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Arizona Corporation Commission

BEFORE THE ARIZONA CORPORATION COMMISSION

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2 CARL J. KUNASEK
CHAIRMAN
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COMMISSIONER
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COMMISSIONER
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ARIZONA CORPORATION COMMISSION
DOCUMENT CONTROL

6 IN THE MATTER OF THE APPLICATION) **DOCKET NO. T-01051B-99-0105**
7 OF U S WEST COMMUNICATIONS, INC.)
8 A COLORADO CORPORATION, FOR A)
9 HEARING TO DETERMINE THE EARNINGS)
10 OF THE COMPANY, THE FAIR VALUE OF)
11 THE COMPANY FOR RATEMAKING) **STAFF'S BRIEF IN SUPPORT**
12 PURPOSES, TO FIX A JUST AND) **OF SETTLEMENT**
13 REASONABLE RATE OF RETURN)
14 THEREON AND TO APPROVE RATE)
15 SCHEDULES DESIGNED TO DEVELOP)
16 SUCH RETURN.)

INTRODUCTION

14 On October 20, 2000, the Arizona Corporation Commission Utilities Division Staff
15 ("Staff") and Qwest Corporation ("Qwest"), formerly U S West Communications, Inc., jointly filed
16 their Settlement Agreement, resolving all issues in this docket. The Settlement Agreement includes
17 proposed revenue requirements findings, supporting a fair value of Qwest's property devoted to
18 public service in Arizona and a fair return on that fair value. The Settlement Agreement resolves
19 issues of rate design and includes specific rate design changes, by which Qwest will be authorized
20 an opportunity to earn its revenue requirements. In addition, the Settlement Agreement provides for
21 the adoption of a Price Cap Plan for Qwest. Under the terms of the Price Cap Plan, Qwest will be
22 authorized to exercise pricing flexibility regarding the rates for some of its services. The Price Cap
23 Plan is structured in such a manner that a portion of the revenues necessary for Qwest to earn a fair
24 return on the fair value of its property will be earned in connection with flexibly priced services. The
25 Proposed Price Cap Plan includes important consumer benefits and protections including a hard cap
26 on the rates for Basic/Essential Services for the Term of the Plan.

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1 Following the submittal of the Settlement Agreement, Staff and Qwest submitted
2 testimony in support of the Settlement Agreement, other Parties submitted comments and testimony,
3 after which Staff and Qwest submitted Rebuttal testimony in support. This Brief will place the
4 positions of the various parties in context, explaining why the Commission should find the
5 Settlement to be in the public interest, notwithstanding the objections of some parties.

6 At the outset, it should be noted that Staff and Qwest are not the only parties who
7 believe the Settlement Agreement is in the public interest. The Communications Workers of
8 America Arizona State Council ("CWA") submitted testimony that is generally supportive of the
9 Settlement. The United States Department of Defense and All Other Federal Executive Agencies
10 ("DOD") also submitted the testimony of Richard B. Lee, which supports a finding that the
11 Settlement is in the public interest. In addition, the Arizona Payphone Association ("APA"), unlike
12 some of the other parties to this proceeding, continued discussions with Qwest beyond the date when
13 the Settlement Agreement was filed, and ultimately resolved all remaining issues such that the APA
14 filed testimony finding that the Settlement is in the public interest.

15 Testimony in opposition to the Settlement was filed on behalf of the Residential
16 Utility Consumer Office ("RUCO"), AT&T Communications of the Mountain States, Inc. ("AT&T")
17 and Cox Arizona Telecom L.L.C. ("Cox"). In general, the parties in opposition to the Settlement
18 raised three broad issues: 1) RUCO and AT&T believed that the revenue requirement contained in
19 the Settlement is too high; 2) AT&T and Cox believed that the access charge reductions under the
20 Settlement are too low; and, 3) all three parties had specific areas in which they disagreed with the
21 Price Cap Plan contained in the Settlement. This Brief is structured to respond to each of those
22 broad areas of objection. The first part of the Brief will describe why the revenue requirements
23 contained in the Settlement Agreement should be found to be in the public interest. The second
24 section of the Brief discusses intrastate access charges and explains why the reductions contained
25 in the Settlement Agreement are reasonable. The third and final section of the Brief responds to the
26 objections to the Price Cap Plan, explaining why the Price Cap Plan contained in the Settlement
27 Agreement promotes competition in the state, provides just and reasonable rates for Qwest, and is
28 in the public interest generally.

1 Certain of the objections to the Settlement Agreement resulted from
2 misunderstanding of the terms of the Agreement on the part of the parties. Under separate cover,
3 Staff and Qwest are submitting certain statements intended to clarify the meaning of the Settlement
4 Agreement. The Commission is urged to consider these points of clarification along with the
5 Settlement Agreement itself. After due consideration of the Settlement Agreement, the points of
6 clarification, and the issues surrounding this matter, the Commission should: 1) find the Settlement
7 Agreement to be in the public interest; 2) find that it results in just and reasonable rates for Qwest,
8 including a finding of the fair value of Qwest's property devoted to public service in Arizona and
9 a fair rate of return on that fair value; and 3) approve the Settlement Agreement.

10 **I. REVENUE REQUIREMENTS.**

11 **A. Overall Reasonableness.**

12 The Settlement Agreement provides a revenue requirement increase to Qwest in the
13 amount of \$42.9 million. RUCO and AT&T each contend that the revenue increase is too high.
14 RUCO filed testimony from its witness Ralph Smith in support of the proposition that a lower
15 revenue requirement was necessary. AT&T filed testimony from Susan Gately with similar intent.
16 Neither party suggested a specific revenue requirement level that they would have supported in
17 settlement of the rate case.

18 Staff continues to believe that the overall revenue requirement increase of \$42.9
19 million contained in the Settlement Agreement provides just and reasonable rates and is in the public
20 interest. Staff's witness, Michael L. Brosch, testified in support of the revenue requirements
21 contained in the Settlement. Mr. Brosch described the process by which the revenue requirement
22 amount was negotiated between Staff and Qwest, (Brosch Supplemental Test., Ex. S-1 at 1-2). Mr.
23 Brosch concluded that the revenue requirement increase was just and reasonable and in the public
24 interest.

25 Both RUCO and AT&T complained that the revenue requirement was excessive.
26 Each complained that their proposed adjustments were not given adequate consideration in the
27 development of the \$42.9 million revenue increase. The next section of this Brief will discuss some
28 of the specific issues, however, it is important to remember that the Settlement was not reached by

1 issue specific negotiations. Rather, the overall revenue requirements were negotiated on an overall
2 basis, Id.

