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February 9, 2001

Arizona Corporation Commission
DOCKETED
FEB 12 2001
DOCKETED BY

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 ***AT&T's Exceptions to Proposed Opinion and Order*** in the above named docket. An electronic copy of the brief will be sent via e-mail to the e-mail service list on Monday, February 12th. Please call me if there are any questions concerning this filing.

Very truly yours,

Davis Wright Tremaine LLP

Larry J. Weathers

Larry J. Weathers
Paralegal

Enclosures

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BEFORE THE ARIZONA CORPORATION COMMISSION

2001 FEB 12 A 11: 43

AZ CORP COMMISSION
DOCUMENT CONTROL

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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 **AT&T'S EXCEPTIONS TO PROPOSED OPINION AND ORDER**

I. INTRODUCTION

On October 20, 2000, Qwest and Commission Staff filed a proposed Settlement Agreement and Price Cap Plan requesting that the Commission approve a fundamental restructuring of the nature of telecommunications regulation competition in Arizona. Members of the public who commented on this proposal on November 29, 2000, almost universally urged that it be rejected. This public response should not be surprising. The proposed settlement will provide substantial benefits to Qwest with limited counterveiling benefits to consumers and significant potential for harm to both consumers and competition in the state's telecommunications markets.

The Hearing Examiner's Proposed Order has addressed some of the serious problems evident in the Price Cap Plan as initially proposed by Commission Staff and Qwest. Nevertheless, the Proposed Order does not cure the harm to consumers and competitors at the core of the proposed settlement. The Price Cap Plan remains contrary to the public interest. AT&T, therefore, takes exception to the approval of the proposed order and urges the Commission to reject the Settlement Agreement and Price Cap Plan in its entirety.

II. DISCUSSION

The Commission should reject the proposed Settlement Agreement and Price Cap Plan for two fundamental reasons. First, the procedure surrounding the filing of the Settlement Agreement and its proposed approval has been rushed and flawed, depriving intervenors of fundamental rights. Second, and perhaps because of the rushed nature of the proceedings, the proposed settlement has fundamental structural flaws. Although the procedural flaws with the proceeding prevented the intervenors from creating a full and adequate record in this proceeding, the record does reveal a number of deficiencies that make this plan contrary to the public interest. These problems include the following:

1. **Overstated Revenue Requirement.** The revenue requirement established by the Price Plan will allow Qwest to over-earn in Arizona to the detriment of Arizona consumers.

2. **Insufficient Switched Access Reductions.** Because Qwest is permitted to over-earn, the proposed Plan does not sufficiently reduce Qwest's charges for switched access to a competitive level, ensuring that intraLATA toll rates for Arizona consumers will remain higher than they would be in a competitive market.

3. **Insufficient Productivity Adjustment.** The Plan fails to share with consumers the gains that Qwest is likely to experience in productivity over the term of the Plan.

4. **Automatic Pricing Flexibility for New Services.** The Plan gives Qwest pricing flexibility for new services that will enable Qwest to injure competitors in local telecommunications markets.

Any one of these flaws would be sufficient to justify rejection of the Plan. In combination, these flaws ensure that the Price Cap Plan will act to the detriment of Arizona consumers.

A. The Proposed Settlement Should Be Rejected Because the Approval Process Is Procedurally Flawed.

Qwest and Staff first filed the proposed Settlement Agreement and Price Cap Plan on October 20, 2000. The public and intervenors had only limited opportunity to review and analyze the proposal. Intervenors were required to file testimony addressing their concerns with the proposal on November 13, 2000, only three weeks after the proposal was first filed. The parties were then required to proceed to hearing two weeks later on November 29, 2000.

This rush to judgment prevented the parties from developing an adequate record. For example, the Hearing Examiner permitted the parties to file proposed changes to the Plan with post-hearing briefs on December 18, 2000. With additional time to review the Plan, AT&T was able to present substantial additional proposals for revisions that would bring the Plan closer to the public interest. *See* AT&T Post-Hearing Brief, Appendix A. Nevertheless, AT&T was not able to develop a record at the hearing with respect to the proposals because of the short time it had to develop testimony objecting to the settlement.

