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BEFORE THE ARIZONA CORPORATION COMMISSION

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Commissioner

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Commissioner

KRISTIN K. 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 CROSS ANSWER AND SURREBUTTAL TESTIMONY OF DON PRICE ON BEHALF OF MCI, INC.

On January 12, 2005, MCI, Inc. filed the attached cross answer and surrebuttal testimony of Don Price in the above-referenced matter.

LEWIS AND ROCA LLP
LAWYERS

RESPECTFULLY SUBMITTED this 12th day of January, 2005.

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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

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JEFF HATCH-MILLER
MIKE GLEASON
KRISTIN K. MAYES

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

CROSS ANSWER AND SURREBUTTAL TESTIMONY

OF

DON PRICE

MCI, Inc.

JANUARY 12, 2005

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Introduction and Background

Q. Please state your name.

A. My name is Don Price.

Q. Are you the same Don Price who previously filed direct testimony in this proceeding?

A. Yes.

Purpose of Testimony

Q. What is the purpose of your reply testimony?

A. In this testimony, I reply to the recommendations of Staff witness Regan and RUCO witness Johnson to explain why – even though MCI does not disagree with certain of their key conclusions – MCI disagrees with the manner by which both witnesses reach those conclusions. Importantly, the effect of both witnesses' testimony is to urge this Commission to take a "business as usual" approach to regulating Qwest's rates, notwithstanding the numerous fundamental changes affecting state retail regulation in the 21st Century.

Moreover, Qwest witness McIntyre also urges the Commission to delay any significant reduction in Qwest access rates unless the Commission implements a revenue neutral solution even though he acknowledges that intrastate switched access are set well above cost and Qwest interstate rates. For the reasons stated in my direct testimony, Mr. McIntyre's proposal simply demonstrates Qwest's belief that in a competitive market it is *entitled* to revenue neutrality in order for the Commission to reduce its switched access rates, and should be rejected as I have testified earlier. His effort to distinguish Qwest's

1 Communications Corporation's advocacy to expedite switched access rate
2 reductions in California while seeking to delay in such reductions in Arizona only
3 demonstrates Qwest last ditch efforts to preserve its excessive revenue stream
4 in Arizona. As discussed at length in my direct testimony, this proceeding
5 provides a perfect vehicle for the Commission to take a fresh and realistic look at
6 its regulatory philosophy and adjust regulation to the level that will best serve the
7 people of Arizona in increasing information and communications investment and
8 innovation. The trends leading to convergence[1] clearly indicate that
9 telecommunications can no longer be thought of as a traditional "utility service"
10 that should be subject to state regulation. And one of the foremost and urgent
11 challenges for this Commission is in the area of intercarrier compensation, and
12 specifically, intrastate switched access rates. The current intercarrier
13 compensation mechanism – a hydra of different rates for different "types" of
14 traffic that relies on outmoded concepts of jurisdiction – is both nonsensical and
15 unsustainable. And this proceeding represents an obvious and logical
16 mechanism by which the Commission affirmatively can act to eliminate the
17 unreasonably discriminatory pricing scheme for intrastate switched access.
18 As I stated in my direct testimony, MCI respectfully urges the Commission
19 to reduce Qwest's Arizona intrastate switched access charges to levels
20 approximating economic cost but, requiring Qwest's intrastate switched access
21 rates to mirror its interstate switched access rates should be the absolute
22 minimum required of Qwest as an outcome of the instant proceeding.

[1] These trends are most apparent in the areas of technology, communications law, and retail markets for information and communications services, as discussed in my direct testimony at pp. 6 - 25.

Summary of Arguments

Q. Would you please summarize your reply testimony?

A. Yes. Initially, I describe the fundamental difference between the approach taken by Staff witness Regan and RUCO witness Johnson and that urged in my direct testimony on behalf of MCI. Then, I expand on that description to highlight the dangers associated with the cost allocation that is central to the approach urged by Staff witness Regan and RUCO witness Johnson. Third, I explain why MCI's recommendation -- by permitting the Commission to exercise its authority in a straightforward manner consistent with the technological, legal, and market transformations that are occurring in information and communications services – would resolve a significant problem in terms of wholesale pricing while avoiding the dangers raised by the outdated approach taken by the Staff and RUCO.

Q. What is the fundamental difference between MCI's approach and that espoused by Regan on behalf of the Staff and Johnson on behalf of RUCO?

A. Importantly, MCI agrees with the conclusions of Staff witness Regan and RUCO witness Johnson – specifically, that Qwest does not need universal service support under the formula set out in R14-2-1202. As I demonstrated in my direct testimony, under any plausible calculation, the benchmark rates for basic local exchange service more than cover the cost of providing that service even if 100 percent of the loop and port costs are allocated to basic local exchange service. But MCI respectfully disagrees with the ***manner*** in which Staff witness Regan and RUCO witness Johnson reaches their conclusions.