3 RUCO witness Ralph Smith points out that Staff is the only party (other than Qwest)
4 supporting a revenue increase in the testimony from the underlying rate case. At page 1 of RUCO
5 Exhibit 27, Mr. Smith provides a chart that describes the revenue requirements positions of the
6 parties (other than Qwest). Mr. Smith's chart shows that Staff's proposed revenue requirement was
7 \$7.242 million, while the other parties each supported decreases of \$34.101 million (RUCO),
8 \$51.972 million (DOD), \$45 million (AT&T, w/o increased directory imputation), and \$308.849
9 million (AT&T, w/ increased directory imputation). From this chart, Mr. Smith concludes that no
10 settlement revenue requirement including an increase can be reasonable.

11 Mr. Smith is wrong. Aside from the expert testimony of Mr. Brosch in support of the
12 Settlement, there are a number of analyses that can be applied to conclude that the overall number
13 is reasonable. First, Mr. Smith ignores the fact that Qwest's case supports a revenue requirement
14 of \$201 million. The agreed revenue requirement is approximately 21% of the asserted one. In fact,
15 setting aside the aberration of AT&T's directory imputation, the negotiated Settlement revenue
16 requirement is closer to any party's asserted revenue requirement than it is to the Qwest requested
17 amount. If the approach to settlement were a "split the baby" approach, as suggested by AT&T
18 witness Gately, the lowest revenue requirement attainable would have been the midpoint between
19 Qwest's \$201 million and DOD's minus \$52 million, or a revenue requirement of about \$74.5
20 million. (Gately Supplemental Test., Ex. AT&T-2 at 2). A "split the baby" approach between
21 Qwest's \$201 million and Staff's \$7.2 million would have resulted in a required increase of about
22 \$97 million, even disregarding the additional corrections to Staff's case, which Mr. Brosch testified
23 would have caused our revenue requirement amount to go up somewhat from the \$7.2 million. (Tr.
24 at 481.)

25 Nor can the negotiated revenue requirement figure be fairly characterized as adopting
26 the Commission's previous analysis on some issues and "splitting the baby" on other issues. Ms.
27 Gately asserts that this was plainly the methodology employed. (Gately Supplemental Test., Ex.
28 AT&T-2 at 5). The error in this assumption can be demonstrated a number of ways. Mr. Brosch's

1 Rebuttal Testimony dispels any notion that this was the approach. He points out that the starting
2 point incorporated Staff's rate of return and fair value rate base. (Brosch Rebuttal Test., Ex. S-2 at
3 4). Certainly no one believes that the rate of return was decided by reference to the last Commission
4 decision, since the rate of return calculation is inherently a forward looking calculation made at the
5 time new rates are adopted. No reasonable analyst would conclude that the calculation of fair value
6 rate base could be made, in its entirety, by reference to the past Commission decision. Mr. Brosch's
7 description of the process by which he analyzed the Settlement, as presented in his direct testimony,
8 responds directly to the assertion that a "split the baby" approach was utilized, as well as the
9 assertion that issues presented by other parties were ignored in the Settlement process. He says, "My
10 advice to Staff was based upon judgments associated with the litigation risk of presenting and
11 arguing the many issues set forth in Staff' and other parties' prefiled evidence.'" (Brosch
12 Supplemental Test., Ex. S-1 at 1-2).

13 There is one other, highly significant indication that the revenue increase agreed upon
14 in the Settlement Agreement is fair. That indication is the testimony of DOD witness (Lee Test., Ex.
15 DOD-5). As RUCO witness Smith points out, DOD was sponsoring the lowest revenue requirement
16 of any party to the case, other than the AT&T case including the incorporation of the aberrational
17 Directory Imputation testimony. Yet Mr. Lee concludes that, "The Settlement Agreement strikes an
18 appropriate balance between the interests of Qwest and its ratepayers." Id. at 3-4. Mr. Lee
19 acknowledges that there may be ways to improve the terms of the Settlement, but recognizes that the
20 Settlement, as presented, is in the public interest.

21 Staff freely acknowledges that this Settlement does not represent the only possible
22 resolution of this matter that would be in the public interest. However, the evidence is
23 overwhelming that this Settlement is in the public interest. Having failed to participate in the
24 settlement discussions, despite being given an opportunity to do so, RUCO and AT&T cannot be
25 allowed to dismantle this carefully crafted Settlement, simply by making unsupported assertions that
26 the revenue requirement is too high. No one can possibly know what overall revenue requirement
27 the Commission might have found had this case gone to hearing. There is every reason to believe
28 that the Settlement revenue requirement approximates the result from a contested hearing. In any

1 event, there is substantial evidence on the record in this proceeding to support the notion that the
2 Settlement is fair, in the public interest and establishes just and reasonable rates.

3 **B. The Settlement Incorporates The Full Range Of Issues.**

4 The revenue requirements objections raised by RUCO and AT&T rest largely on
5 their assertions that Staff and Qwest ignored issues raised by them in the rate case evidence. RUCO
6 and AT&T each posit the proposition that, if their adjustments were considered, the resultant revenue
7 requirement in the Settlement would be lower than \$42.9 million. Again, there are a host of reasons
8 why this position is wrong.

9 First, as was pointed out earlier, Staff's assessment of Settlement positions incorporated the strengths
10 and weaknesses of the adjustments proposed by all parties. Mr. Brosch makes this point in his
11 Supplemental Testimony, Exhibit S-1 at 1, again in his Rebuttal Testimony, Exhibit S-2 at 1, and,
12 finally, during cross-examination, Transcript at 485. Secondly, Mr. Brosch points out that Staff had
13 made certain corrections to Qwest's case which would have caused all parties' revenue requirements
14 calculations to be increased, if properly considered. (Tr. at 488). The overall rate reductions
15 advocated by RUCO and AT&T are incomplete, overstated and unreliable, due to the omission of
16 necessary correction adjustments made only by Staff to Qwest's asserted revenue requirement
17 (Brosch Rebuttal Test., Ex. S-2 at 3). Finally, the specific adjustments proposed by RUCO and
18 AT&T that are incremental to Staff's proposals suffer from other infirmities noted by Mr. Brosch.
19 For example, the RUCO gain on sale of exchanges adjustment is being separately addressed in
20 another pending Docket before the Commission and each of AT&T's seven asserted corrections to
21 the Settlement revenue requirement are based upon incorrect assumptions, misunderstanding of
22 Staff's case, improper ratemaking policies and are inconsistent with prior ACC Decisions (Id at 2, 5).

23 Perhaps the most important point to consider in considering the impact of RUCO and
24 AT&T adjustments on the reasonableness of the Settlement revenue requirements is the process
25 undertaken to arrive at settlement. Mr. Brosch testified repeatedly that the negotiation was not
26 conducted on an issue by issue basis. When pressed on the topic of a quantification of certain issues
27 that lead to an approximation of the Settlement revenue requirement, Mr. Brosch confirms that it
28 represents "...an explanation of a path to the number that was negotiated in settlement." (Tr. at 489).

