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ARIZONA CORPORATION COMMISSION

BRIAN C. McNEIL
EXECUTIVE SECRETARY

March 2, 2001

Chairman William A. Mundell
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Re: Qwest Proposed Rate Case Settlement
Docket No. T-01051B-99-0105

Dear Chairman Mundell:

The Staff has prepared the following response to the issues raised in your March 1, 2001, letter to Commissioners Irvin and Spitzer regarding the proposed settlement of the Qwest Corporation, Inc. ("Qwest") rate case.

1) **The $43 million revenue requirement/rate increase has no hard data basis but rather is a negotiated sum not tied to a cost of service analysis.**

While the $43 million revenue requirement/rate increase is a negotiated sum, there is more hard data behind the revenue requirement in this Docket than any rate case in recent ACC history. The Company has made two complete filings based upon different test years, with several updates and corrections at intervening times. Staff, RUCO and the other intervenors have conducted extensive discovery on all of these filings and have each made multiple testimony filings before and after the Settlement Agreement was published. The negotiated settlement reduced the $266 million revenue requirement requested by the Company in its updated filing to $43 million, or about 16% of the amount requested. The Settlement Agreement represents a vigorously negotiated resolution of a handful of specifically identified adjustments which compromises were defined and quantified on the record. Additionally, Staff also carefully weighed the risks of proceeding with a full blown rate case, where the Commission could have ruled against it on a number of these adjustments, which would result in a revenue requirement much greater than the negotiated amount of $43 million.

By its very nature, a settlement of any proceeding is the result of multiple negotiation discussions and "give and take" on any number of differences between the parties. As you are aware, seldom will settlement negotiations address each "difference" line-by-line in an effort to reach a "finding" on which party won or lost each issue. Such an approach would produce a chilling effect on the willingness of the parties to come to the table in good faith in order to avoid the commitment of the extensive resources required to support the litigation process.

In March of 1999, Staff retained the consulting services of Utilitech and its subcontractors for assistance in reviewing the multiple binders of evidence and workpapers filed by USWC/ Qwest as part of its prefiled evidence. On August, Staff retained Strategic Policy Research to assist in evaluating alternative regulation issues. To date, the Staff and its consultants have considered, reviewed and evaluated two separate test years filed by the Company at a cost exceeding $600,000 for Staff consulting services alone. During this process, thousands of documents have been reviewed and considered in the formulation of Staff's position on the issues.

During the extended period this proceeding has been pending before the Commission, the parties have submitted and reviewed responses to extensive discovery. Staff alone has submitted approximately 118 discovery requests for information, many containing multiple parts. Staff filed voluminous direct and surrebuttal testimony with 13 exhibits that served to analyze and present Staff views on various issues that arose during this proceeding. This Staff evidence presented 37 adjustments (i.e., to both rate base and operating income) and discussed various recommendations supporting alternatives to the Company's updated filing, that employed a test year ending December 1999. Six additional testimonies were prepared and subjected to cross examination at hearings to explain in considerable detail the Settlement Agreement.

Staff's willingness to enter into the settlement was based on the careful and deliberate analysis and consideration of extensive factual evidence obtained during Staff's investigation and contained in the record of this proceeding.

2) **The test year reviewed was 1999. The rapid growth in access line and other revenue sources are therefore, not adequately accounted for in the Order.**

Qwest originally filed its rate case revenue requirement exhibits on March 15, 1999, based on an historic test year ended June 1998. However, the processing of that filing was delayed considerably by the Commission's deliberation of depreciation accrual rates in Docket No. T-01051-97-0689. During a procedural conference on April 4, 2000, the Chief Hearing Officer concurred with Staff concerns regarding the staleness of the original test year and ordered Qwest to submit an updated filing based on a test year ended December 1999. Thus, the Company has already presented two separate revenue requirement filings in this case.

Although the ACC has typically adopted a historic test year, other commissions have employed a variety of test year approaches for ratemaking purposes, including historical, forecast, and historic with partially forecasted elements. Each of these test year approaches have strengths and weaknesses. One of the weaknesses of using a historical test year is that it typically results in a phenomenon referred to as "regulatory lag". The concept of "regulatory lag" refers to the time delay between the end of the selected test year and the issuance of an order revising rates based on the results of that test year. With a historic test year, it is not unusual for a rate order to issue in early 2001 based on a calendar 1999 test year.

In the instant proceeding, the complexity and delays in the Docket concerning the Company's proposed depreciation rates was the primary factor contributing to the extensive delay that lead to the Staff's recommendation to update the historic test year from the twelve months ended June 1998 to December 1999, which consisted of the most recent information available at that time. Absent this update, the revenue requirement underlying the Settlement Agreement now before the Commission would have been based on data that was, on average, 18 months more stale that the updated 1999 test year. Because of the delays resulting from the Depreciation Docket, the Company's updated filing was processed on an expedited time line.

