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BEFORE THE ARIZONA CORPORATION COMMISSION

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William A. Mundell
Commissioner
Mike Gleason
Commissioner
Jeff Hatch-Miller
Commissioner
Kristin Mayes
Commissioner

Arizona Corporation Commission
DOCKETED
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IN THE MATTER OF QWEST CORPORATION'S FILING AMENDED RENEWED PRICE REGULATION PLAN	DOCKET NO. T-01051B-03-0454
IN THE MATTER OF THE INVESTIGATION OF THE COST OF TELECOMMUNICATIONS ACCESS	DOCKET NO. T-00000D-00-0672

NOTICE OF FILING TESTIMONY

Pursuant to the amended procedural order in this matter, the ARIZONA UTILITY INVESTORS ASSOCIATION (AUIA) hereby submits the rebuttal testimony of Walter W. Meek.

Respectfully submitted, this 20th day of December, 2004.

Walter W. Meek

Walter W. Meek, President

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An original and 15 copies of the referenced testimony
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Docket Control
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Copies of the referenced testimony
hand delivered this 20th day of December, 2004, to:

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Walter W. Meek

WALTER W. MEEK

DOCKET NO. T-01051B-03-0454

REBUTTAL TESTIMONY OF WALTER W. MEEK

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REBUTTAL TESTIMONY OF WALTER W. MEEK

I. INTRODUCTION, QUALIFICATIONS AND PURPOSE OF TESTIMONY

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Walter W. Meek. My business address is 2100 North Central Avenue, Suite 210, Phoenix, Arizona 85004.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am the president of the Arizona Utility Investors Association (AUIA), a non-profit organization formed to represent the interests of equity owners and bondholders who are invested in utility companies that are based in or do business in the State of Arizona.

Q. DOES AUIA'S MEMBERSHIP INCLUDE SHAREHOLDERS WHO HAVE EQUITY INTERESTS IN QWEST COMMUNICATIONS INTERNATIONAL, INC.?

A. Yes. Although they are a shrinking number, we have members whose stock ownership dates to the breakup of the Bell system.

Q. ON WHOSE BEHALF ARE YOU TESTIFYING IN THIS PROCEEDING?

A. On behalf of AUIA, an intervener in this proceeding.

Q. HAVE YOU FILED TESTIMONY PREVIOUSLY IN THIS DOCKET?

A. No. AUIA did not file direct testimony. We are filing rebuttal concurrently with Qwest's rebuttal because AUIA's position is more closely aligned with that of the company than with other parties.

Q. WHAT IS THE OVERALL PURPOSE OF YOUR TESTIMONY?

A. In general, I am testifying in support of amendments to Qwest's price regulation plan that would improve the company's ability to operate profitably in a rapidly changing competitive environment. In the process, I will touch on the testimony of Staff witnesses Elijah Abinah, Matthew Rowell and Armando Fimbres.

Q. CAN YOU SUMMARIZE THE ELEMENTS OF YOUR TESTIMONY?

A. Yes. I will begin by summarizing AUIA's concern about the competitive crisis, which we believe is confronting Qwest in Arizona. Next, I will comment generally on Staff's reactions to the Qwest proposal. Finally, I will discuss the relative positions of Staff, Qwest and AUIA on specific elements of the price cap plan and other aspects of Qwest's proposal. These include:

- Elimination of the Inflation/Productivity Adjustment
- A proposed new rate cap for Basket One
- Elimination of the hard caps on Basket One services
- Adoption of new competitive zones
- Elimination of the revenue cap on Basket Three
- Treatment of new services and promotional offerings
- Elimination of the free call allowance in Directory Assistance
- Deregulation of billing & collection and voicemail services
- Changes to the Arizona Universal Service Fund

Q. WOULD YOU PLEASE EXPLAIN WHY YOU ARE QUALIFIED TO PROVIDE TESTIMONY ON THIS SUBJECT MATTER?

A. I represent the largest cross-section of utility stockholders in the State of Arizona and I have been involved with the utility business in Arizona for 28 years. I have participated in dozens of Commission dockets on behalf of AUIA and testified in numerous proceedings. My testimony and written comments have covered topics including competition rules, rate of return issues, stranded costs, depreciation, disposition of regulatory assets, AFUDC, inclusion of CWIP in rate base and the impact of regulatory decisions on analyst and investor expectations.

