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BEFORE THE ARIZONA CORPORATION COMMISSION

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JEFF HATCH-MILLER, Chairman
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MIKE GLEASON
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|---|---|
| IN THE MATTER OF QWEST CORPORATION'S FILING OF 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<br>**NOTICE OF FILING SURREBUTTAL TESTIMONY** |

Staff hereby provides Notice of Filing its Surrebuttal Testimony in this docket. An original and fifteen copies are submitted of the Surrebuttal Testimony of Matthew Rowell, Armando Fimbres, Del Smith, Joel Reiker, Michael L. Brosch, Steven C. Carver, William Dunkel and Thomas Regan.

Copies of the confidential versions of the Surrebuttal Testimony of Michael L. Brosch, William Dunkel and Thomas Regan are being provided to the Commissioners and their aides, the presiding Administrative Law Judge and those parties who have executed and docketed Exhibits A to the Protective Order in this proceeding.

RESPECTFULLY submitted this 12th day of January, 2005.

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# SURREBUTTAL

# TESTIMONY

# OF


MATT ROWELL

ARMANDO FIMBRES

DEL SMITH

JOEL M. REIKER


DOCKET NOS. T-01051B-03-0454 AND T-00000D-00-0672

IN THE MATTER OF QWEST
CORORATION'S FILING AMENDED
RENEWED PRICE REGULATION PLAN

IN THE MATTER OF THE INVESTIGATION OF
THE COST OF TELECOMMUNICATIONS
ACCESS

JANUARY 12, 2005

# ROWELL

**BEFORE THE ARIZONA CORPORATION COMMISSION**

MARC SPITZER
Chairman
WILLIAM A. MUNDELL
Commissioner
JEFF HATCH-MILLER
Commissioner
MIKE GLEASON
Commissioner
KRISTIN K. MAYES
Commissioner

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SURREBUTTAL

TESTIMONY

OF

MATTHEW ROWELL

CHIEF ECONOMIST

UTILITIES DIVISION

ARIZONA CORPORATION COMMISSION

JANUARY 12, 2005

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## EXECUTIVE SUMMARY
## QWEST CORPORATION
## DOCKET NOS. T-01051B-03-0454 AND T-00000D-00-0672

My surrebuttal testimony rebuts selected points from the rebuttal testimonies of Qwest witnesses David Teitzel and Harry Shooshan. Points addressed in my surrebuttal testimony include: the Federal standard regarding rate relief for cable providers; the use of the HHI; the use of Zip Codes rather than wire centers for Competitive Zones; the maximum rates for basic services in Competitive Zones; the availability of competitive data; and the use of the elasticity of supply in evaluating the competitiveness of markets.

## INTRODUCTION

**Q. Please state your name and business address for the record.**

A. My name is Matthew Rowell. My business address is: Arizona Corporation Commission, 1200 W. Washington St., Phoenix, Arizona 85007.

**Q. Are you the same Matthew Rowell who filed direct testimony in this case on November 18, 2004?**

A. Yes.

**Q. What is the purpose of your testimony?**

A. This testimony responds to certain points made by Qwest witnesses David Teitzel and Harry Shooshan in their rebuttal testimony concerning my direct testimony. My position on any matters not discussed herein is as set forth in my direct testimony.

**Q. Do you have any general observations about Mr. Teitzel's and Mr. Shooshan's Rebuttal Testimonies?**

A. Yes. Staff is somewhat surprised about the emphasis both of these witnesses place on intermodal (particularly cellular) competitors. Qwest's direct case did not rely on intermodal competition to a great extent. Additionally, Qwest's proposed criteria for the establishment of competitive zones did not account for intermodal carriers. Thus the purpose of the emphasis on intermodal competition in Qwest's rebuttal testimony is not entirely clear.

Additionally, the Qwest witnesses appear to be opposed to *any* form of analysis. In our direct testimony, Staff offered several different analysis of the market situation. Qwest appears to have taken exception to all of them and advocates that the Commission make

its decision based on generalized statements and anecdotal evidence rather than a review of the available facts.