If a more recent test year is to be substituted at this juncture, it should be recognized that the Company would likely require several more months to prepare and assemble a second update to the test year (e.g., using data for calendar year 2000), which would once again need to be examined and evaluated by the Staff and other parties. This examination would include the submission of extensive discovery on the new test year and the filing of additional direct, rebuttal and surrebuttal testimony. The additional hearings or evidence in this matter would ensure that rate changes sought by the Company about two years ago will not be resolved for many more months.

The regulatory process is admittedly imperfect. However, the Staff does not believe that the answer to the current dilemma is yet another test year update, with the unavoidable delays required for further analysis and processing of the "new" filing. Instead, the Staff recommends that the Commission hold the March 7, 2001, opening meeting as currently scheduled and that Staff, Qwest and the parties be given an opportunity to address the Commission's concerns at that time.

3) **The depreciation decision resulted in shorter depreciation lives for certain assets, but the actual percentage of assets retired appear to be considerably less than what was anticipated by the Commission based on the applicant's representations.**

Depreciation accrual rates are based upon studies of estimated asset lives as well as other parameters, such as removal costs and salvage. From one year to the next, the rate of retirement of existing assets can vary considerably. Since the Commission's depreciation order was issued only about ten months ago, it would be difficult, if not impossible, to judge yet whether or not asset lives for any specific plant accounts or all plant in general were reasonably estimated in the Commission's Order. Because of the very concerns you raise, however, the Settlement Agreement specifically provides for monitoring of new investment and retirement experience after more experience can be quantified and evaluated in the scheduled review of the Price Cap Plan.

The result of more rapid depreciation accruals resulting from the Commission's Order is accelerated future growth in the accumulated depreciation reserve, which will reduce future rate base. For every dollar of additional depreciation collected from customers, the future revenue requirement is reduced because of this rate base reduction impact. In the scheduled review of the Price Cap Plan under the Settlement Agreement, the rate base effect of larger depreciation accruals will be fully captured in Staff's financial review of achieved rates of return on rate base. Thus ratepayers will receive full "credit" for the larger depreciation charges upon review of the Price Cap plan based upon actual retirement results.

In the scheduled Price Cap Plan review in year three, all parties and the Commission will be able to fully consider actual plant investment and retirement levels to discern whether service prices should be further reduced or the Price Cap Plan otherwise modified. Staff insisted upon a limited initial plan term and the third-year financial review for several reasons, including the need to carefully consider depreciation accruals and plant investment/retirement levels with actual empirical data, prior to recommending a more permanent plan. Staff believes the provisions of the Settlement Agreement in this regard are reasonable since retirements are inexorably driven by the responsibilities of management to prudently plan and manage its Arizona telecommunications network without excessive or inadequate capital investment, human resources and technological improvements.

4) **The mere monitoring of capital investment seems to be an inadequate oversight mechanism.**

Staff agrees that the Company has the responsibility to prudently manage its business and should be held fully accountable by regulators, customers and investors in the discharge of this responsibility. "Investments" are one of the critical input resources required to provide high-quality services at reasonable prices. The other critical inputs include having the proper mix of human resources, information technologies, purchased materials and a myriad of purchased services. While the Commission could take a more active role than monitoring capital investments, and actually prescribe the schedule and timing of future capital investments by Qwest, Staff is concerned that there may still be no assurance that more efficient results could be attained.

Staff also believes that the concern identified will also be addressed in large part through two important components of the Settlement Agreement, the Price Cap Plan and the additional service quality provisions and penalties. Qwest will have no incentive to over- or under-invest in the Arizona network under price cap regulation. Price cap regulation tends to "unhook" traditional earnings review and depreciation prescription from revenue levels prospectively. However, if Qwest collects more depreciation than is invested in the Arizona network, and therefore, experiences reduced future rate base, any resulting excessive earnings in the scheduled review of the Plan, may suggest further reductions in prices and revenues as a condition of Plan extension.

Under the Settlement Agreement, Qwest is held fully accountable for both service price and service quality. If Qwest does not invest adequately in the Arizona network as well as all other key inputs (labor, training, technology, etc.), customer credits are expanded in the Settlement Agreement for any resulting service quality deterioration. If Qwest responds to the enhanced incentives to reduce its costs while providing good quality service, the cost reductions will be quantified and "captured" for ratepayers in the scheduled financial review of the plan in year three. A thorough review of the Company's services, prices, costs and investment levels will be conducted during year three of the Plan, and Staff will recommend to the Commission any necessary changes to the Plan which are supported through the course of that review.