1 Mr. Regan's recommendation that access rates be reduced slightly
2 appears to be based on traditional, rate-of-return regulatory principles. For
3 example, in describing his "overall analysis" of Qwest's request to draw funds
4 from the Arizona USF, Mr. Regan references Qwest's "total intrastate costs," a
5 concept that is the essence of traditional rate-of-return regulation.[2] Dr. Johnson's
6 recommendations are made in the context of the limited price cap regime for
7 Qwest previously adopted by the Commission, but his recommendation that
8 access charges not be reduced in this proceeding implicitly relies on general
9 principles of traditional regulation.

10 Stripped of its "TSLRIC" rhetoric, the effect of these recommendations is
11 to propose a traditional "top down" ratemaking process through which Qwest is
12 allowed to recover "needed" revenue through high intrastate switched access
13 rates, which is then used effectively to subsidize what Qwest wrongly claims are
14 low basic service rates.[3] The staff does so through the guise of a loop cost
15 allocation scheme that is never properly justified either on economic or sound
16 policy grounds. For his part, Mr. Regan's recommendation of a 25% reduction in
17 Qwest's intrastate switched access rates[4] is predicated on an arithmetic
18 calculation that mixes apples and oranges. As to Dr. Johnson's testimony that
19 there is no "pressing need to greatly reduce" Qwest's intrastate switched access

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[2] Regan direct at 3.

[3] See, e.g., testimony of Dr. Johnson at 2, lines 18 – 22, and 46, lines 8 - 12. In Mr. Regan's testimony at 10 – 11, wherein he cites the FCC's Access Charge Reform Order, the passage clearly references the FCC's separations rules that are based on accounting rather than economic principles and are the basis for traditional, rate-of-return regulation by the states. Also, see *infra* at footnote 10.

[4] Regan at 4, lines 14 – 15, and at 35, line 22 through 37, line 21.

rates,[5] his conclusion appears to be based on a concern that reductions in switched access rates would be accompanied by rate increases for local service or other services. When one recognizes that a problem exists – as this Commission has done as regards Qwest's intrastate switched access rates -- taking no action as recommended by Dr. Johnson can hardly be seen as a step toward resolving the problem.

Q. What are MCI's concerns with the approach espoused by Dr. Johnson and Mr. Regan?

A. Their recommendations in essence ask the wrong questions and thus cannot lead to answers that address and resolve the problems properly before this Commission. As will be shown, traditional "top down" ratemaking principles that were developed decades ago in an environment of exclusive monopoly service franchises are no longer suited to the tasks facing regulators. Because technology, the law, and the markets have changed so dramatically over the recent past, the Commission's focus must shift away from determining the level of revenues to which Qwest is entitled. It should instead examine a relatively few set of issues regarding conditions in the wholesale arena. It should no longer be the Commission's job to assure that Qwest obtains the revenues it "needs" to operate with a profit in Arizona.[6] Instead, Qwest should be left to compete in the marketplace, as should all other communications providers. This approach is

[5] Johnson at 191, line 31.

[6] As discussed more fully below, even when Qwest operated only in monopoly markets, regulators had an extremely difficult time answering questions regarding the utility's corporate structure and how to apportion certain expenses to, e.g., Arizona versus Colorado. In the vastly more complex circumstances that exist today, those allocation and other questions that were once merely difficult are now virtually impossible to answer.

also appropriate in light of Qwest's constant refrain about the substantial increase in competition that it encounters. When faced with any proposal to regulate, the Commission should first assure itself that the intended benefits of such regulation outweigh the costs inherent in regulation. As the various markets that the Commission has traditionally regulated shift from monopoly to more competitive markets, the Commission needs to proceed with a "first do no harm" principal firmly in focus.

Q. You stated above that there are dangers inherent in the cost allocation methodologies discussed by Dr. Johnson and Mr. Regan. What do you mean by that?

A. The principal vehicle the Staff and RUCO use to engage in their top down analysis is their use of loop "cost allocations." Specifically, Mr. Regan discusses at pp. 16 through 21 his recommendation that the Commission "allocate" the costs of the local loop to various services, including the intrastate switched access rates paid by traditional IXCs such as MCI. The act of subscribing to Qwest's phone service permits the customer to use Qwest's facilities in a variety of ways. The facilities may be used to call other persons within the local calling area, or in another part of Arizona, or across the world. Those facilities may also be used by the customer (in conjunction with a computer) to reach an Information Services Provider (ISP) on a dial-up basis and thereby view art works in great museums, send and receive email, communicate in real time using instant messaging, or even utilize voice communications capabilities of non-traditional providers such as Skype. These examples highlight a significant shortcoming in Mr. Regan's recommendation, because there is no fair way for the Commission

1 to "allocate" the cost of the Qwest facilities – and particularly, the local loop –
2 among the various possible uses.