1 He declines to speculate as to whether it was the path by which the negotiation occurred. RUCO and
2 AT&T would like the Commission to “get into the heads” of the negotiators and determine which
3 issues were compromised to reach the Settlement Agreement. Thereafter, RUCO and AT&T would
4 have the Commission determine that there were other issues that should have been compromised,
5 all of which would reduce the Settlement revenue requirement. The Settlement wasn’t negotiated
6 that way, and the Commission should decline the invitation to analyze it that way.

7 It is also clear that each of the issues which RUCO and AT&T see as additive to the
8 Settlement revenue requirement calculation is susceptible of some infirmity. Mr. Brosch’s Rebuttal
9 Testimony describes some of the difficulties with some of the adjustments. For example, RUCO
10 proposed an adjustment relating to Toll Revenue Annualization. Mr. Brosch explains in his Rebuttal
11 Testimony that, due to changed circumstances, annualization of toll revenue losses is appropriate in
12 this case, notwithstanding the fact that the Commission had declined to adopt such an adjustment
13 in Qwest’s most recent previous case. (See Brosch Rebuttal Test., Ex. S-2 at 2; Tr. at 499-503).
14 Similarly, AT&T proposed a major adjustment related to imputation of directory revenues.
15 Mr. Brosch explained that, in light of the results from the last Qwest rate case, adjusting directory
16 revenue imputation beyond the \$43 million described in the Settlement Agreement between U S
17 West and the Commission would be fraught with peril. (Tr. at 507-510).

18 Other parties may choose to provide a detailed explanation of why each of their
19 adjustments should or would have been adopted by the Commission had the case proceeded to a fully
20 contested hearing. They will be attempting to persuade the Administrative Law Judge that you
21 should incorporate those assumed outcomes in considering the reasonableness of the Settlement
22 revenue requirement. Staff declines to participate in the exercise. The issue presented is whether
23 the Settlement revenue requirement increase is fair, just and reasonable and in the public interest.

24 It is an issue that should be determined by considering whether, based on the entire record in this
25 case, the Settlement revenue requirement represents a fair compromise among the various positions
26 of the parties. It is important to remember that the Settlement revenue requirement is adopted by
27 Staff and Qwest without reference to the resolution of any specific issue, and that it does not rely on

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1 the adoption of any particular regulatory theory. Nor is the Settlement intended to act as precedent
2 either for or against the adoption of any particular adjustment or theory.

3 Staff and Qwest have negotiated the Settlement, and believe that its adoption by the
4 Commission is in the public interest, based on consideration of the entire record in this proceeding.
5 DOD, the CWA, and the APA have each considered the matter and concur with Staff and Qwest.
6 The fact that the Settlement does not specifically incorporate adjustments proposed by other parties,
7 where it doesn't specifically incorporate even the proponents' adjustments, should not be held out
8 as a basis to deny approval to this Settlement.

9 **II. THE SETTLEMENT ACCESS CHARGE REDUCTIONS ARE APPROPRIATE.**

10 The Settlement Agreement between Staff and Qwest incorporates a number of
11 features. The overall revenue requirement increase proposed is \$42.9 million. Page 3 of the
12 Settlement Agreement describes various rate decreases and rate increases that cumulatively account
13 for the revenue requirements increase. One of the specific rate changes incorporated in the
14 Settlement is a reduction of \$5 million in Intrastate Access Charges for the first year of the Price Cap
15 Plan. In addition, the Settlement provides that Intrastate Switched Access Service rates shall be
16 reduced an additional \$5 million at the start of the second year of the Price Cap Plan, as well as a
17 third \$5 million at the start of the third year of the Price Cap Plan. The Settlement Agreement also
18 states the goal of further reducing Access Charges in the future, with the stated objective of reaching
19 parity with Qwest's Interstate Access Charge rates.

20 AT&T has taken the position that the reduction in access charges is inadequate. In
21 support of its position, AT&T submitted the testimony of Arleen M. Starr. (Starr Direct Test., Ex.
22 AT&T- 4). Ms. Starr advocates that, at a minimum, intrastate switched access rates should be
23 reduced to parallel Qwest's interstate rates in no longer than five years. Ms. Starr also advocates the
24 elimination of the Carrier Common Line Charge ("CCLC") and the Interconnection Charge ("IC"),
25 Id. at 12.

26 Staff believes the Commission should adopt the Settlement Agreement as proposed
27 by Staff and Qwest, recognizing the Settlement as a fair compromise of contested claims. Staff
28 witness William Dunkel explains Staff's position in his Rebuttal Testimony. Mr. Dunkel points out

1 that the reduction in Intrastate Access Charges under the Settlement is significantly higher than was
2 proposed initially by Qwest. (Dunkel Rebuttal Test., Ex. S-4 at 10-11). Mr. Dunkel also points out
3 that the level of contribution to joint and common costs from switched access service is reasonable.
4 Id. at 10. Finally, Mr. Dunkel points out that further reductions to switched access revenues would
5 necessitate raising rates for some other service. AT&T has adopted the untenable position that
6 access charge rates should be reduced, while offering no alternative category from which it would
7 allow the revenue shortfall may be recouped by Qwest. Id. at 9-10. Under these circumstances, the
8 Commission should find the compromise contained in the Settlement Agreement to be fair and in
9 the public interest. Over the term of the Price Cap Plan, intrastate switched access charges will see
10 reductions totaling \$15 million annually. In other words, during the third year of the Plan, access
11 charge rates will generate \$15 million less in revenue, on a test year basis, than was true during the
12 test year. Those reductions will be permanent, remaining in place until further order by the
13 Commission. Presumably, any such subsequent order from the Commission will be designed to
14 promote the Settlement's stated goal to ultimately reduce intrastate access charges to correspond with
15 Qwest's interstate access charges.

16 Finally, Mr. Dunkel responds directly to Ms. Starr's assertion that the CCLC should
17 be eliminated. Mr. Dunkel explains that AT&T necessarily uses loop facilities of Qwest to originate
18 and terminate calls and further explains that such usage has cost consequences such that there is no
19 cost basis for elimination of the CCLC. Id. at 3-6. Under cross-examination, Ms. Starr conceded
20 that AT&T's origination and completion of call required the use of Qwest loop facilities. Ms. Starr
21 ultimately appeared to only object to the imposition of CCLC on a usage sensitive basis, as opposed
22 to on a flat rate basis. (Tr. at 695-96). It is clear that AT&T's use of Qwest loop facilities imposes
23 costs on the system, which the CCLC is intended to recover. The Settlement need not be revised to
24 eliminate CCLC in order to be in the public interest.