AT&T and other intervenors objected on several occasions to the rush to judgment forced in this proceeding. *See, e.g. Joint Motion of AT&T and Cox to Reconsider Procedural Order*, (filed November 15, 2000). Given the substantial changes brought by the proposed settlement upon telecommunications regulation in the state, there was no reason for the haste with which this matter was heard. That haste prevented the full and complete development of information that would be relevant to the Commission evaluating the proposal. This is reason enough to reject the Price Cap Plan.

In addition, procedural and evidentiary orders entered before and during the course of the hearing on the Settlement Agreement also prevented the development of an adequate record upon which the Commission could evaluate the proposal. The issue before the Commission in evaluating the settlement is whether, in light of the entire record, the settlement reasonably resolves the issues before it. *See Mobil Oil Corp. v. Fed. Power Comm'n*, 417 U.S. 283, 313, 94 S.Ct. 2328, 2348, 41 L.Ed. 2d 72 (1974); *Business and Professional People for the Public Interest v. Illinois Commerce Commission*, 136 Ill. 2d 192, 144 Ill. Dec. 334, 555 N.E.2d 692, 704 (1989). In this case, the Hearing Examiner accepted into the record all of the testimony previously filed by the parties. The Hearing Examiner necessarily relied upon this evidence in determining the reasonableness of the settlement. Nevertheless, the Hearing Examiner did not permit the intervenors to cross-examine Qwest and Staff witnesses except on testimony filed specifically in support of the settlement. Staff and Qwest introduced more than 40 testimonial exhibits upon which parties objecting to the Price Cap Plan had no opportunity to cross-examine.

Cross-examination is a fundamental right necessary for a fair hearing. *Division of Finance v. Industrial Commission*, 159 Ariz. 553, 556, 769 P.2d 461 (App. 1989); *see also* A.A.C. R14-3-104(A). By denying parties the opportunity to cross-examine on evidence included within the record for a decision, intervenors have been denied a fundamental right. On procedural grounds alone, therefore, the Proposed Order accepting the Qwest/Staff settlement must be rejected.

B. The Proposed Agreement Is Substantively Flawed And Fails To Further the Public Interest.

As initially proposed, the Price Cap Plan and Settlement Agreement were riddled with errors and ambiguities. Although Qwest and Staff both took the position during hearings on the Settlement Agreement that the Commission was required to accept or reject the settlement without changing it, Qwest and Staff did agree to remedy some of the more obvious errors prior to the Hearing Officer's Proposed Order. The Hearing Officer has now proposed additional revisions that address a few of the concerns raised by intervenors in this proceeding. The revisions, however, do not address the core problem that the Settlement Agreement fails to secure sufficient benefits for consumers to justify the tremendous benefits and competitive advantages provided to Qwest by the settlement. The proposed settlement is not in the public interest and should be rejected for this reason as well.

1. The Revenue Requirement Established by the Settlement Is Overstated.

The Proposed Order accepts a compromise between Staff and Qwest that will allow Qwest to impose a $42.9 million rate increase on Arizona consumers. This position is unjustified and should be rejected.

AT&T, RUCO, and the Department of Defense each filed substantial testimony in this proceeding describing the adjustments required to Qwest's proposed rate base and earnings to develop a revenue requirement that would lead to just and reasonable rates. All of these witnesses determined that Qwest was over-earning. Staff witnesses as well identified significant problems with the revenue requirement proposed by Qwest. Although the testimony of Staff witnesses supported a slight increase in Qwest's current revenue requirement, the cumulative effect of reductions proposed by all the parties would be to decrease Qwest's revenue in Arizona by more than $200 million from their current level. *See* Exs. Staff 16, AT&T 6 to 9; RUCO 3, DOD 2 and 3.