3 As MCI demonstrated in its initial comments, there is no need to engage in
4 this allocation. The reason for this is that, even if ***all*** loop and port costs are
5 allocated to local service, the benchmark rates still more than adequately
6 compensate Qwest, as required by R14-2-1202. Because the principles that
7 govern the loop allocation proposed by the Staff and RUCO are not adequately
8 explained, the loop allocation exercise becomes a vehicle to engage in traditional
9 "top down" utility regulation -- starting with a figure of revenue that is supposedly
10 "needed," and then allowing it to be collected essentially on an arbitrary basis
11 through certain services.

12 To the extent Staff's and RUCO's allocation recommendations are guided
13 by any principle, however, the principle is faulty. That principle easily can be
14 summarized – namely, that residential customers ultimately do not pay those
15 costs that are "allocated" to other services. It is misleading to frame the issue, as
16 Mr. Regan does, as an issue of cost allocation, because what is really at stake is
17 the question of how Qwest recovers the costs of operating and maintaining its
18 loop plant used to serve customers in Arizona. Although in some instances such
19 costs are not paid ***directly*** by the consumer, they are by necessity paid either
20 directly, in other instances, or ***indirectly*** by consumers. For example, the
21 amounts paid to Qwest by a small business customer represent simply another
22 component of that business' operating costs that must be recovered through the

1 prices that consumers pay for the business' goods or services.[7] As to residential
2 users, if the cost recovery is shifted elsewhere, it only means that some
3 customers are paying a disproportionate share while others get the equivalent of
4 a "free ride." While there was a policy rationale for transferring cost recovery
5 among services when Qwest provided solely regulated services under the
6 Commission's jurisdiction, in the conditions of today, such efforts cannot be
7 justified and can only distort the choices made by consumers. By asking the
8 question of how to "allocate" certain costs, Mr. Regan's testimony simply sweeps
9 under the proverbial rug the very real fact that consumers ultimately do pay.

10 As to the dangers inherent in the Staff and RUCO approaches, they
11 involve the cost of significant regulation versus the minimal public benefits. As
12 discussed at length in my direct testimony, emerging competitive pressures in the
13 retail communications marketplace make it clear that currently the benefits of
14 continued retail rate regulation are outweighed by the potential costs. With the
15 retail picture changing so quickly, presently the Commission should refrain from
16 further retail regulation and instead simply monitor retail practices to assure that
17 Qwest (or other providers with market power) do not take advantage of their
18 remaining market power by improperly raising rates or restricting output. That is,
19 the primary danger of continuing to applying traditional, top-down regulatory tools
20 is to engage in a regulatory exercise, the cost of which far outweighs the public
21 benefit.

[7] Qwest's local service rates certainly are not the only communications cost paid by a small business. To the contrary, other services such as toll, data lines (e.g., DSL), voice mail and so on also make up a portion of its communications bill, and all of that cost must be recovered for the business to be a going concern.

The traditional, top-down, rate case approach as recommended by the Staff and RUCO not only asks the wrong questions, it leads to a host of needlessly complex and intractable problems, as I discuss in detail below. Further, such an approach unnecessarily places the Commission squarely in the role of micromanaging an increasingly competitive retail marketplace. In other words, unless the Commission has full confidence that its decisions are superior to the collective decisions made by consumers in the retail marketplace, it should forbear from engaging in such micro-management.

Q. How does the approach recommended by MCI achieve the correct public policy result and avoid the dangers you have described?

A. In contrast with my criticisms of Staff and RUCO, the approach MCI recommends is straightforward. That approach is a bottoms-up, focused, problem-solving approach that provides the Commission with the tools to correct pricing anomalies as to wholesale inputs used by other services providers where existing prices distort the operation of retail markets. It relies on readily available (and relatively non-controversial) analytical tools such as bottoms-up, economic cost analyses (e.g., TSLRIC) with which the Commission is already familiar. Also, because MCI's approach does not attempt to quantify the level of revenues to which Qwest is entitled, it avoids the ambiguities and needlessly complex analyses required by outmoded "top down" approaches. MCI's approach further does not encourage the Commission to attempt micromanagement of retail markets where consumers are increasingly able to "vote with their feet" among various service providers. Finally, MCI's recommendation squarely deals with the fact that ***all*** costs ultimately are paid by consumers, and by addressing that

1 question directly, avoids the need for "allocations" that have no principled or
2 objective basis.