25 The Settlement's resolution of contested issues relating to access charge reductions
26 is reasonable based on the entire record in this proceeding. While AT&T might prefer larger
27 reductions, there is no basis to conclude that the Settlement is not fair, in the public interest and the
28 resultant rates just and reasonable. The Settlement should be approved.

1 **III. THE PROPOSED PRICE CAP PLAN.**

2 **A. Price Cap Regulation Will Benefit Both Consumers and Competitors.**

3 The Settlement negotiated by Staff and Qwest includes provisions for Qwest to be
4 regulated under an alternative form of regulation in the future, known as Price Cap regulation. Price
5 Cap regulation would move Arizona away from the traditional form of regulation that relies
6 exclusively on setting a rate of return to control earnings and prices. (Shooshan Test., Ex. S-5 at 1-
7 2). If the Commission approves the Settlement, Arizona will become one of 41 States to use Price
8 Cap regulation. (Shooshan Test., Ex. S-5 at Attach. C).

9 The benefits of Price Cap regulation are well known. Price Cap regulation has the
10 effect of incenting a company to become more efficient and more innovative and to make new
11 investments more rapidly. (Shooshan Test., Ex. S-5 at 2). Regulating earnings at the corporate level
12 is an inefficient way to control the prices charged for various services and distorts the signal (profits)
13 the market gives to any company to guide its behavior. Id. at 3. Price Cap regulation more closely
14 mirrors the effects of a competitive market which should be the goal of regulation. Id. at 2.

15 Price Cap regulation also protects competitors and consumers who are still captive
16 customers of Qwest for many basic services during the transition to fully competitive markets. Id.
17 at 3. As the number of services offered by regulated firms increases, it becomes more difficult for
18 the regulator to determine how to assign costs among services and the process of assigning costs
19 becomes more arbitrary with a much higher risk of "getting it wrong." Id.

20 No party to this proceeding objects to Price Cap regulation per se and in fact all
21 parties recognize its benefits. AT&T witness Selwyn testified:

22 Price caps is a form of 'incentive regulation' in which the ILEC is rewarded for
23 superior efficiency and penalized for inefficiency, as measured by an industry-wide
24 standard. Presumably, this system of 'rewards' and 'penalties' is supposed to afford
25 the regulated firm an incentive to increase its operating efficiency and produce its
services at lower overall cost.

26 (Selwin Supplemental Direct Test., Ex. AT&T-8 at 4-5).

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1 Cox witness Collins testified:

2 Cox does not generally object to price cap regimes similar to that recommended in
3 the proposed Settlement Agreement because many of the factors and their levels are
4 those which Cox has supported in other jurisdictions.

5 (Collins Test., Ex. Cox-1 at 7).

6 RUCO witness Johnson testified:

7 The main goal of a price cap formula is to eliminate, or at least weaken, the linkage
8 between cost and rates, without greatly deviating from the desirable results which
9 would normally be anticipated under traditional regulation or, for that matter, under
10 effective competition (since traditional regulation is designed to simulate the results
11 of competition).

12 Once the price cap is in place, it is fixed for a specified period, usually a year. In
13 turn, the firm is expected to produce with the cost-minimizing input mix, invest in
14 cost-effective innovation, and adjust optimally to changes in input cost conditions.
15 The reasons for this behavior is rooted in economic incentive. Since the firm is
16 allowed to retain as profit (or, at least, a portion of the profit) any cost reductions
17 achieved relative to the price cap, it will choose (in theory) to produce efficiently.

18 (Johnson Supplemental Test., Ex. RUCO-14 at 6).

19 **B. The Proposed Price Cap Plan Contained in the Settlement is Reasonable and in**
20 **the Public Interest.**

21 The proposed Price Cap Plan contained in the proposed Settlement Agreement
22 separates services into three "baskets". Basket One contains Basic/Essential and Non-competitive
23 Services. Basket Two contains Wholesale Services. Basket Three contains Flexibly Priced
24 Competitive Services. (Shooshan Test., Ex. S-5 at 4). Each of the baskets is treated differently
25 under the Plan and is subject to their own pricing and indexing rules. Basket 1 which contains
26 Basic/Essential and Non-competitive Services is subject to an "inflation less productivity" cap. The
27 Plan caps the index at zero with no lower bound which means that, if the inflation exceeds
28 productivity, the index itself will not be raised. If, as is more often the case, the productivity offset
exceeds the rate of inflation, the overall index will be reduced forcing aggregate price reductions
for the services in Basket 1. *Id.* at 5. The proposed Settlement contains Staff witness Shooshan's
recommended productivity offset of 4.2 which includes a 0.5 "consumer dividend". *Id.*

Another significant benefit of the Settlement, is that the Basket 1 Basic/Essential
services identified in Attachment A to the Agreement are subject to a hard cap. *Id.* at 5. This means

1 that they can not increase over existing levels for the term of the Plan. The other services and
2 individual rate elements which make up those services contained in Basket 1 may increase no more
3 than 25% in each succeeding year.

4 The Plan segregates "Wholesale" services into Basket 2 which allows for separate
5 treatment given their importance to competitors and the need to use specific, already established
6 pricing rules at both the state and federal levels for these services. Because of these established
7 pricing rules, Basket 2 is not subject to any indexing mechanism, as are the Basket 1 and 3 services.

8 Finally, Basket 3 contains services which have already been declared competitive or
9 which have been granted pricing flexibility by the Commission. New services and new service
10 packages may also be added to this Basket. The index for Basket 3 is set at the initial weighted
11 average price level of all services in the Basket, subject to annual updates in quantities. Id. Basket
12 3 also includes "headroom" above the initial prices to provide Qwest the opportunity to achieve its
13 full revenue requirement through the pricing of services in this Basket. Id.

14 Many aspects of the Price Cap Plan contained in the Settlement Agreement are not
15 in dispute and are viewed favorably by many of the intervenors. For instance, RUCO witness
16 Johnson commented favorably on the Plan's separation of wholesale and retail services into distinct
17 baskets. Dr. Johnson stated that he strongly approved of placing all of the Wholesale services
18 offered to Qwest's competitors into a distinct "Wholesale" basket, which is separate from the
19 analogous retail services. (Johnson Supplemental Test., Ex. RUCO-14 at 19). RUCO witness
20 Johnson also commented, as will be discussed in more detail below, that the productivity offset is
21 higher than the analogous factors adopted in other states, where offsets of 3% to 4% are not unusual.
22 Id. at 18. Dr. Johnson also commented favorably on the fact that under the proposed Plan, most of
23 the increase would be borne by Basket 3 or competitive services, which he characterized as "...a
24 significant improvement over the Company's previous proposal, which included an excessive
25 increase in local rates." Id. at 12. Finally, Dr. Johnson, also testified favorably as to the hard cap
26 on Basic/Essential Services contained in Basket 1. See, id. at 20. See also Tr. at page 425: ("One
27 good thing about the plan is that it tends to have a hard cap on some of the rates that RUCO is most
28 concerned with...").