Qwest and Staff have provided no adequate justification for their "compromise" that allows Qwest to impose a $42.9 million rate increase on Arizona consumers. In contrast, many states have required substantial rate reductions from local exchange carriers in moving to price cap regulation as a trade-off for gaining the pricing flexibility permitted under such a plan. RUCO Ex. 14 at 9-10. Moreover, given the record before the Commission, there is simply no basis that would permit the Commission to determine that such a substantial rate increase is just and reasonable.

During the course of the hearing on the proposed settlement, Qwest witness Mr. Redding admitted that Qwest and Staff arrived at the agreed revenue requirement by according no value to adjustments proposed by any party other than Staff. Tr. 166. In essence, Staff and Qwest agreed that the Commission would not accept these other adjustments. This approach removes from the Commission an opportunity to make its own decision as to an appropriate and reasonable revenue requirement.

As an example, consider the directory imputation adjustment proposed by AT&T witnesses Dr. Selwyn and Ms. Gately. This adjustment is based on the principle that Qwest's directory business in Arizona is a regulatory asset of Qwest in Arizona and that Qwest should, therefore, be required to impute to its regulated business the fair value of fees and services provided by Qwest in Arizona to the directory affiliate. *See*, *e.g.*, Ex. AT&T 9 at 29-39. Dr. Selwyn's analysis determined Qwest should be required to impute the full amount of Yellow Pages revenues attributable to Arizona, net of expenses -- $184 million. *See* Ex. AT&T 5 at 33.

Staff witness Mr. Brosch conducted his own analysis of the imputation requirement. He determined that the amount of imputation that should be required was between $93 million and $104 million. Ex. Staff 7 at 48. Yet, notwithstanding this calculation, Staff and Qwest agreed to impute only $43 million in calculating the revenue requirement for purposes of the Settlement Agreement.

The only basis for Staff's decision to agree to such a limited imputation amount is a 1988 settlement agreement between the Commission and Qwest predecessor, Mountain Bell. *See* Ex. Qwest 48. Both that settlement and case law interpreting the settlement, however, recognize that the amount agreed upon as imputation in 1988 could be adjusted in future rate cases. *Id; see also* Ex. Qwest 49. Moreover, as Mr. Brosch himself admitted,

> That $43 million amount is woefully inadequate as imputation of a reasonable ratepayer's share of the directory publishing business.

Id. at 47.

Based on the testimony of Staff witness Mr. Brosch and AT&T witness Dr. Selwyn, the Commission very well could have determined that a directory imputation adjustment significantly larger than $43 million was required to ensure that Arizona consumers were treated fairly and charged just and reasonable rates. This single adjustment, even using Mr. Brosch's calculation on behalf of Staff, would eliminate or virtually eliminate the additional revenue requirement established by the Settlement Agreement. Nevertheless, Staff and Qwest ignored this adjustment in coming to an agreement.

AT&T, RUCO and the Department of Defense have proposed numerous other revenue adjustments that should have been accorded value for the purposes of settling this dispute. Even if only some or a portion of these adjustments were adopted, it is clear that the Settlement Agreement starts from an improperly inflated revenue requirement in determining rates that Qwest may charge to Arizona consumers under the Plan. The rates generated under the Plan, therefore, cannot be just and reasonable. For these reasons alone, the Commission must reject the Proposed Order.

2. The Agreement Fails to Set Access Rates at Cost.

In order to reach end use customers who receive their local service from Qwest, providers of toll services have no option but to purchase switched access services from Qwest to originate and terminate toll calls. *See* AT&T Ex. 2 at 5-6. Because Qwest still maintains monopoly power in the local market, Qwest is able to charge substantially more than its cost of providing switched access services. *Id.* at 22-23; *see also* Tr. 186. This injures Arizona consumers by improperly inflating the cost of toll services. *Id.* at 34-35. As Qwest agrees, switched access must move towards cost to mirror the rates that would result from a competitive market. Tr. 189.