3 Instead of the traditional top-down retail regulation, the Commission
4 should focus its regulatory efforts on two matters. First, the Commission urgently
5 needs to assure access to those specific communications inputs necessary to
6 assure a vibrant wholesale market, which will in turn promote more retail
7 competition.[8] Second, the Commission needs to undertake immediate and real
8 intercarrier compensation reform, so that the marketplace, and not irrational and
9 discriminatory regulatory categories, determines which services at what prices
10 through what modalities consumers can obtain.

11 MCI's approach accomplishes several important public policy objectives.
12 First, the approach supports MCI's recommendation to lower Qwest's intrastate
13 switched access rates to levels approximating their economic cost (TSLRIC).
14 This recommendation allows the Commission to correct the current situation
15 where traditional interexchange carriers (IXCs) such as MCI are subjected to
16 unreasonably discriminatory wholesale rates relative to other providers of
17 comparable services such as Qwest and wireless carriers. By focusing on
18 specific wholesale "problem areas" the Commission can impact the operation of
19 retail markets without the need to micromanage retail rates. MCI's approach
20 further provides support for the position that residential local service rates should
21 remain at affordable levels. By using bottoms up, economic cost analyses, MCI
22 demonstrates that Qwest's existing residential rates are well above Qwest's

[8] As the Commission is aware, the FCC recently decided certain questions regarding access to certain wholesale inputs (UNEs) in a manner unfavorable to retail competition for residential subscribers.

relevant costs and that there is no legitimate public policy (or economic) basis on which Qwest could request an increase in those rates. For all these reasons, the Commission justifiably can grant MCI's requested relief on the basis of objective evidence. With regard to the argument that any such reductions must be offset with local service increases as feared by RUCO and suggested by Qwest with its AUSF proposal, there is a principled basis for the Commission to reject that argument.

Traditional Top-Down Ratemaking Principles

Q. You have used the phrase "traditional top-down ratemaking principles." Would you explain what is meant by that phrase?

A. By that, I mean the historic tools used by state regulators to set prices for the various services in the utility's tariffs, typically in the context of a rate case proceeding. Those tools had been crafted over a number of decades, as demonstrated by some of the case law cited in Dr. Johnson's testimony going back more than 75 years. Step one in traditional top-down ratemaking was the determination of the utility's "revenue requirement." The regulator established the utility's "revenue requirement" as the sum of its reasonably incurred operating expenses plus return on its "rate base" -- that is the prudent capital investment in plant and equipment necessary to provide utility service.[9]

The process of establishing the utility's revenue requirement was one that typically required literally weeks of hearings and the testimony of numerous

[9] I will use the generic term "utility" here, although my discussion is most applicable to the Bell Operating Companies. With few exceptions, such as the former GTE operating companies, the small local exchange carriers were never subject to heavy regulation by either the states or the FCC.

1 accounting and financial experts. Also, it is important to recall that the utility's
2 accounting books and records, maintained in accordance with the FCC's Part 32
3 Uniform System of Accounts ("USOA") rules, formed the basis for each of the
4 myriad components that were used to construct the revenue requirement.

5 Further complicating the regulators' task was the fact that both expenses
6 and investments were apportioned between jurisdictions. That is, the FCC's Part
7 36 Separations rules[10] governed the many mathematical gyrations necessary to
8 determine that portion of each Part 32 account that was subject to the State's
9 purview versus that portion assigned to the interstate jurisdiction. Importantly, it
10 should be noted that the Separations rules, as well as the USOA rules, were
11 developed when regulated facilities were used solely for the provision of
12 monopoly utility services. Although there were problem areas requiring the
13 regulator to make arbitrary allocations of expenses or investment, those
14 problems were limited to allocations of cost responsibility between regulated
15 services.[11]

16 Central to this testimony is that the situation facing the Commission today
17 is fundamentally different than in the past. In recognition of these changed

[10] The complete title for Part 36 of the FCC's rules is "Jurisdictional Separations Procedures; Standard Procedures for Separating Telecommunications Property Costs, Revenues, Expenses, Taxes and Reserves for Telecommunications Companies."

[11] In the 1980s, as part of its decision to allow utilities to integrate certain unregulated services into their regulated operations, the FCC adopted detailed accounting rules for utilities to use in apportioning costs between regulated and unregulated operations. Those accounting rules, implemented through what is referred to as a "Cost Allocation Manual," were virtually impossible for regulators to effectively audit, and thus were incapable of enforcement.

circumstances, the FCC and the courts have begun to refer to the historic accounting and separations rules as part of the "old regime." [12]

Q. Please continue you discussion of "traditional top-down ratemaking principles."

A. Once the regulator had held hearings and made the numerous decisions required to establish the utility's revenue requirement, a separate phase of the proceeding was undertaken to set rates. This phase was referred to as the rate design phase. Key for our purposes is that the sole objective of this phase of the process was to develop a set of rates that, in total, would yield annual revenues at the level of the revenue requirement the regulator had established. In other words, the sum of the rates times the number of units must equal the revenue requirement. If the level of revenues was greater, the utility could be said to be "over earning," and if that level was less, the utility would likely seek additional revenue relief in the form of higher rates.