Q. ARE YOU TESTIFYING AS AN EXPERT WITNESS?

A. Not really. I will attempt to bring a "real world" investor perspective to some of the complicated pricing issues raised in the rate case.

Q. HAVE YOU PERSONALLY PURCHASED AND SOLD COMMON STOCK OR OTHER EQUITY INSTRUMENTS?

A. Certainly, both in and outside the utility arena. I own stock in utilities that are regulated by this Commission, although my portfolio does not currently include Qwest.

Q. IN YOUR POSITION WITH AUIA, HAVE YOU DISCUSSED INVESTING IN COMMON STOCKS OR BONDS OF UTILITIES AND/OR OTHER CORPORATIONS?

A. Yes. Investment in equities and debt, particularly in utilities, is the foundation of AUIA's existence. In order to advance the interests of AUIA's members, I have developed a good working knowledge of the utility industry and, specifically, investment related matters.

II. QWEST IS A CASUALTY OF UNINTENDED CONSEQUENCES.

Q. DOES AUIA HAVE PARTICULAR CONCERNS ABOUT QWEST'S COMPETITIVE SITUATION IN ARIZONA?

A. Yes. We believe Qwest is in the early stages of what I call the utility "death spiral."

Q. WHAT IS THAT?

A. It occurs when a price-regulated utility begins losing customers, market share and revenues to lower priced competitors or new technologies. The utility has to maintain the system it has, regardless of utilization, and if it is a provider of last resort, it must continue to add infrastructure, even to the point of creating excess capacity. As costs outpace new revenues, the utility has to seek rate increases, which motivates more customers to go to other providers. And so, the downward spiral continues.

Taken to its final conclusion, this scenario can lead to the financial collapse or bankruptcy of the utility. If that result seems implausible, it is certainly clear that under traditional rate regulation, a shrinking number of customers who can't escape the utility's service will pay higher and higher charges to support it.

Q. WHAT IS THE SOLUTION TO THIS DILEMMA?

A. Frankly, given the turbulence in this industry today, I don't know that there is a definitive solution. However, AUIA believes these things: 1) The Commission cannot solve this dilemma by throwing money at the problem through rate increases; and 2) If the Commission doesn't want to preside over a telecom disaster, it must give Qwest the pricing and marketing flexibility to challenge its competitors fairly in the best way it can.

Q. WHAT IS QWEST'S SITUATION?

A. For starters, Pat Quinn, Qwest's president in Arizona, has described Arizona as the most competitive telecommunications market in the counry. That shouldn't be surprising, given that the state's growth rate would attract many telecom providers.

In that environment, Qwest has experienced a net loss of 577,000 residential access lines from 2000 through 2003, including nearly 17% of primary residential lines and 33% of additional lines. According to Qwest, that translates into lost revenues of about $350 million a year.

Company officials estimate that competitors have captured more than 22% of the residential and business wire-line market, excluding the business lost to wireless companies. When wireless is included, Qwest officials estimate that their market share has fallen to about 40%. That is no longer a monopoly business.

Q. ISN'T THIS COMPETITIVE SQUEEZE HAPPENING TO OTHER BABY BELLS AND THROUGHOUT QWEST'S SERVICE AREA?

A. Yes. All of the Baby Bell ILECs report line losses, but not to the same extent as Qwest. In addition, some Bell ILECs, like Verizon and SBC, are much better insulated from displacements that are due to wireless competition.

Company witness David Teitzel noted in his direct testimony that 35% of Qwest's line losses in its entire 14-state region occurred in Arizona. I don't know whether that's disproportionate to Arizona's market size, but it should sound an alarm to this Commission. Arizona is Qwest's most important market, both in terms of size and rate of growth. If Qwest continues to lose market share in Arizona, they won't be able to make it up in South Dakota. The inevitable results are service failures somewhere in their system.

Q, HOW HAS THE COMPETITIVE MODEL DEVELOPED IN ARIZONA?