Recognizing these concerns, Staff expert Mr. Shooshan recommended that Qwest's switched access prices be reduced substantially over the course of the Price Cap Plan. *See* Ex. Staff 12 at 12. Mr. Shooshan recommended that access rates be reduced to a level agreed upon by Qwest as part of the CALLS proposal for interstate access charges. *Id.* This would require a reduction of Qwest's access charges from the composite rate of approximately 4.5 cents per minute charged today[1] to the interstate rate of 0.5 cents per minute. *See* Ex. AT&T 1 at 3.

The proposed Settlement Agreement abandons this approach, guaranteeing the toll rates for Arizona consumers will remain higher than they would experience in a competitive market. Under the proposed agreement, access rates are reduced by only $15 million over the 3-year term of the Plan, resulting in a composite rate of 3.3 cents per minute. *Id.* The gap between cost and price of switched access under this proposal remains astronomical. This has a substantial negative impact on consumers and competition in Arizona's telecommunications market. *Id.* at 8

If the Commission recognized that Qwest is actually overearning and that revenue reductions should be ordered rather than the substantial revenue increase allowed by the Proposed Order, switched access charges could easily be reduced towards cost. AT&T has proposed reducing switched access rates to interstate levels over a five-year transition period, consistent with the transition Qwest has agreed to accept in the CALLS proposal. This reduction

[1] 4.5 cents is the switched access average weighted rate per minute for origination or termination of a telephone call. The cost to an interexchange carrier to both originate and terminate a telephone call on Qwest's network is 9 cents per minute.

in charges would benefit Arizona consumers by allowing intraLATA toll rates to go down. Without such a reduction, however, the settlement is contrary to the public interest and should be rejected.

3. The Agreement Fails to Share Productivity Gains with Consumers.

The very purpose of a price cap plan is to allow both the incumbent carrier and consumers to benefit from operating efficiencies achieved by the carrier during the course of the Plan. *See* Ex. AT&T 5 at 5. As with most price cap plans, the Qwest/Staff proposal uses a productivity or "X" factor to attempt to capture Qwest's increased efficiency. The Proposed Order accepts this 4.2% X-factor proposed by Staff and Qwest. However, this X-factor allows Qwest to retain most of the benefit of efficiency rather than sharing it with consumers. For this reason, this ruling of the Proposed Order is also detrimental to the public interest.

There are a number of significant problems with the proposed X-factor agreed upon by Qwest and Staff. First, Staff has admitted that the calculation relies on insufficient data. In addition, the factor is significantly below productivity factors accepted by Qwest both at the FCC and in other states. There is also no proposal to adjust for additional productivity gains Qwest may experience during the three-year period of the Plan, such as gains resulting from the merger between U S WEST and Qwest and the sale by Qwest of rural exchanges to Citizens. Finally, the X-factor does not apply across the board to all Qwest services, but rather only to the monopoly services in Basket 1. This results in an actual effective X-factor that is substantially below the 4.2% represented in the Settlement Agreement. These significant limitations in the productivity calculation ensure that consumers will not benefit from all of Qwest's anticipated efficiency gains during the term of this Plan.

Staff conducted no independent productivity study in determining an appropriate factor for measuring Qwest's efficiency gains. The productivity data relied upon in calculating the X-factor proposed by the Plan is based completely upon limited evidence provided by Qwest of its past productivity gains. Ex. Staff 12 at 12-13. Mr. Shooshan, whose staff performed the calculation, has admitted that Staff sought additional information from Qwest to ensure the accuracy of its calculation. *Id.* Mr. Shooshan did not receive that information in time for use in calculating the 4.2% X-factor used in the proposed settlement, and he has never reanalyzed the calculation based on the additional information. Ex. 3 at 13-14.

Because Mr. Shooshan had such limited information, he relied upon figures including an adjusted Qwest revenue stream, with no evidence of the basis for the adjustments. Without knowing whether the adjustments where appropriate, Staff should have used an unadjusted Qwest revenue stream to ensure a more accurate measure of Qwest's productivity gains. Ex. AT&T 3 at 13-14. Use of the proper unadjusted revenue stream results in an X-factor of at least 5.3%. *Id.* at 14.