In this latter phase of the proceeding, the utility, other parties, and the regulatory staff typically presented competing proposals as to which rates should be lowered and which should be increased. If the setting of the utility's revenue requirement was a battle over the size of the pie, the rate design portion of a rate proceeding was a battle over how to divide that pie into component parts, i.e., the various services provided by the utility.

Because it was unusual for the utility to furnish economic (TSLRIC) cost studies demonstrating the cost to furnish basic local service, one may well

[12] See, e.g., TX OPUC vs. FCC at [illegible]. "By recommending replacing the historical cost system with a forward-looking "most efficient" cost model, the Joint Board must have considered that the jurisdictional separations rules no longer would apply in the same way."

wonder how, in the absence of economic cost analyses of basic local service, the rates for such services were set. The answer is that regulators typically set local service prices using what was termed "residual pricing." First, the prices for all other services were set at levels intended to meet as much of the Revenue Requirement as possible. The impact on local service rates was then determined by quantifying the incremental increase that, when added to the revenues generated from all other services', would "sum" to the total revenue requirement. Another way of describing this process would be to say that local service rates were the "swing" after the regulator had raised and/or lowered the rates for other services.

Traditional top-down ratemaking principles can thus be described as a two phase process. In the first phase, the regulator waded through mountains of accounting data to arrive at the "revenue requirement. In the second phase, the regulator decided which service rates to raise and which to lower, but under the constraint that the sum of all services rates times the number of units must equal the revenue requirement determined in the first phase.

Q. How was the concept of the utility's recovery of "overhead" costs handled under "traditional top-down ratemaking principles?"

A. Quite simply, the regulator was put in the role of making determinations as to how much "overhead" the utility could recover. Applied under today's conditions, that approach can be quite harmful to consumers of communications services. By that, I mean that the philosophy of a regulated entity is one of "cost plus." An entity that historically has not been subject to the rigors of a competitive

marketplace conceives of its costs as a given, and the rates that it charges then must be adjusted to conform to its costs.

Conversely, companies who operate in competitive markets recognize a completely different philosophy, because the market – rather than a regulator -- establishes the prices they are permitted to charge. Thus, the variable is the company's cost structure rather than its rates.

This difference in philosophies is of critical importance to this proceeding. If the Commission adopts the recommendations of Mr. Regan, it will in essence have "blessed" Qwest's cost structure, shielding its costs from the rigors of a market in which the market price is the great "regulator." That is why my testimony cautions the Commission against taking steps that put it in the position of micro-managing markets that are becoming more competitive. Such steps would send the wrong signals to the market and to consumers of communications services in Arizona.

<u>The "Tradition" Begins to Fade</u>

Q. Are the types of rate setting proceedings you have described still common?

A. No. For decades, traditional top-down ratemaking was perceived by the utilities as a "protection" against downside financial risk. That is, the utility always had the option of demonstrating to the regulator that its costs had increased and (hopefully) obtaining higher rates. Beginning in the 1980s, however, the Bell companies began to experience declining costs as also discussed extensively by Dr. Johnson, and what had previously been seen as a protection now became a

1 liability. That is, with lower costs, the utility faced the unhappy prospect of being
2 required to lower rates.

3 Faced with this prospect, the regulated utilities began urging variations on
4 the traditional top-down principles, and thus began a trend where commissions
5 and legislatures adopted various types of "alternative regulation" plans in place of
6 traditional rate case proceedings. This trend spread very quickly, and very few
7 traditional rate cases have been prosecuted in the past 15 years. The
8 "alternative regulation" plans that were adopted varied somewhat from state to
9 state, but most plans were based on the concept of "capping" rates for certain
10 services as a means of protecting consumers. Another common feature was a
11 grant of pricing flexibility for services within service categories, or "baskets,"
12 where the services were deemed to be subject to some competition. In some
13 instances, the plans included provisions allowing consumers to share in a
14 predetermined portion of "excess earnings." Importantly, even though there were
15 minor variations across the states' alternative regulation plans, the common
16 element was that at least some of the utility's earnings were shielded from
17 regulatory oversight.