A. I would say very differently from what was envisioned when the Telecommunications Act was passed in 1996. I think the vision then was that while the long distance giants slugged it out for market share, the Baby Bells would unbundle their networks and services and newly formed CLECs would eventually figure out how to make a buck in local competition. Then the ILECs would re-engage the long distance business and everyone who survived would own a similar basket of products. Telephone customers would bask in a Nirvana of price alternatives.

For years, this Commission and regulators across the country hacked their way through the jungle of telephone networks and wholesale pricing to arrive at this competitive model. In Arizona, Qwest reclaimed access to the long distance market only a year ago.

Q. **HOW IS THE RESULT DIFFERENT TODAY?**

A. Although the CLECs are not unimportant, especially in the contest for business customers, it is clear that the real competitive threat to Qwest is cable, i.e., Cox Arizona, and wireless. Cox is absorbing new and existing wire-line business and the wireless companies are apparently sopping up the growth in usage. Both are essentially unregulated. Long distance service barely has any business value, since wireless providers are simply giving it away. Just over the competitive horizon is voice over Internet protocol (VOIP), another unregulated service.

Q. **WHAT IS UNIQUE ABOUT COX?**

A. To begin with, the fact that Cox cable probably passes 90% of the homes in Maricopa County. It was always assumed that the competitive landscape would include some facilities-based carriers and that they would probably provide the strongest competition to the ILEC. But there is no way that any other CLEC could match the penetration of cable.

In addition, the technology and infrastructure of cable television produce a heavenly marketing match when packaged with high-speed Internet access and local and long distance telephone service.

There is no doubt that Cox has invested massive sums to upgrade its system to handle internet access and telephone service, but it is also clear that Cox enjoys a huge marketing advantage when it is able to roll out its entire package on the back of a cable monopoly that is unregulated.

Q. **HAVE YOU EXPERIENCED COX'S MARKETING TECHNIQUES?**

A. Yes. Cox is a marketing powerhouse that has great flexibility. When Qwest announced its 5-cent long distance offering, Cox responded immediately with a 3-cent plan, which has now been added to its market basket.

I'm a cable TV customer of Cox and I live in a neighborhood that has about 100% cable penetration, so I may be high on their marketing list. After all, in marketing you try to hunt ducks where the ducks are. Nevertheless, I haven't bought anything new from Cox in 17 years, yet I receive six to eight pieces of high quality mail from them every month in addition to bill inserts.

In contrast, as a Qwest local exchange customer, I have received exactly one piece of mail from them about their long distance plan. As a long distance customer of MCI, I have never received anything from them regarding local phone service. Clearly, Cox is the big dog in marketing communications.

Q. IS QWEST BEING DAMAGED BY WIRELESS COMPETITION?

A. There is no question about that, but there seems to be a lack of data to quantify its impact to date on existing wire-line business versus new phones. It seems clear that wireless has killed the pay phone business and most of the market for second wire-line phones.

Mr. Teitzel cites Federal Communications Commission (FCC) data, which shows that in mid-2003 there were 2.64 million wireless connections in Arizona, making up 45% of all telephone connections in the state. That is already a huge number, but AUIA is concerned that it may be just the beginning.

It was long assumed that the greatest barrier to an explosion of wireless usage was the absence of number portability. Now we have portability, but it has only been available for a short time and we have no clear idea of its ultimate impact. I have seen market survey results which indicate that as many as 70% of wire-line subscribers would switch to wireless if they could keep their phone numbers.

The next barrier may relate to emergency (911) calling and the inability to pinpoint the location of a wireless caller. Technology will remove that barrier relatively soon and make wireless service even more attractive.

We have also just learned about the merger of Sprint and Nextel, creating a third behemoth wireless company. It's unclear what direct impact this merger may have on Qwest, since Qwest's wireless customers already use the Sprint network. At a minimum, the merger will further concentrate marketing power among three companies that will control about 75% of all wireless voice traffic.

Based on Mr. Fimbres' testimony, Commission Staff seems to believe that wireless has not yet proven to be a viable substitute for wire-line service and that its chief impact may be in discretionary usage that is in addition to primary residential usage.

In AUIA's view, this distinction is not relevant. In the short run, it may seem to be more damaging to give up revenue from a lost connection, but the long run outlook is grim for a regulated company that doesn't benefit from the growth of its customer base, especially if it must continue to add utility plant that eventually becomes excess capacity.