1 Additionally, Cox Witness Collins testified that he believed many aspects of the
2 proposed Price Cap Plan were similar to provisions in other state plans which Cox had supported:

3 Cox does not generally object to price cap regimes similar to that
4 recommended in the proposed Settlement Agreement because many of the
5 factors and their levels are those which Cox has supported in other
6 jurisdictions. The formula for the price ceilings appears to be reasonable.
7 The inflation factors, the total productivity offset of 4.2% (3.7% and 0.5%),
8 the fair value return on rate base of 9.61%, and the treatment of quality of
9 service issues are within the bounds of reasonableness for use in a
‘settlement’ approach. The term of three years for the Price Cap Plan appears
to be a reasonable period of time for a ‘first look’ at how the process will
work and what major corrections are required.

10 (Collins Test., Ex. Cox-1 at 7).

11 DOD witness Lee testified that the proposed Price Cap Plan “appropriately balances
12 the interests of Qwest and its ratepayers”. (Lee Test., Ex. DOD-5 at 4).

13 **C. The Areas of Disagreement Regarding the Price Cap Plan are Narrowly**
14 **Focused.**

15 The areas of disagreement with regard to the Price Cap Plan are narrowly focused
16 on several areas or provisions in the proposed Plan. Indeed, during the hearing, it was revealed that
17 several perceived deficiencies were the product of misunderstanding. There were still other
18 provisions which parties believed need clarification which Staff and Qwest have done clarifying
19 amendments through a separate simultaneous filing today. The remaining areas of disagreement will
20 be discussed in turn.

21 **I. The Productivity Factor Used for Basket 1 Services is Reasonable.**

22 The Settlement Agreement adopts Staff witness Shooshan’s proposed productivity
23 factor of 4.2%, which contains a consumer dividend of 0.5%. Only AT&T witness Selwyn appears
24 to take issue with the productivity factor of 4.2% contained in the Settlement Agreement. RUCO
25 witness Johnson, while expressing some reservation because of merger savings which will be
26 discussed later, characterized the 4.2% productivity offset as “...one of the less objectionable aspects
27 of the settlement agreement.” (Johnson Supplemental Test., Ex. RUCO-14 at 18). Dr. Johnson went
28 on the state “An productivity offset of 3.7% plus a consumer dividend of 0.5% results in a 4.2%

1 offset, which is a bit higher than the analogous factors adopted in other states, where offsets of 3%
2 to 4% are not unusual.” *Id.* Cox witness Collins stated: “The inflation factors, the total productivity
3 offset of 4.2% (3.7% and 0.5%), the fair value return on rate base of 9.61%, and the treatment of
4 quality of service issues are within the bounds of reasonableness for use in a ‘settlement’ approach.”
5 (Collins Test., Ex. Cox-1 at 7). DOD witness Richard B. Lee stated, “The productivity factor of 4.2
6 percent represents a realistic, but challenging, target for Qwest over the next three years.” (Lee Test.,
7 Ex. DOD-5 at 4).

8 AT&T witness Selwyn first argues that if the Commission approves a lower X-factor
9 than that adopted by the FCC, Qwest will obtain a windfall gain. AT&T’s argument is premised
10 upon the notion that the 6.5% X-factor adopted by the FCC for interstate services is based upon
11 unseparated total company productivity results (Selwyn Supplemental Direct Test., Ex. AT&T-3 at
12 7). However, as witness Selwyn himself acknowledged, the 6.5% factor used by the FCC was
13 adopted as part of the CALLS settlement plan.¹ (Selwyn Supplemental Direct Test., Ex. AT&T-3
14 at 12). Under the CALLS proposal, the X-Factor is used as a transitional mechanism to reduce
15 access charges to targeted levels, rather than simply as a productivity offset. (Johnson Supplemental
16 Test., Ex. RUCO-14 at 17).

17 In addition, as Staff witness Shooshan pointed out in his Rebuttal Testimony
18 Regarding the Settlement Agreement, Exhibit S-6, at page 10, the 4.2 percent productivity factor
19 must be seen in the context of the other elements of the formula. For example, the inflation minus
20 productivity calculation is capped at zero and has no lower bound. This is a significant concession
21 by Qwest in that it has accepted the risk of inflation for the term of the Price Cap Plan. This
22 provision of the proposed Settlement Agreement is not found in the FCC CALLs settlement plan or
23 the plans of other state commissions since those plans allow an increase in prices to the extent
24 inflation exceeds productivity. *See*, Shooshan Rebuttal Test., Ex. S-6 at 10.

25 Dr. Selwyn also criticizes the data used by Staff witness Shooshan to develop the
26 4.2% productivity offset. (Selwyn Supplemental Rebuttal Test., Ex. AT&T-3 at 9-14). The Staff

27
28 ¹ See, In the Matter of Access Charge Reform, CC Docket Nos. 96-262 and 94-1, Sixth Report and
Order; Report and Order in CC Docket No. 99-249; Eleventh Report and Order in CC Docket 96-45, FCC 00-193 (Rel.
May 31, 2000).

1 recommendation of 4.2% was as a result of the only available Arizona-specific information on
2 Qwest's productivity. (Shooshan Rebuttal Test., Ex. S-6 at 10). The data relied upon was the most
3 relevant data available and included intrastate data from Qwest from 1988 to 1998. Id. at 10-11.
4 Unseparated data was not used because the accounting rules differ between the FCC and the Arizona
5 Commission and the unseparated data would, therefore, not be appropriate for use in this proceeding
6 which relates to Qwest's intrastate services. Id.

7 Dr. Selwyn also notes that the Utah Public Service Commission has proposed a 6.2%
8 productivity factor for use in its price cap formula and surmises as to why Arizona should accept a
9 value for X that differs so dramatically from the value that Qwest had accepted in an adjoining state.
10 (Selwyn Supplemental Direct Test., Ex. AT&T-3 at 20-21). The 6.2% productivity factor adopted
11 by the Utah Public Service Commission was part of a negotiated set of terms and conditions arrived
12 at through settlement of the Qwest - U S WEST merger docket in Utah and that rate is only in effect
13 for one year. See, Redding Rebuttal Test., Ex. Q-4 at 14. Qwest witness Redding stated in his
14 prefiled Rebuttal Testimony that "Qwest fully intends to seek such a revision and will present
15 evidence that 6.2% is far too high." Id. In addition, the Utah settlement did not include a provision
16 similar to Arizona's which caps the index at zero, with no lower bound, which was a significant
17 concession on Qwest's part.