5. **The $43 million imputation for the directory publishing business needs to be more closely examined.**

This issue has been the subject of an exhaustive examination by the Staff and its consultant in this and the three previous Arizona rate cases, as well as in several other Qwest rate cases in Washington and Utah. The Settlement Agreement rejects Qwest's proposal to completely eliminate directory imputation, in favor of Staff's recommendation to impute $43 million. Staff's recommendation is set forth in extensive testimony of Michael Brosch in Exhibit S-7 at pages 28-48 and Exhibit S-8 at pages 9-17 on this issue. However, to fully appreciate how "closely examined" this issue has been, one must consider the record, hearings and appeals from Qwest's last Arizona rate case.

Staff's recommended imputation amount in the last Arizona rate case was $60.3 million and was sponsored by Mr. Brosch and approved by the Commission in Decision No. 58927. This imputation amount was based upon the actual financial results of the publishing affiliate and exceeded the $43 million imputation amount that had been established in a Settlement Agreement between Staff and U S West dating back to 1988 that was approved by the Commission in Decision No. 56020. After approving the $60.3 million imputation in the last rate case, the Commission's Decision was appealed, remanded and modified to the $43 million level required by the Court of Appeals. Exhibit S-7 in this rate case describes in detail the background of these facts and the history of imputation in Arizona at pages 30 through 32.

The Court of Appeals Order cited the Commission-approved 1988 Settlement Agreement and stated, "[t]he imputation method approved in the agreement was not the excess-profit imputation adopted by the Commission but rather a method dependent upon proof of 'the fees and value of services received by Mountain Bell from USWD under publishing agreements with USWD'. Thus, only what is "received by Mountain Bell" (now Qwest) can serve as the basis for modification of the imputation amount. Unfortunately, what is received by Mountain Bell is much less significant that what the publishing affiliate receives from the telephone business.

Upon careful consideration of these facts and the Court of Appeals Order, the Settlement Agreement adopts Staff's recommended imputation at the "presumptive imputation of $43 million" found reasonable by the Court and Commission on remand in the last rate case. This amount is $43 million more than Qwest advocated, based upon the Company's interpretation of the same judicial history.

6. **Synergies from the merger and cost savings associated with the approved pending sale of 38 high-cost rural exchanges to Citizens are factors that may not be adequately reflected in the proposed settlement. Specifically, the 4.2% productivity factor needs to be reexamined with the updated information not previously available to the parties.**

The U S WEST/Qwest merger was approved by the Commission on June 3, 2000. The issue of merger savings was not a part of the rate case evidence because the merger closed well after the test period had ended. However, the Settlement Agreement was negotiated with knowledge of certain facts associated with the merger, most notably that the merger may eventually contribute to higher productivity growth in the future, but that merger costs would likely be encountered prior to the realization of any net merger savings to the regulated business. Staff Witness Brosch represented consumer interests in the review of the Qwest/US West merger transaction in the States of Iowa, Utah and Washington and explained the timing and treatment of Qwest merger savings in the transcript of the hearings regarding in this Docket. Tr. 496-498.

By year three of the Settlement Agreement, when earnings are to be examined by Staff, the merger transition with Qwest should be more settled and the up-front costs of systems integration, employee relocation or severance, and other transaction costs should be yielding to actual merger savings. The Settlement Agreement locks-in a favorable productivity factor while costly merger transition activities are occurring, then enables Staff to capture net synergies three years after the merger has closed.

As to the sale of rural exchanges to Citizens, Staff's revenue requirement included full operating income and rate base adjustments to remove the high cost rural exchanges from the revenue requirement and these adjustments are fully reflected in the Settlement Agreement. With respect to the productivity factor, it is specifically scheduled for review in year three with updated information available at that time. Evidence of record fully supports adoption of 4.2 percent from evidence that is now available, which factor is considerably higher than the average of that used by the other State jurisdictions analyzed.

7) **The proposed settlement could lead the Commission astray from its primary goal of insuring that the rates paid by Arizona consumers will be just and reasonable, based on a thorough analysis of the applicant's cost of service, revenue streams, and appropriate revenue requirement.**

The Staff and its consultants share the expressed concern that "the rates paid by Arizona consumers will be just and reasonable, based on a thorough analysis of the applicant's cost of service, revenue streams, and appropriate revenue requirement." In fact, the Staff and its consultants have conducted thorough and extensive analyses and evaluations of the Applicant's cost of service, revenue streams and revenue requirement over a __ year time frame. These analyses are the foundation for Staff's negotiation and support for the Settlement Agreement.

The Settlement Agreement reflects the results of the extensive investigation conducted by Staff and its consultants. The Staff continues to believe that the Agreement represents a vigorously negotiated compromise which will serve Arizona consumers well in the future. The Price Cap Plan incorporates a hard cap on essential local service rates, including residential local service rates, for three years, in addition to a number of other important consumer safeguards and benefits. Staff urges the Commissioners to at least hear the arguments presented at Open Meeting, at which time Staff will attempt to further address any concerns regarding the Settlement Agreement.

Sincerely,

Deborah R. Scott
Director, Utilities Division

cc: Commissioner Irvin
Commissioner Spitzer
All parties of record