18 The utilities aggressively advocated for adoption of such plans before their
19 respective regulatory agencies or legislatures. Because the utilities were able to
20 forecast their expense, investment, and revenue trends, it is inconceivable they
21 would have supported a move away from the protections of regulation without
22 knowledge that costs were declining to the point where existing revenues would
23 be deemed "excessive." Their support for such plans signaled the utilities'
24 abandonment of the "protections" of traditional regulation. From the perspective

of the regulator, the perceived benefit of these plans was that the regulator was no longer required to engage in the rigorous, complex and time consuming tasks required of traditional ratemaking to protect consumers. From the utility's perspective, it was able to avoid the expense of traditional rate cases and enjoy the prospect of increased earnings with no down-side constraints -- in other words, a "have one's cake and eat it, too" form of regulation.

Setting a Revenue Requirement Today is Impossible

Q. Would it be possible for a state regulator today to utilize the traditional ratemaking tools you described above?

A. No. The toothpaste is out of the proverbial tube, and there's no getting it back in. I hinted above at one of the key reasons why setting a revenue requirement given today's conditions is simply impossible. Recall that the Bell Operating Companies', including Qwest's, historic operations were limited almost exclusively to monopoly services. At the time of divestiture in 1984, the consent decree contained strict line of business restrictions precluding Qwest and the other Bell Companies from engaging in businesses other than their historic monopoly operations.[13]

From the standpoint of traditional top-down ratemaking, the elimination of the line of business restrictions profoundly complicates the task of accounting for "regulated" expenses. Utility personnel whose job functions were once limited to "regulated" services are now performing a combination of functions that are not easily sorted out. The problems created can easily be seen with a simple

[13] Price direct at 16.

example. At the most fundamental level, consider a craft employee who is involved with hooking up telephone services at residential premises. If that craft employee also turns up Qwest Choice™ TV, the question of how to allocate that employee's time between the regulated utility and the unregulated cable TV operations becomes quite difficult. Does the Commission require that each such employee track his or her time in some type of self-reporting system? How does the Commission deal with questions about incentives to misreport time under such a plan? How would the Commission attempt to audit the reported results of even one employee, much less the self reports of hundreds or thousands of employees? And even assuming away all of these questions, how would the Commission apportion the numerous support costs – the buildings, furniture and fixtures – that Qwest uses in providing both regulated and unregulated offerings?

These simple questions demonstrate why it would be impossible for the Commission today to make the kinds of determinations it made historically so as to determine the expenses associated with Qwest's "regulated" operations in Arizona. In the past, the types of issues raised in these examples existed only in extremely rare instances. Today, if the Commission sought to apply traditional ratemaking principles, these questions only hint at the intractable problems the Commission would face. And it is for these reasons that it would be impossible for the Commission to reach a determination of the Qwest operating expenses that are "reasonably incurred" in providing individual utility services.

Q. Do these difficulties exist only as to the expense component?

1 **A.** Not at all. The same problems exist in valuing the utility's "rate base." The
2 earlier example of Qwest Choice™ TV is directly relevant to this issue, because
3 Qwest utilizes the same loop facilities to offer both the regulated telephone
4 service and the unregulated TV offering, as well as several other services. In
5 such a situation, how can the Commission have any confidence in the accuracy
6 of what it considers the "regulated" costs of the local loop?[14] As noted above, the
7 real issue before the Commission is not cost ***allocation***, but cost ***recovery***.
8
9 **Q. How does this issue relate to your concerns with the loop allocation**
10 **discussions of Dr. Johnson and Mr. Regan?**
11
12 **A.** A critical failure in their analyses is that neither of these witnesses acknowledges
13 Qwest's use of the loop to provide a variety of both regulated and unregulated
14 offerings. The danger inherent in their recommendations is that they lead the
15 Commission into a regulatory "dead end." By ignoring the fact that Qwest
16 actually uses its network to provide both regulated and unregulated offerings,
17 they assume the allocation issues of loop costs can be resolved among services
18 regulated by this Commission. In so doing, they present a false promise: that
19 the Commission can determine Qwest's "regulated" network investment.[15] In
20 fact, such a determination is impossible.
21

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[14] The Staff has recommended an adjustment to the "rate base" figure presented by Qwest to account for the fact that DSL is considered an interstate service. See, Direct Testimony of William Dunkel at 6 – 13. Although I don't disagree with the premise on which the recommendation is made, because it fails to address the question of regulated versus unregulated operations, it cannot resolve the numerous problems of applying historic ratemaking tools in today's more complex environment.

[15] Recall from the above discussion on traditional ratemaking principles that a key component of the utility's revenue requirement is the regulated "rate base" on which the "return" is calculated. Qwest's use of network facilities to provide both regulated and unregulated services creates myriad opportunities for the utility to "game the system" by misallocating facilities to its "regulated" operations, and within the category of "regulated" operations to various regulated services, e.g., local, long distance and access.