18 While RUCO witness Johnson states that the productivity offset contained in the
19 proposed Price Cap Plan is "...one of the less objectionable aspects of the settlement agreement", he
20 goes on to express concern because in his words "Qwest is expecting to achieve substantial cost
21 savings and 'synergies' as a result of its recent merger..." See, Johnson Supplemental Test., Ex.
22 RUCO-14 at 19. RUCO witness Johnson's concern is without merit. As Staff Witness Brosch
23 testified: "In the early years it's entirely likely that these synergies would be negative if you
24 attempted to measure them because the cost of integration tend to outweigh the benefits in the year
25 or two immediately following the merger." (Tr. at 498). At the end of three years, the Settlement
26 Agreement provides that the productivity offset is subject to reevaluation, along with the other terms
27 and conditions of the Plan. See, Settlement Agreement, Attachment A, Subparts 2) v)² and 6) c).

28

2 Subpart 2) v) of Attachment A provides that "[i]n the first quarter of the third year of the Price Cap Plan, Qwest shall file, along with other required materials, productivity evidence for the past 2 years under price

1 Consequently, the synergies associated with the merger can be better identified and taken into
2 account as appropriate in the subsequent scheduled review of the Price Cap Plan, at which time
3 Qwest is obligated to provide updated information regarding its achieved productivity.

4 Finally, Dr. Selwyn argues that the inflation minus productivity index used for
5 Basket 1 services should also be applied to Basket 2, which contains Wholesale services. (Selwyn
6 Supplemental Direct Test., Ex. AT&T-3 at 30-33). Dr. Selwyn argues that by failing to reflect the
7 same productivity offset with respect to Wholesale prices, the Settlement Agreement discriminates
8 against competing providers and subjects them to an anticompetitive price squeeze. *Id.* Dr.
9 Selwyn's arguments are misplaced. For instance, Dr. Selwyn's depiction of how a price squeeze
10 would occur with regard to resale services in his diagram on page 31 of his Testimony, Exhibit
11 AT&T-3, fails to recognize that under federal law the discount for resale providers is applied to the
12 existing retail rate. Thus, if Qwest lowers its residential or business access line rates, the discount
13 would be applied to the lower rates due to operation of the indexing mechanism, and any resale
14 provider would get the benefit in lower resale rates.³ Further, if the index were applied to Basket 2
15 services, resale rates would obtain the benefit twice, which would not be appropriate. Dr. Selwyn's
16 argument also fails to pass muster when Unbundled Network Element rates are considered. Because
17 UNE rates represent the entire loop, and the Settlement Agreement provides for both reductions and
18 increases in a variety of services, the likelihood of an actual price squeeze is virtually nonexistent.
19 Finally, Wholesale services are subject to their own pricing rules and changes to those rates will take
20 place in separate proceedings designed to address those specific issues.

21 In summary, the Commission should reject the arguments of AT&T witness Selwyn
22 for a productivity factor of 6.5%. As shown in Attachment A to Exhibit S-5, Testimony of Harry
23 M. Shooshan, the productivity factor of 4.2% contained in the proposed Settlement Agreement is
24 well in line with the productivity factors of other states. The average productivity offset of the
25 twenty states surveyed was 3.2%. A similar survey conducted by Qwest produced an average

26
27 regulation." Subpart 6) c) provides in pertinent part: "[w]hether and under what terms and condition to renew the Price
28 Cap Plan will be determined by negotiations among Staff, Qwest, and other parties subject of the Commission's approval.
"

3 See Section 252(d)(3) of the Telecommunications Act of 1996 which governs the pricing of wholesale services provided on a resale basis.

1 productivity offset of 2.95% for various states. (Redding Rebuttal Test., Ex. Q-4 at 15). When all
2 of the above factors are considered, Staff's proposed productivity offset is reasonable and should be
3 adopted.

4 **2. The Proposed Price Cap Plan is Not Anti-Competitive.**

5 By far, the main arguments against the adoption of the proposed Price Cap Plan
6 contained in the Settlement Agreement focus on two provisions in the Price Cap Plan in
7 Attachment A, Subparts 4) e) and g); which provisions govern in part the treatment of flexibly-priced
8 competitive services contained in Basket 3. AT&T, Cox and RUCO all argue that these provisions
9 would allow Qwest to engage in anticompetitive and predatory pricing behavior against its
10 competitors. (Johnson Supplemental Test., Ex. RUCO-14 at 25-26; Collins Test., Ex. Cox-1 at 10-
11 11; Selwyn Supplemental Direct Test., Ex. AT&T-5 at 35-37).

12 Subpart 4) e) allows Qwest to include any Basket 1 service as a component of a new
13 service package for purposes of Basket 3, as long as the Basket 1 service is combined with at least
14 one Basket 3 service. This Subpart would also allow Qwest to place any new service into Basket
15 3. The Settlement Agreement provides that any proposal by Qwest to include a new service or
16 service package in Basket 3 is subject to Commission consideration as provided in A.R.S. Section
17 40-250.

18 Dr. Johnson, on behalf of RUCO, states that the Plan is "fatally flawed" because it
19 doesn't contemplate the possibility that a new service or service package might more appropriately
20 be classified as non-competitive. Dr. Johnson goes on to state that just because something is new
21 doesn't automatically ensure that competitive alternatives exist, or that Qwest should be given total
22 pricing freedom. (Johnson Supplemental Test., Ex. RUCO-14 at 25). What Dr. Johnson obviously
23 ignores, however, is the provision in the Settlement Agreement which requires Qwest to submit its
24 tariffs containing any "new services" or "new service packages" to the Commission at least 30 days
25 in advance of the proposed effective date of the tariff for consideration under A.R.S. Section 40-250.

26 Clearly, one of the things the Commission will be looking at is whether the proposed classification
27 is appropriate or not. In addition, Qwest and Staff have added specific language to this section of
28 Attachment A of the Settlement Agreement which states that: "The Commission retains the right

1 to reject any proposed classification or filing.” Certainly, the addition of this language should
2 alleviate many of Cox’s concerns.

3 Dr. Johnson also argues that new product offerings should be subject to the criteria
4 and procedures contained in Commission rule A.A.C. 14-2-1108. Id. at 26. As Staff witness
5 Shooshan pointed out, however, what Dr. Johnson proposes runs counter to consumers’ interests.
6 (Shooshan Rebuttal Test., Ex. S-6 at 7). Witness Shooshan stated that, “[p]utting truly new services
7 in Basket 3 ensures that Qwest bears the risk for the success or failure of the new service, not basic
8 telephone consumers.” Id. Dr. Shooshan further testified:

9 Part of what bearing the risk means is that Qwest decides what to charge and,
10 thus, is in control of the success of , or failure of the new service. This
11 greatly improves the incentives for Qwest to offer a variety of new services
12 in a way that benefits consumers. Either it offers a new service that
13 consumers embrace, and it is rewarded; or it fails to do so and its
14 shareholders incur a loss.