This higher X-factor is more in line with productivity adjustments accepted in other Qwest jurisdictions. For example, earlier this year, Qwest became a signatory to the CALLS settlement in which it agreed to a 6.5% X-factor for reductions to interstate switched access charges. *Id.* at 12. Qwest has also recently agreed to a 6.2% X-factor for the price formula adopted in Utah. *Id.*, 20-21. Qwest has provided no explanation for why this Commission should agree to a smaller X-factor than those Qwest has voluntarily agreed to accept in other jurisdictions.

One of the reasons that the Commission should require a larger X-factor is the likelihood that Qwest will, in fact, experience greater productivity increases during the term of the Plan than it has historically experienced. Qwest represented to the Commission in the merger proceeding regarding the Qwest/U S WEST merger that the merger would result in efficiency gains. Tr. 79-80. The historical data used in this proceeding, however, did not take these efficiencies into account. Tr. 83. The historical data also did not take in account efficiencies that Qwest may experience due to sales of high-cost exchanges that it expects to complete sometime in 2001. Failure to consider these factors must render the Settlement Agreement's productivity adjustment suspect.

Finally, because the X-factor applies only to services found in Basket 1, the actual effective X-factor is substantially below the 4.2% set forth in the Agreement. Qwest witness

Ms. Mason has admitted that if Qwest experiences productivity gains for the retail services in Basket 1, there is no reason to believe that it will not also experience those gains for the wholesale services in Basket 2. Tr. 114. This makes sense, since the same underlying facilities are used by Qwest to provide both wholesale and retail services. There is no reason for limiting the benefit of Qwest's increased productivity to monopoly retail services, particularly when competitors must make use of wholesale services provided by Qwest in seeking to make competitive inroads to Qwest's monopoly.

The effect of not applying the X-factor in Baskets 2 or 3 is that the overall productivity benefit to Arizona consumers is substantially less than 4.2%. Although the actual X-factor cannot be calculated without knowing precisely what share of Qwest's revenue is represented in each Basket, the following table shows what the effect of X-factor would be making logical assumptions about the revenue share and the possible year-to-year increase in the gross domestic product-price index ("GDP-PI").[2]

Basket	Applicable X-Factor	Revenue Share	Weighted Value
1	- 4.2%	50%	- 2.10%
2	- 2.0%	25%	- 0.50%
3	+ 10.0%	25%	+ 2.50%
EFFECTIVE X-FACTOR			- 0.10%

This example demonstrates that when viewed comprehensively across all of Qwest's intrastate services, the "productivity offset" may all but vanish. This will necessarily result in excessive rate levels. AT&T Ex. 3 at 23.

Because the Plan as set forth in the Proposed Order does not guarantee that consumers will achieve the benefits of productivity gains and efficiencies achieved by Qwest, the Plan again is contrary to the public interest and should be rejected.

[2] This table is reproduced from AT&T Ex. 3 at 23.

4. The Proposed Order Does Not Fully Address the Potential for Competitive Injury Permitted by the Plan's Pricing Flexibility Provisions.

The Price Cap Plan as initially proposed by Qwest and Staff created the potential for Qwest to eliminate actual and potential competition in Arizona's telecommunications markets. The Proposed Order rightly recognizes these problems. The Proposed Order takes necessary steps to protect competitors by eliminating provisions in the Qwest/Staff proposal that would have allowed Qwest to reclassify noncompetitive services as competitive at will and to offer different prices and services in different geographic areas without justifying the price or service differential. The Proposed Order also helps to ensure that Qwest may not act anticompetitively by requiring that competitors be given notice when Qwest seeks competitive classification for existing or new services.

Two problems remain that allow Qwest the ability to harm competitors and competition contrary to the public interest. First, Qwest must now comply with the provisions of A.C.C. R14-2-1108 in order to obtain competitive treatment for new services. The Proposed Order creates a new and lesser standard for when new services may be classified as competitive. In essence, the Proposed Order amends an existing Commission rule without meeting the requirements of a rulemaking under Arizona law.