Q. ARE CLECs OTHER THAN COX MAKING COMPETITIVE INROADS?

A. Yes, although the empirical data are difficult to interpret. Mr. Teitzel noted that there were 118 approved interconnection agreements on file with the Commission as of February 2004. In addition, the FCC statistics he cited indicated that there were 519,000 CLEC lines in existence in mid-2003. That would equate to about 16% of the wire-lines in the state and would include Cox's penetration at that time.

I would assume that Cox's residential telephone business has increased significantly since then. However, based on the dearth of residential marketing communications from other CLECs, I believe that their market penetration is skewed heavily toward business customers.

Q. WHY WOULD THEY CONCENTRATE ON BUSINESS CUSTOMERS?

A. Business customers are easier to identify, easier to market to, less costly to serve and simply more profitable. A cable run will pass many more line connections in a business area than in a residential neighborhood. Besides, in the early days of local competition, there were things going on in the marketplace that were very difficult for an incumbent utility to deal with.

For example, building owners and property managers would make deals with CLECs to help them wire new buildings or rewire old ones in exchange for exclusive rights to provide service to the tenants. It's difficult for an ILEC to respond to that kind of competition when they don't know it's happening and when they're conditioned to wait for customers to knock on their door.

A few years ago, we decided in my office that we needed a new phone system with some better features. We had 10 lines at the time, provided by US West. We contacted a recommended equipment supplier whose first question was, who provided our phone service? I found out a couple of weeks later why it mattered.

We settled on a system we liked, but we balked at the price because it was significantly more expensive than the system we had. The supplier said he would take care of the differential. The next thing we knew, we were contacted by a CLEC who offered us phone service at a large enough discount from US West that it made up for the difference in equipment cost. We bit.

An acquaintance of mine in telephone equipment sales told me later that it was not unusual to use CLEC discounts to help sell phone systems to small and medium size businesses.

Q. WHERE DOES VOIP FIT IN THIS DYNAMIC?

A. I don't think anyone knows for sure, but it should be of concern to anyone who's in the wire-line or long distance business. As far as I know, the only real barriers to VOIP are disinterest and the need for broadband access. If you obtain broadband for other purposes (i.e., high speed internet access), there is almost no reason not to employ VOIP. It just hasn't caught on yet.

I can hardly imagine a business that can get along without broadband access through cable or DSL, provided it's available at their location. Broadband penetration is increasing at the residential level, with some estimates as high as 50% penetration. The simple fact is that if you have a computer at home, you're going to get fed up with dial-up service and opt for broadband from someone. It's an easy next step to VOIP.

VOIP has significant political support at the federal level. In addition, there is beta testing under way at two or more large electric utilities to determine whether it is practical to provide broadband access over power lines, which could aid VOIP penetration.

III. ACC STAFF IS STRUGGLING TO ADAPT TO THE COMPETITIVE MARKET THE COMMISSION HAS HELPED TO CREATE.

Q. DOES AUIA HAVE AN OVERALL REACTION TO STAFF'S CURRENT APPROACH TO PRICE CAP REGULATION?

A. Yes. Setting revenue issues aside, Staff's response to Qwest's proposals is encouraging in several respects. For example, Staff is willing to explore the concept of competitive zones, the centerpiece of Qwest's amended price regulation plan. Staff also has agreed to update the administration of the plan, grant Qwest some additional flexibility in marketing promotions and deregulate certain services.

Underlying these decisions is an implicit recognition that the competitive market has developed in unexpected ways and that Qwest is constrained in its ability to respond to the competition. I suspect that Staff is also concerned that its provider of last resort may land in serious financial jeopardy if its competitive position continues to deteriorate.

Q. ARE THERE AREAS OF CONCERN TO AUIA IN STAFF'S RESPONSES?

A. Yes. Some of Staff's responses reflect a fear of uncertainty and a reluctance to leave the safe harbor of rate regulation.

Mr. Fimbres' analysis of the competitive landscape and Mr. Rowell's discussion of the criteria for defining competitive zones are pervaded by a rage for data. They want to know what the CLECs are <u>really</u> doing, rather than what they <u>say</u> they are doing in their tariffs and marketing materials. They would like to know who the new cell phone users are and whether they gave up wire-line service.