**RESPONSE TO THE REBUTTAL TESTIMONY OF DAVID L. TEITZEL**

**Q. At page 15 line 5 through page 17 line 2 of his rebuttal testimony Mr. Teitzel discusses the Federal standard for the removal of rate regulation from cable television providers. Please comment on this part of Mr. Teitzel's testimony.**

A. Here Mr. Teitzel points out that 47 U.S.C. §543(a)(2) allows for the relief of rate regulation (by the FCC) of cable television providers if the cable system is subject to "effective competition." Mr. Teitzel goes on to state that:

> "In fact, under the requirements of 47 U.S.C. §543(1), the cable television provider need only demonstrate that at least two unaffiliated multichannel video programming distributors ("MVPDs"), offering at least 12 channels, are capable of serving at least 50 percent of the households in the cable provider's franchise area *and are actually serving at least 15 percent of the households in that area.* If these minimal criteria are met, the incumbent cable television provider's services are removed from federal, state and local rate regulation."[1]

These criteria that Mr. Teitzel describes as "minimal" are in fact far more stringent than the criteria Qwest has proposed be applied to its Competitive Zone proposal (which is essentially the elimination of traditional rate regulation.) Rather than asses the capacity of Qwest's competitors and measure their current combined market share (as the FCC must do for cable providers) Qwest would limit the Commission to only a cursory review of telephone competition based on the following three criteria:

1. A competitor has facilities in place and is marketing or offering services in competition with Qwest; or,
2. A competitor is marketing or offering services through the provision of unbundled network elements provided by Qwest; or,

[1] Teitzel surrebuttal page 15 line 19 thru page 16 line 5. Emphasis added.

3. A competitor is marketing or offering services through the resale of Qwest's service.[2]

Additionally, the cable industry is much different from the telephone industry and thus cable regulations should not control the formulation of appropriate criteria for determining the competitiveness of telecommunications markets.

**Q. On page 20 line 2 thru page 21 line 5 Mr. Teitzel discusses Staff's use of the Herfindahl-Hirschman Index ("HHI") in your direct testimony. Please comment on Mr. Teitzel's remarks concerning Staff's use of the HHI.**

A. Mr. Teitzel's comments here mischaracterize my direct testimony. While we believe the HHI is an informative statistic, my direct testimony did not advocate a particular value of the HHI that should be used as a standard for Qwest to obtain pricing flexibility. However, Staff does believe that some consideration of the HHI is appropriate in the overall analysis.

**Q. At page 21 line 9 thru page 22 line 2 Mr. Teitzel discusses Staff's recommendation that Competitive Zones be based on zip codes rather than on wire centers (as proposed by Qwest.) Please comment on Mr. Teitzel's critique of Staff's zip code proposal.**

A. Mr. Teitzel's comments are centered on the geographic area that is most convenient and advantageous for Qwest, rather than on an area that is competitively neutral. He states that "All of *Qwest's* network and billing systems are structured around the wire center and exchange concepts..."[3] and that accommodating a zip code based Competitive Zone structure would be costly and difficult for Qwest. It may be true that *Qwest's* network and billing systems are structured around the wire center and exchange concepts but this is not

[2] See the attachment to Qwest's May 20, 2004 filing: "Revised Price Cap Plan Terms, Conditions and Operation of the Revised Price Cap Plan."
[3] Emphasis added.

the case for the CLECs. As stated in my direct testimony, wire centers are not competitively neutral. A Competitive Zone structure based on wire centers may be very easy to accommodate for Qwest but Qwest's CLEC competitors may be disadvantaged by such a scheme. If Qwest is granted the geographic pricing flexibility it proposes, it is only fair that CLECs should be allowed the same sort of flexibility. CLECs that wish to match Qwest's offers in particular zones should be able to do so. If the zones are based on wire centers, CLECs will be disadvantages because they do not know which customers are in which wire centers (this is especially true of CLECs that use their own facilities exclusively.) Thus, under a wire center based regime CLECs that wish to match Qwest's zone based offers would have to go through the expense of changing their billing systems and Qwest would not. In short, Staff sought to propose an alternative that would benefit *competition* not one that would benefit a *particular* competitor.

**Q. Has Qwest provided an estimate of the cost of implementing a Competitive Zone proposal based on zip codes?**

A. No. In response to Staff data request STF 35-003 Qwest indicated that they have not quantified the cost of basing Competitive Zones on zip codes.

**Q. Is Qwest capable of mapping customer locations from wire centers to zip codes?**

A. Yes. In response to Staff data request STF 33-1 Qwest provided a mapping of wire centers into zip codes. Interestingly, that response was provided on a confidential basis.