Q. Are you claiming that Dr. Johnson's and Mr. Regan's discussions regarding loop allocations are incorrect?

A. Their testimonies describe debates that did in fact take place in the rate design portion of rate cases across most, if not all, states. They are not incorrect as a matter of history. But the fact that such debates took place does not make those discussions relevant to this proceeding, and that fact provides no guidance as to how the Commission can resolve the issues of unreasonable discrimination between providers of substitutable services.

At the outset of my testimony I stated that both Mr. Regan and Dr. Johnson "ask the wrong questions." Given Qwest's use of its loop plant to provide both regulated and unregulated offerings, those witnesses' focus on allocating joint and common costs to various regulated services is unhelpful. And by stating that there are dangers inherent in Dr. Johnson's and Mr. Regan's recommendations, I mean that they invite the Commission to walk into a morass from which there is no escape. As I will show in the following section, MCI's recommendations present no such danger.

The MCI Proposal is Straightforward

Q. Please explain the basis for your argument that MCI's recommendation does not risk the "dangers" that you associate with the recommendations of Dr. Johnson's and Mr. Regan's loop allocations?

A. My discussion at pages 8 through 12 regarding historic ratemaking principles described how all of the steps – the determination of the utility's revenue requirement and the setting of rates to achieve that amount – were parts of a "whole cloth." That is, step one required the Commission to determine the

amount of money to which Qwest was entitled (the revenue requirement). Then, step two involved making decisions as to ***how*** Qwest would recover that level of revenues (the rate design).

Those two steps operated in conjunction with each other as necessary parts of the "old regime." In that "old regime," one of the Commission's responsibilities was to assure Qwest an opportunity to earn a reasonable return on the prudent investments it needed to make to offer utility services in Arizona. Given the fundamental changes I described in my direct testimony, there are two serious flaws in attempting to utilize the traditional top-down tools in the current environment. One involves the question of the principle, and can be stated as whether the Commission any longer has a responsibility to determine Quest's revenue "needs." The second flaw if a practical one because, for the reasons discussed above, it is simply not possible for the Commission to apply the traditional ratemaking tools of the "old regime."

Under MCI's recommendations, there is no need for the Commission to even attempt to utilize the tools of the "old regime." As noted above, MCI would have the Commission take a narrow, problem-solving approach focused on resolving wholesale pricing anomalies that distort the operation of retail markets. By removing itself from the role of determining Qwest's revenue "needs," the Commission avoids the historic "balloon problem" theory. By that, I am referring to the traditional rate case concern that reductions in one service's rates must be made up by rate increases to another service.

Q. Please explain further MCI's recommendation.

1 **A.** In this case, MCI has recommended that Qwest's intrastate switched access
2 rates be significantly reduced to avoid serious market distortions and
3 unreasonable discrimination that arise out of the existing rate levels. But there
4 should be no concern that the effect of MCI's reduction would be to increase
5 local rates, because the evidence presented by Qwest, as well as the analyses of
6 Mr. Regan and Dr. Johnson, and the discussion presented in my direct testimony
7 all agree that Qwest's existing rates cover the economic cost of providing basic
8 residential local exchange service in Arizona. As noted above, the Commission
9 can exercise its authority to resolve a problem, with the certainty that in so doing
10 it does not create another one.

11 To state this in terms of the "pie" analogy used earlier in my testimony, the
12 Commission no longer needs to concern itself with the "size of the pie." Setting
13 aside that historic role permits the Commission to focus on the question of
14 whether basic local service rates are sufficient. If those rates are in fact sufficient
15 to cover the economic costs of providing the service, the Commission is free to
16 turn its attention to a relatively narrow set of problem areas related to wholesale
17 inputs on which other service providers must rely. By freeing itself of the need to
18 worry about the "size of the pie," the Commission can both eliminate the
19 competitive harms that result from setting wholesale rates significantly above
20 cost and at the same time assure itself that basic local service rate issues have
21 been addressed. This is why I have stated that the approach recommended by
22 MCI is straightforward.

23

24 **Q. Early in your testimony, you criticized part of Mr. Regan's testimony as**
25 **mixing apples and oranges. Can you explain your criticism in more detail?**

A. Yes. In footnote 50 of his direct testimony, Mr. Regan states that in response to a discovery response, "Qwest provided what its intrastate switched access revenues would be if its switched access rates were set equal to (i.e. at "parity") with Qwest's interstate switched access rates (not including the interstate EUCL charge)." Mr. Regan further stated that he "then calculated the interstate EUCL charge on a per-minute-of-use basis, by dividing the average monthly interstate EUCL rate by the total monthly interstate switched access minutes of use." For the following reasons, I strongly disagree with the assumptions on which Mr. Regan based his "equivalent" rate calculation.