Staff may argue that the Commission's duty to nurture competition requires it to act only with optimal information. But the Commission might have to accept the fact that empirical data precisely defining the competitive market may never be available, partly because the market is extremely fluid and partly because the competitors will not be completely forthcoming about their business.

Staff's insistence on retaining the hard caps on Basket One services and their refusal to let competitive forces determine Basket Three revenues demonstrate a reluctance to forsake traditional rate regulation.

Having said all of that, AUIA is extremely optimistic that are areas of accommodation between the company and Staff positions.

IV. <u>AUIA RESPONSES TO SPECIFIC QWEST PROPOSALS AND STAFF RECOMMENDATIONS.</u>

Q. WHAT IS AUIA'S POSITION ON QWEST'S REVENUE DEFICIENCY?

A. Obviously, AUIA is concerned about an annual revenue deficiency of between $320 and $450 million. However, I believe we are on the same page with Qwest in believing that raising rates to cover the deficit can't solve the problem. That could result in doubling Qwest's basic residential and business rates and it would send Qwest customers racing to find alternative providers.

Q. WHAT IS AUIA'S VIEW OF THE STAFF RECOMMENDATION ON RETURN ON EQUITY (ROE)?

A. Because AUIA is not focused on the revenue deficiency, we have not pored over Staff witness Joel Reiker's DCF and CAPM calculations. However, I note that Mr. Reiker has recommended an ROE of 14.6%. My response to that recommendation is, where was he hiding when I needed him a couple of rate cases ago? Either Mr. Reiker has experienced an epiphany, or I am not conversant with the current risk factors associated with this industry. I suspect the latter is the case.

Q. CAN YOU COMMENT FOR AUIA ON SPECIFIC ELEMENTS OF QWEST'S PRICE CAP AMENDMENTS AND OTHER PROPOSALS?

A. Yes. I'll discuss nine separate elements of their proposal:

1. Elimination of the Inflation/Productivity Adjustment from Basket One Services.

AUIA agrees with Staff and the company that this adjustment should go. It's an anachronistic device, which is designed to limit company earnings. It is inappropriate in a competitive environment and has been punitive in recent years.

2. Replace the Productivity Adjustment with a New Rate Cap.

AUIA concurs with the Staff and the Company on this change.

3. Eliminate the Hard Caps on Basket One Services.

AUIA parts company with the Staff on this element. This is an example in which the Staff shows great reluctance to embrace competition fully and depart from traditional price regulation. While this basket contains what are generally regarded as basic or essential services, the hard caps limit Qwest's ability to package its products in response to market conditions. If they were removed, the overall cap on Basket One revenue would still protect consumers and any price adjustments imposed by Qwest would have to be revenue neutral. The hard caps should be removed.

4. Adopt a Test to Designate New Competitive Zones.

Qwest proposes to create a test by which the Commission could designate certain areas as competitive zones in which Basket One services would be reclassified into Basket Three, providing Qwest with maximum flexibility in pricing and packaging its products. According to Mr. Teitzel, Qwest has been granted similar flexibility in six other states.

AUIA views this as the most significant element in Qwest's amended price cap plan. Although the devil may be in the details, we are gratified that Staff, as discussed in Mr. Rowell's testimony, is willing to give this concept fair consideration.

Mr. Rowell and Mr. Fimbres exhibit some discomfort with the precise test parameters proposed by Qwest. In their view, the mere presence of a CLEC in a zone may not guarantee real competition. AUIA has no firm position on this point except that the test should fairly represent the competitive pressure that Qwest faces. We understand Staff's desire to proceed cautiously and to avoid over-reacting, but Mr. Fimbres' discussion of the competitive environment sounds a little like a physician who wants to see the corpse before he can prescribe a cure.

Mr. Rowell takes issue with Qwest's suggestion that competitive zones should be delineated by the company's wire centers. He has concerns about customer confusion over wire center boundaries and the fact that Qwest's competitors cannot produce data based on the company's wire centers. Staff's preferred delineation is the zip code. Although this approach may produce some problems for Qwest, AUIA believes it is worth exploring. AUIA agrees with Qwest that a separate docket to consider this issue is not necessary.