15 Id.

16 Qwest Witness Teitzel also testified that:

17 “[a]ny new services will simply be enhancements to the basic transmission
18 of voice provided over access lines. Treatment of new services in this
19 manner will facilitate the rapid deployment of new technologies and non-
20 essential, optional alternatives to Arizona consumers.”

21 (Teitzel Rebuttal Test., Ex. Q-28 at 12).

22 Qwest Witness Teitzel also noted that other states have adopted similar rules
23 concerning new services. Id. He stated that for example, in Montana, new services are automatically
24 afforded pricing flexibility and are treated as detariffed services. Id. He also stated that the same
25 is true in Utah and that in Oregon, new service introductions are not subject ot Commission
26 approval, and notice is not required to be provided the Commission of new service or package
27 introductions until 30 days following the effective date. Id.

28 While Staff witness Dunkel in his initial testimony expressed some reservation about
affording new services pricing flexibility, his initial testimony in this Docket was filed before the
Settlement Agreement was entered into and without regard to the terms and conditions of the
Settlement Agreement which was later entered into between Qwest and Staff. (Tr. at 592-93). Staff

1 witness Dunkel testified that the numerous restrictions put in the Settlement Agreement were
2 attempts to address the concerns he had identified in his earlier testimony in this Docket which
3 concerns he had raised in response to Qwest's proposed competitive zone proposal. Id.

4 In addition, the Staff and Qwest have further clarified Subpart 4 e) ii) of
5 Attachment A in response to the concerns raised by AT&T, Cox, and RUCO to read "The mere
6 repackaging of existing Basket 1 services does not create a 'new service' or 'new service package'
7 for purposes of the Price Cap Plan." The Commission should adopt the Settlement Agreement's
8 provisions regarding the treatment of new services and new service packages since many of the
9 concerns expressed ignore the many safeguards and restrictions contained in Attachment A to the
10 Settlement Agreement.

11 The other significant area of concern expressed by AT&T, RUCO and Cox pertains
12 to Subpart 4) g) contained in Attachment A to the Settlement Agreement. That provision would
13 allow "[n]ew services and packages in Basket 3 ... [to] be offered to selected customer groups based
14 on their purchasing patterns or geographic location, for example." The provision further states that
15 it shall not be "construed to permit red-lining based on criteria such as wealth or race, or to permit
16 Qwest to discriminate against any class of customers in violation A.R.S. Section 40-334."

17 Cox Witness Collins argues that this provision "substitutes 'spot' pricing and
18 'customer specific pricing' (with or without the presence of competition) for the 'competitive wire
19 center' criteria Qwest requested in its previous filing. (Collins Test., Ex. Cox-1 at 12). AT&T
20 shares these concerns. (Selwyn Supplemental Direct Test., Ex. AT&T-3 at 33-35). Dr. Selwyn
21 claims that Qwest could use the provision for geographically-specific rates to "...surgically 'take out'
22 competition that might actually arise." Id. at page 35. The Staff disagrees. First, both Cox and
23 AT&T ignore the fact that under Subpart 4) g), Qwest is also prohibited from discriminating "against
24 any class of customers in violation of A.R.S. Section 40-334." A.R.S. Section 40-334(a) expressly
25 prohibits the granting of any preference or advantage to any person or subjecting any person to any
26 prejudice or disadvantage. In addition, A.R.S. Section 40-334(b) expressly prohibits any public
27 service corporation from establishing or maintain any unreasonable difference as to rates, charges,
28 service, facilities or in any other respect either between localities or between classes of service.

1 Subpart (c) of A.R.S. Section 40-334 vests with the Commission the responsibility to determine any
2 question of fact arising under this Section. This important safeguard should act to prevent the type
3 of anticompetitive behavior which Cox and AT&T both point to as being permissible under this
4 provision of the Settlement Agreement. In that all such offerings must be submitted to the
5 Commission at least 30 days in advance of their going into effective for review and consideration,
6 any inappropriate classification or anticompetitive pricing which Qwest may attempt to engage in
7 on a limited geographic basis would result in Commission denial of its proposed filing.

8 **3. Other Concerns Expressed Relating To The Proposed Price Cap Plan**
9 **Indicate A Misunderstanding Of The Plan's Provisions Or Are**
10 **Meritless.**

11 AT&T, Cox and RUCO voiced several other concerns regarding the proposed Price
12 Cap Plan which indicated a misunderstanding of how the proposed Plan is to operate and/or are
13 meritless. First, RUCO witness Johnson expressed concern that the 25% restraint on price increases
14 for non-competitive, nonessential services contained in Basket 1 was too loose. (Johnson
15 Supplemental Test., Ex. RUCO-14 at 27). Dr. Johnson stated that instead the "...Plan should
16 include reasonable pricing limits on individual rate elements." *Id.* Dr. Johnson subsequently
17 testified at the evidentiary hearing that with the additional clarification offered by Qwest Witness
18 Teitzel on the operation of this provision, his concerns were diminished. (Tr. at 426-27). In
19 addition, the Staff and Qwest have agreed to clarify the existing language in Attachment A, Subpart
20 2) iii) so that it now reads: "Individual service rate elements within Basket 1, other than those
21 services listed in subpart I) above, may increase no more than 25 percent within a year."

22 Second, both Cox and RUCO argue that there should be additional Baskets added,
23 or that existing Baskets should be subdivided under the proposed Price Cap Plan. (Johnson
24 Supplemental Test. at 19-20; Collins Test., Ex. Cox-1 at 6). RUCO argues that the three basket
25 structure contained in the Settlement Agreement incorporates an "all or nothing" approach. (Johnson
26 Supplemental Test., Ex. RUCO-14 at 22). In urging that more baskets be incorporated or that
27 existing baskets be subdivided, both parties ignore the fact that Basket 1 is already essentially
28 subdivided in the sense that Basic/Essential services are treated differently from the Non-competitive

1 Non-essential services contained in Basket 1. The Basic/Essential services are subject to a hard cap
2 while the Non-competitive, Non-essential services in Basket 1 are subject to less stringent pricing
3 rules, including the 25% limit contained in Subpart 2) c) iii) of Attachment A. Therefore, there is
4 simply no need to add more baskets or further subdivide existing baskets. Indeed, even RUCO
5 witness Johnson noted in his testimony, that with the hard cap on essential services in Basket 1, his
6 concerns that “drastic rate restructuring” between business and residential rates could occur unless
7 business and residential services were placed in different baskets, was significantly ameliorated. Id.
8 at 20.

