility or service means any portion, component, or function of the network or service offered by a provider of local exchange service: that is necessary for a competitor to provide a public telecommunications service; that cannot be reasonable duplicated; and for which there is no adequate economic alternative to the competitor in terms of quality, quantity, and price.

The definition of essential, as provided in Rule 14-2-1302, is clearly applicable in calculating the price floor for intraLATA toll services. The Settlement Agreement should be modified to clarify that the price of both origination and termination of switched access must be included in the price floor for intraLATA toll services. Without such a requirement, and until Qwest's intrastate switched access rates are set at forward-looking economic cost, Qwest will be at a competitive advantage verses its competitors in the intraLATA toll market due to the significant difference between the cost and price of intrastate switched access.