The bottom line is that designation of competitive zones is a creative way to allow Qwest to confront its competition on a level playing field and should be adopted by the Commission in a workable form.

5. Eliminate the Revenue Cap on Basket Three.

AUIA supports this provision because it makes sense. If Basket Three services are competitive by definition, why cap the revenues? The competitive market will provide its own cap on the prices and, therefore, the revenues that Qwest can realize from these services. It is a mechanism to control earnings, which doesn't fit a competitive model. Rather than eliminating the cap, Staff proposes to increase it. This is another indication of Staff's reluctance to shed traditional price regulation in a competitive environment.

6. Treat New Services as Competitive and Put Qwest on the Same Footing as Its Competitors on Promotional Offerings.

Although these proposals are separated in the plan they are similar in the effect they would have on Qwest's marketing flexibility. Currently, Qwest must go through a time-consuming two-step process to have a new product declared competitive. Qwest believes that new services should be classified as competitive automatically, as they are in some other Qwest jurisdictions. Staff disagrees and supports a continuation of the existing process.

Qwest also must provide the Commission with 30 days notice of new promotions and it proposes to eliminate this requirement. In this instance, Staff agrees. AUIA sides with Qwest on both counts because they constrain the company's ability to move with the same alacrity as their competitors. Timing is everything in marketing.

7. Eliminate the Free Call Allowance in Directory Assistance.

Qwest proposes to eliminate the distance sensitive zone charges in UNE Zones 2 and 3. As a rate-balancing offset, Qwest also proposes to eliminate the monthly free call to directory assistance (DA). Irrespective of the UNE zone charges, AUIA agrees that the free call should be eliminated. According to Mr. Abinah, Staff wants to retain this feature because it helps to cure deficient listings in the printed directory. AUIA finds it hard to believe that a single free directory assistance call benefits anyone. Directory assistance is available from numerous sources, including the Internet and all wireless providers, and Mr. Teitzel's testimony indicates that Qwest's DA call volume has diminished more that 50 percent since 1999. Almost no service is more competitive than directory assistance and the Commission should simply get out of that business.

8. Deregulate Billing and Collection and Voicemail Services.

Staff agrees with the company that there are sufficient competitive alternatives for these services to permit them to be deregulated. AUIA concurs.

9. Augment the Arizona Universal Service Fund (AUSF).

Qwest proposes to close the gap between the actual cost of serving remote areas of the state and the allowable charge to customers by imposing a monthly surcharge of approximately $.46 on all wire-line and wireless customers in the state. The surcharge would generate approximately $64 million of new revenue.

According to Mr. Abinah's testimony, staff opposes this idea, partly in the belief that it would simply provide Qwest with a new revenue stream, and because Qwest has not committed to use the fund for specific upgrades such as broadband deployment.

The underpinning for Qwest's proposal is that a loop in a rural zone costs about $36 and the customer charge is limited to the statewide rate of $13 for a residential line. Qwest argues that eliminating this difference will motivate all providers, including Qwest's competitors, to engage in remote service. The AUSF allocation would be assignable to any subsequent provider.

While it may be that Qwest would be the largest beneficiary of the augmented fund at the outset, it is difficult to argue Qwest's logic that the surcharge would be beneficial to remote service. AUIA believes that Qwest's AUSF proposal deserves a tryout.

V. CONCLUSION

Q. DO YOU HAVE ANY CONCLUDING REMARKS?

A. The Commission and the stakeholders in the telecommunications industry are caught in a competitive dynamic that is not well understood by most of us. In just a few years, the relative positions in the Arizona marketplace of Qwest and its competitors have changed dramatically in ways that were not anticipated when the 1996 Telecommunications Act was passed.

Although Qwest is still the major player in the market, it is no longer the only elephant in the room. In fact, its market share and competitive position are eroding hourly, at least in part because the company is too constricted by regulation and cannot match the flexibility and responsiveness of its largely unregulated competitors.

This case is not about money. It is about creating a more level playing field. Through the price cap amendments and increased flexibility proposed by Qwest, much of which is supported by Staff, the Commission has the opportunity to redress the balance, hopefully before it is too late. There may not be much time.

Q. DOES THAT CONCLUDE YOUR TESTIMONY?

A. Yes it does.