This provision of the Proposed Order may permit Qwest the flexibility to price a new service competitively even if it does not, in fact, face competition for the service. For example, today custom calling features are treated as monopoly services because Qwest continues to maintain monopoly power in the provision of local exchange service, and with it a monopoly in the provision of calling features to local exchange customers. Under the proposed settlement, Qwest could introduce a new custom calling feature and have that feature declared competitive, even though the features can only be offered by Qwest as a monopoly provider of local service. Tr. 284. Qwest could then reap monopoly profits from the service by pricing that service far above its actual cost of providing the new feature.

The second problem with the Proposed Order's treatment of pricing and competitive issues is that the Proposed Order does not fully address the extent of Qwest's pricing flexibility. The Price Cap Plan states that Qwest will be required to meet the Commission's imputation rules in establishing the price floors for services offered in Basket 3. The Plan does not indicate, however, what elements Qwest will be required to impute into the price floors of competitive services. As it became clear at the hearing, Qwest and Staff have strikingly different views as to what imputation will be required.

AT&T and other intervenors proposed that the issue of the price floors for competitive services should be resolved in the Price Cap Plan itself. The Proposed Order instead would open a new docket to address scope of the Commission's imputation rules. AT&T does not have an exception to this proposal. Nevertheless, this will require that the Staff be diligent in assessing Qwest's prices for competitive services until the proposed investigatory docket is complete.

C. Additional Proposals to Increase Benefit to Consumers.

In addition to these problems with the Plan, AT&T proposed the adoption of additional changes that would benefit Arizona consumers as part of its post-hearing filing. Although the procedural posture of the proceeding prevented AT&T from fully developing a record on these proposals, the Commission should con

First, the plan as originally proposed by Staff witness Mr. Shooshan would have extended for a five-year term. *See* Ex. Staff 5 at 3. This extended term would benefit Arizona consumers by ensuring that the plan is "long enough for the new incentives to have impact, but short enough to enable the Commission to review the Company's performance under the plan to ascertain that it is actually providing the expected benefits to consumers." *Id.* AT&T, therefore, proposed that the plan should be extended to five years as originally proposed by Staff. The Proposed Order's failure to change the agreement between Qwest and Staff to extend the term of the Price Cap Plan is contrary to the public interest.

The Plan should also incorporate an opportunity for consumers to share explicitly in any excess earnings generated by the Plan. It is common for an incumbent under a price cap plan to share the benefits of overearning. AT&T has proposed that Qwest be permitted to decide whether it will be protected against the risk of under earning in return for sharing part of any overearning with consumers.

Finally, AT&T has proposed strengthening of the service quality provisions of the Plan in order to ensure that Qwest does not sacrifice service quality in response to the increased pricing flexibility that the Plan provides. It is common for local exchange carriers to agree to increased service quality oversight under relaxed regulation to ensure that carriers do not sacrifice quality as a result of the increased ability to benefit financially from efficiency gains. The Proposed Order's failure to achieve this protection for Arizona consumers again takes the Qwest/Staff settlement agreement outside the public interest.

III. CONCLUSION

AT&T agrees that Price Cap regulation, if properly implemented, is a laudable step toward competitive markets and public benefit in Arizona. The Proposed Order, however, adopts a plan that is hastily conceived and fails to gain for consumers the benefit that they deserve as a condition of decreased regulation for Qwest. For all these reasons, AT&T requests that the Commission reject the Proposed Order adopting the Qwest/Staff Settlement Agreement and Price Cap Plan.

DATED this 9th day of February, 2001.

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CERTIFICATE OF SERVICE
ACC Docket No. T-01051B-99-0105

I hereby certify on this 9th day of February 2001, that the original and 10 copies of ***AT&T's Exceptions to Proposed Opinion and Order*** were filed via FedEx next business morning service to:

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Dated this February 9, 2001

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