**Q. At page 22 lines 16 thru 20 of his rebuttal testimony Mr. Teitzel takes issue with the proposition contained in your direct testimony that zip codes are more familiar to customers than wire centers and thus a Competitive Zone regime based on zip codes would lead to less customer confusion than one based on wire centers. Please**

**comment on Mr. Teitzel's remarks regarding customer familiarity with zip codes and wire centers.**

A. Neither Staff nor Qwest has performed a study or conducted a survey that determines whether customers are more familiar with zip codes or wire centers. Staff believes it is common knowledge that zip codes are familiar to a large portion of the population. Further, it is common knowledge that wire centers are not a familiar concept to most of the population.

**Q. On page 24 of his rebuttal testimony Mr. Teitzel presents an alternative Competitive Zone proposal based on prefixes rather than on wire centers. What are Staff's comments on this alternative proposal?**

A. Staff appreciates Qwest's attempt to provide an alternative proposal. However, Staff is not sure exactly how the Competitive Zone proposal would work if it were based on prefixes. This is mainly because prefixes are no longer tied to specific geographic locations. Staff witness Armando Fimbres discusses practical difficulties associated with using prefixes in his surrebuttal testimony.

**Q. In your direct testimony you pointed out that Qwest's Competitive Zone proposal did not explain how maximum rates for services in the Competitive Zones should be established. Has Qwest addressed this issue in their rebuttal testimony?**

A. Yes. On page 25 of his rebuttal testimony Mr. Teitzel suggests that the maximum rates for all services in Competitive Zones be set at double their current rates. In response to Staff data request STF 35-8 concerning the derivation of this maximum rate level Qwest indicated that: "The upper boundary of 'double current rates' was not grounded in an empirical analysis, but rather as a negotiable 'safety net' against unchecked rate increases." Staff is encouraged that Qwest recognizes the need for a "safety net";

however, we still believe that the maximum rates for the basic services identified in my direct testimony should be established at their current level.

**Q. At page 29 line 17 thru page 30 line 3, Mr. Teitzel contends that certain information that Staff thinks is necessary for a proper analysis of competitive zones is not in Qwest's possession and thus such analysis is impractical. Please comment on the practicality of Staff's proposed Competitive Zone analysis.**

A. Mr. Teitzel misrepresents the content of my direct testimony. In my direct testimony I was clear that certain information would have to be supplied by the CLECs. This is especially true of CLECs that use their own facilities exclusively. Thus, Mr. Teitzel's claim that the analysis is impractical because Qwest does not have all of the information is spurious.

**RESPONSE TO THE REBUTTAL TESTIMONY OF HARRY M. SHOOSHAN III**

**Q. At page 5 lines 2 thru 5 of his testimony Mr. Shooshan accuses Staff of "reaching in to basket 3 with a variety of subconstraints..." Mr. Shooshan goes on to state that this "reaching in" undermines the Commission's intent when it established basket 3. Please comment on this part of Mr. Shooshan's testimony.**

A. Mr. Shooshan's analysis is based on a mischaracterization of my direct testimony. Staff is not advocating any additional pricing restrictions on current basket 3 services. Thus Staff is not "reaching in to" some existing part of basket 3 that was previously not subject to rate regulation. Similarly, since Staff is not recommending changes to how current basket 3 services (i.e., services that the Commission saw fit to place in basket 3) are regulated, Staff's recommendations can not be said to undermine the Commissions intentions when basket 3 was established. When basket 3 was established it did not contain basic

telephone services. The Competitive Zone pricing restrictions discussed in my direct testimony apply only to basic services.

**Q. At page 10 line 13 thru page 14 line 15 of his rebuttal testimony Mr. Shooshan indicates that the elasticity of supply is the best measure of "competitive effectiveness." Please comment on Mr. Shooshan's advocacy of supply elasticity as the best measure of the competitive situation.**

A. Mr. Shooshan's comments on supply elasticity are not helpful because he has not provided any actual calculations of the elasticity of supply of telecommunications service. Such calculations would be difficult if not impossible to develop. Since we do not know what the elasticity of supply is, Staff does not understand how the Commission is expected to use the elasticity of supply to make a decision.

In response to Staff data request STF 37-1 Mr. Shooshan acknowledges that the elasticity of supply typically can not be quantified. He goes on to state that:

> "It (the elasticity of supply) is primarily approached as a qualitative assessment of a market. When one analyzes the elasticity of supply in a market, one examines the presence of competitors in the market, the deployment of facilities by competitors as well as the ease to which those facilities or new facilities can be deployed to serve a new or different customer in the market. This analysis yields conclusions regarding the flexibility of firms to meet demand in the market given the various observations."