9 Finally, RUCO, AT&T and Cox all expressed concern regarding the application of
10 the Commission’s existing imputation rules. The Commission should address concerns relating to
11 the Commission’s imputation rules or their application in a separate proceeding. The Settlement
12 Agreement specifically provides that “[n]othing in this Price Cap Plan is intended to change or
13 modify in any way the imputation requirements contained in A.A.C. R14-2-1310. At the request of
14 several parties, Staff and Qwest have amended Attachment A to include this provision in Subpart
15 7 thereof. In addition, Attachment A, Subpart 4) e), as clarified by Staff and Qwest now provides
16 that the price of the new package or service shall exceed the TSLRIC of the package or service and
17 comply with the imputation requirements of A.C.C. R14-2-1310(c). The only change to the rules
18 application pertains to the treatment of 1 FR services. The Settlement Agreement, Attachment A,
19 at 4) e), now reads with clarifications adopted by Qwest and Staff as follows: “For purposes of
20 combining Basket 1 services with Basket 3 services and setting a floor for that package, the imputed
21 price of 1FR service shall be the existing retail price of 1FR.”

22 In summary, if there are concerns with the Commission’s existing imputation rules
23 and their application, these issues should be resolved in a separate proceeding.

24 **IV. MISCELLANEOUS AND CONCLUSION.**

25 This Brief has not attempted to address each and every issue raised in opposition to
26 the Settlement Agreement. The Settlement Agreement was entered into in an attempt to resolve
27 numerous contentious issues in a fair and reasonable manner, proposing just and reasonable rates for
28 Qwest and incorporating a Price Cap Plan which will form the basis for a transition to a fully

1 competitive telecommunications industry in Arizona. Where the parties have raised issues of
2 substance, Staff has responded to them. In addition, the statement of clarifying points, submitted
3 under separate cover, will address many of the issues that the parties raised over interpretation of the
4 Settlement Agreement. Whether those issues were raised due to genuine misunderstanding of the
5 Agreement, or merely to present obstruction to approval, is of little consequence.

6 There are two miscellaneous issues that warrant brief additional discussion in this
7 Brief. Cox has objected to what it calls the "support and defend" provision of the Settlement and
8 RUCO has objected to the provision of the Settlement which precludes the requiring of refunds in
9 the event a court finds the Price Cap Plan to be unlawful. Staff believes that the Settlement
10 Agreement should be approved, including the two provisions.

11 First, Staff fails to comprehend Cox's concern regarding the "support and defend"
12 provision. Cox witness, Dr. Collins indicates that he is concerned that the provision might be
13 unenforceable, and he also expresses concern about the nature and extent of resources required to
14 meet potential obligations under the provision. (Collins Test., Ex. Cox-1 at 5). Staff has several
15 responses. Cox is not a party to the Settlement, and accordingly assumes no obligation under the
16 "Support and Defend" provision of the Settlement. In addition, the intent of the provision seems
17 quite clear to Staff. That is, it is intended to ensure that signatories to the Settlement act together in
18 support of the Settlement should it be subject to challenge. The resources necessary or available to
19 comply with the provision can only be determined by each party in response to a particular challenge
20 that may or may not ever occur. Staff believes the provision to be clear and requests the Commission
21 to approve the Settlement including the provision.

22 RUCO witness Ralph Smith is concerned with Section 13 of the Settlement
23 Agreement, which provides that Qwest shall have no obligation to refund revenues collected during
24 the term of the Price Cap Plan, should the Price Cap Plan be determined by an Arizona court to be
25 unlawful. Mr. Smith contends in his Supplemental Testimony that Qwest should be required to
26 refund amounts it collects, should that eventuality occur. (Smith Supplemental Test., Ex. RUCO-13
27 at 4).

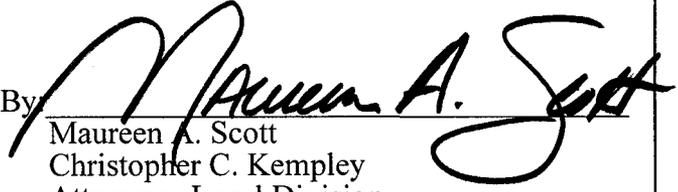
28 ...

1 Staff continues to support the Settlement Agreement as proposed. The Settlement
2 Agreement, including the Price Cap Plan, provides for a wide range of changes in rates for specific
3 services. Some of the rates go up, some go down. For example, under the Settlement Agreement
4 and Price Cap Plan, basic residential rates are subject to a "hard cap" for the term of the Plan.
5 Accordingly, basic residential rates cannot increase during the term of the Plan. However, as a result
6 of the operation of the Price Cap Index, it is possible that basic residential rates could go down
7 during the term of the Price Cap Plan. In order to fairly administer a refund, should the Price Cap
8 Plan be deemed unlawful, fairness would seem to dictate that individuals whose rates increased
9 under the putatively unlawful Plan should be entitled to refunds, but, those whose rates decreased
10 under the same order, should be required to pay surcharges. Even if it were possible to compute the
11 correct amounts of refund and surcharge, the administrative difficulty and cost associated with such
12 a proposal would appear to be prohibitive. Mr. Smith acknowledged the difficulty under cross-
13 examination. (Tr. at 765-69). Since the question of whether to require refunds is discretionary with
14 the Commission in such a situation, Staff supports the Settlement Agreement. The Settlement
15 Agreement implicitly finds that the complexity of determining a refund amount and methodology
16 would be so great that the better course of action is to determine new rates only on a going forward
17 basis, should a finding of unlawfulness be made.

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1 In conclusion, the Settlement Agreement between Staff and Qwest represents a fair
2 compromise of contested claims in a rate case with many complex issues and a long, difficult
3 procedural history. We believe the resultant rates to be just and reasonable, providing Qwest an
4 opportunity to earn a fair return on the fair value of its property devoted to public service in Arizona.
5 In addition, we believe the Price Cap Plan provides a reasonable regulatory response to the changing
6 competitive environment in which Qwest operates in Arizona. It has been developed in a manner
7 calculated to comply with Arizona's constitution. It provides Qwest with a reasonable ability to
8 respond to the changing competitive environment, while embodying protections for captive
9 customers during the time of transition. The Commission should approve the Settlement Agreement
10 as proposed.

11 RESPECTFULLY SUBMITTED this 18th day of December, 2000

12
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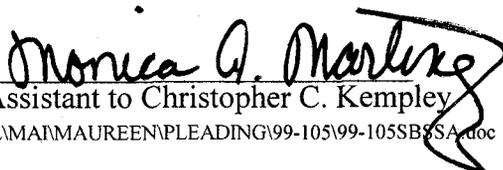
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