First, it is an important principle that cost recovery be matched as closely as possible with the manner in which the costs are incurred. Mr. Regan violates that principle by analyzing a network component that has no usage characteristics on the basis of a usage based rate. The local loop is perhaps the best example of a class of facilities that is non-traffic sensitive – that is, the cost of the facilities do not vary by the amount of traffic they carry. On this point alone, Mr. Regan's analysis fails.

Second, Mr. Regan's starting point was a revenue amount rather than a cost. Because the goal of Mr. Regan's analysis was to shift cost recovery to another service, by starting with a revenue amount rather than Qwest's loop cost, he has used a totally inappropriate starting point. Again, Mr. Regan's analysis fails.

Third, Mr. Regan's discussion is predicated on the faulty premise that consumers are somehow better off if the costs of the services they use are

recovered via hidden and/or indirect ways rather than directly and explicitly. Mr. Regan offers to rationale as to why this is appropriate or reasonable. To the contrary, as discussed above, by shifting cost recovery in such an indirect and implicit way, the effect is to send precisely the wrong signals to the market and to consumers, who nevertheless ultimately pay the higher switched access rates embedded in other services.

Q. You stated at page 7 of your testimony that consumers pay all costs. Can you describe how your recommendation in this regard differs from the recommendation of Mr. Regan?

A. Yes. The "apples and oranges" portion of Mr. Regan's testimony appears to rest on the premise that end user customers somehow benefit if interexchange carriers' switched access rates include an allocation of Qwest's loop costs. Mr. Regan incorrectly presumes that this is an either/or question, that ***either*** IXCs pay these costs ***or*** end user customers will pay. The fallacy of Mr. Regan's logic is obvious: IXCs recover the costs they incur to furnish toll services through the rates they charge to end user customers in Arizona. Furthermore, Mr. Regan's wrong assumption would prevent the Commission from resolving the existing unreasonably discriminatory rate differential between traditional IXCs and wireless carriers. Because there is no basis for the "allocation" of costs that underlies Mr. Regan's recommendation, and because his recommendation fails to achieve an important policy objective of eliminating unreasonable discrimination in existing rates, his recommendation should be summarily dismissed.

Q. Would please comment upon Qwest witness McIntyre's rebuttal testimony?

1
2 **A.** Yes. Mr. McIntyre states that Qwest's intrastate switched access rates are
3 artificially high.[16] However, Mr. McIntyre's proposed remedy is to establish some
4 form of cost recovery mechanism to maintain revenue neutrality for Qwest rather
5 than setting cost-based intrastate switched access rates.[17] He premises his
6 proposal on the supposed fact that switched access rates must remain artificially
7 high to support local service.[18] However, as has been demonstrated by me, Staff
8 and RUCO, Qwest's local rates recover 100 percent of the loop and port costs,
9 as well as other direct costs on a statewide averaged basis. Therefore, as has
10 been demonstrated by me, Staff and RUCO, Qwest's local rates need no support
11 mechanism whether or not the loop and port are totally allocated to local service.
12 Accordingly, any excess revenue derived from intrastate switched access rates is
13 supporting the costs of other services provides by Qwest, but not local service.
14 In addition, while Mr. McIntrye concedes that parity with interstate switched
15 access is, itself, an appropriate goal, he nevertheless persists in his assertion
16 that not even this goal should be adopted by the Commission at this time without
17 shifting the switched access revenue stream to other products.[19] However, to the
18 extent the Commission agrees with Qwest's assertion, and is unwilling to let the
19 market decide what revenues Qwest is entitled to receive, the Commission
20 should only allow Qwest to look to Basket 3 services for such revenue recovery,
21 not Basket 1 or 2 services, as Qwest agreed in the last pricing flexibility plan.

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[16] McIntyre Rebuttal, dated December 20, 22004, at page 5, lines 12-16.

[17] *Id.* at page 5, lines 17-21.

[18] *Id.* at page 6, lines 10-14.

[19] *Id.* at page 8, lines 4-7.

Finally, even Mr. McIntyre states that "under the right circumstances" Qwest has presented arguments in other situations supporting that FCC rates constitute a valid surrogate for free market rates. Unfortunately for MCI, other IXCs, and presumably, even Qwest Communications Corporation, the right circumstances never seem to arise in Arizona for Qwest or in any other in-region state. It has been nearly 5 years since the last pricing flexibility plan was approved, and this plan could presumably continue for 3 or more years based upon the last "3 year" plan. The right circumstance to Qwest is reduction only with a revenue neutral solution. No other telecommunications provider serving in Qwest's service territory in Arizona, including MCI, is entitled to revenue neutrality. Qwest should not be entitled to such a remedy here either.

Q. Does this conclude your reply testimony?

A. Yes, at this time.