However, Qwest does not include a thorough analysis of these factors in its testimony. In fact, it appears that Mr. Shooshan's argument about elasticity of supply is merely semantics. He is simply restating Qwest's position that only a cursory analysis should be performed and he has cloaked that position in the parlance of economic theory.

**Q. Does this conclude Staff' surrebuttal testimony?**

A. Yes, it does.

# FIMBRES

**BEFORE THE ARIZONA CORPORATION COMMISSION**

JEFF HATCH-MILLER
Chairman
WILLIAM A. MUNDELL
Commissioner
MARC SPITZER
Commissioner
MIKE GLEASON
Commissioner
KRISTIN K. MAYES
Commissioner

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| IN THE MATTER OF QWEST CORPORATION'S FILING OF 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 |

SURREBUTTAL

TESTIMONY

OF

ARMANDO FIMBRES

PUBLIC UTILITIES ANALYST IV

UTILITIES DIVISION

ARIZONA CORPORATION COMMISSION

JANUARY 12, 2005

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**EXECUTIVE SUMMARY**
**QWEST CORPORATION**
**Docket Nos. T-01051B-03-0454 & T-00000D-00-0672**

My surrebuttal testimony addresses the rebuttal testimony submitted December 20, 2004 by Mr. Teitzel and Mr. Shooshan on behalf of Qwest Corporation.

So many points addressed by Mr. Teitzel and Mr. Shooshan appear to be out of context that the complex information in my direct testimony was either misunderstood or perhaps a full examination of the workpapers, totaling 25 Microsoft Excel files and equaling 2,020 printed 8.5x11 pages, that I provided to Qwest was not conducted.

Intermodal competition appears to have grown in importance in the rebuttal testimony of Mr. Teitzel and Mr. Shooshan compared to Qwest's direct testimony of May 20, 2004. The change is unexplained. By contrast, CLEC competition receives relatively little discussion.

Qwest's May 20, 2004, subsequent statements by Qwest and even Mr. Shooshan's rebuttal testimony indicate that Wireless competition is excluded from the three criteria proposed by Qwest for the designation of competitive zones. Wireless is not considered a facilities-bypass provider (criteria #1), a user of unbundled elements (criteria #2) or a user of resale services (criteria #3). Wireless is only mentioned once in Mr. Teitzel's Competitive Zone direct testimony and, then, only in a footnote[1] reference.

VoIP has the potential to be a local exchange alternative but its inclusion in this proceeding for the purpose of competitive zone designation is unsupported by the available facts.

Specific issues raised by Mr. Teitzel regarding my use or representation of Listings Information, LERG[2] data, Market Share analysis and HHI[3] estimates are without merit. As supported by my direct testimony, market share and HHI analyses were conducted on three bases – Listings Information; Qwest and CLEC Access Line Information; and, Qwest and CLEC Access Line Information and Wireless Line estimates. Additionally, analyses were done across multiple geographies – Statewide, NPAs, Wire Centers and, in part, Zip Codes – for both business and residence customers.

Qwest's objections to Staff's zip code proposal are not supported with corresponding expense estimates. Adding weight to Staff's zip code proposal is market evidence that providers already use zip codes for communicating service availability to end-users. Cox and Sprint PCS[4] use zip codes within their websites for determining service availability. Even Qwest requires the entry of a zip code for those seeking new service using Qwest's online website.[5].

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[1] Footnote 162 at P. 74
[2] Local Exchange Routing Guide
[3] Herfindahl-Hirschman Index
[4] Cox: http://www.cox.com/DigitalCable/; Sprint PCS: http://www.sprintpcs.com/.
[5] https://iot.qwest.com/iot/control/newnameaddr

## INTRODUCTION

**Q. Please state your name, occupation, and business address.**

A. My name is Armando Fimbres. I am a Public Utilities Analyst employed by the Arizona Corporation Commission ("ACC" or "Commission") in the Utilities Division ("Staff"). My business address is 1200 West Washington Street, Phoenix, Arizona 85007.

**Q. What is your role in this case?**

A. I submitted direct testimony on November 18, 2004 addressing the competitive situation in Arizona on behalf of Staff. My surrebuttal testimony will address the rebuttal testimony submitted on December 20, 2004 by David L. Teitzel on behalf of Qwest Corporation, and Harry M. Shooshan, III, consultant for Qwest Corporation.

## GENERAL OBSERVATIONS

**Q. What general points stand out in Mr. Teitzel's rebuttal testimony?**

A. Many aspects of Mr. Teitzel's rebuttal testimony require clarification. While specific points on which I differ with Mr. Teitzel's rebuttal testimony are addressed later in my testimony, a few introductory comments are appropriate in framing my overall position with respect to Mr. Teitzel's testimony.

1 - Mr. Teitzel has taken many aspects of my direct testimony out of context. I was careful to address the contextual importance of my competitive analysis and related information, directly raising the importance of context at 13 points in my direct testimony. Mr. Teitzel ignores the context in which various analyses are offered in his rebuttal testimony.

2 - The importance of Intermodal telecommunications competition, as conveyed in Mr. Teitzel's rebuttal testimony, appears to have risen substantially in importance compared to his direct testimony. Mr. Teitzel's direct testimony does not address Wireless or

VoIP in substance until page 56 of his 107 page testimony, following his discussion of CLEC competition, and accords these issues very little importance in Qwest's competitive zone proposal. In Mr. Teitzel's rebuttal testimony, Intermodal competition is the second issue addressed on page 2 of his 74 page testimony. Mr. Teitzel chooses to address Intermodal competition issues in advance of CLEC competition issues. Mr. Teitzel goes on to address Intermodal competition at many points in his rebuttal testimony. Qwest's need to support Intermodal competition may have risen as the evidence to support substantial and sustainable CLEC competition has declined.

3 - At several points in his testimony, Mr. Teitzel characterizes my direct testimony as "misleading", "incorrect", "unclear", "wrong", "unsupported", an "opinion" or "not based on facts". The number of protests in Mr. Teitzel's rebuttal testimony suggests that Mr. Teitzel did not review workpapers provided by Staff in response to Qwest's data request. In addition to the 23 exhibits included in my direct testimony, Staff has provided workpapers that totaled 25 Microsoft Excel files, equaling 2,020 printed 8.5x11 pages, and 11.1 MB in electronic storage. Given my extensive analysis, Mr. Teitzel's statements are without merit.

**Q. What general points stand out in Mr. Shooshan's rebuttal testimony?**

A. I observe two general points in Mr. Shooshan's testimony that warrant some discussion:

1 - At P. 19-20, Mr. Shooshan comments that minutes of use ("MOUs") should be the basis for market share and HHI analyses. Qwest did not provide responses to Staff's data requests STF 3.18 and STF 6.2 that requested MOU information. Market share and HHI analyses were conducted on three bases – Listings Information; Qwest and CLEC Access Line Information; and, Qwest and CLEC Access Line Information and Wireless Line estimates. Additionally, I analyzed multiple geographic areas – Statewide, NPAs, Wire Centers and, in part, Zip Codes – for business and residence.

2 - As observed with Mr. Teitzel's rebuttal testimony, Mr. Shooshan's rebuttal testimony of my direct testimony is heavily dependent on observations regarding Wireless. In Qwest's direct testimony, CLEC competition appeared to be the focus. In Qwest's rebuttal testimony, Wireless seems to have been given elevated attention. I note that Wireless does not satisfy any of the three criteria offered by Qwest for competitive zone designation. My attention is captured by Mr. Shooshan's rebuttal testimony at P. 20, lines 8-10, "Although Qwest has elected not to rely on the presence of wireless service in its competitive zone criteria, I believe that wireless service is an effective substitute for Qwest's basic local exchange service." I agree that Qwest has chosen not to include Wireless in the competitive zone criteria. By continuing to offer views on Wireless that do not support Qwest's competitive zone proposal, Mr. Shooshan appears to differ with both Qwest's May 20, 2004 application and with my analysis and direct testimony.

**Q. Can you summarize your general observations regarding Mr. Teitzel's and Mr. Shooshan's rebuttal testimony?**

A. Yes,

1 – Mr. Teitzel's and Mr. Shooshan's rebuttal testimonies are based on points in my direct testimony that have been taken out of context.

2 – Mr. Teitzel and Mr. Shooshan have not based their rebuttal testimony on a thorough examination of the data included in my direct testimony, nor the workpapers provided in response to Qwest's request.

3 – Intermodal competition appears to have grown in importance compared to Qwest's direct testimony, submitted on May 20, 2004. Qwest provides no explanation for this shift in emphasis.

4 – Qwest does not provide any new analysis, as evidenced by Mr. Teitzel's lack of rebuttal testimony workpapers[6].

**COMPETITIVE ISSUES**

**Q. At P. 4, Mr. Teitzel disagrees with your conclusion regarding the state of telecommunications competition in Arizona since the 96 Telecom Act was enacted. Can you clarify?**

A. Mr. Teitzel takes exception to my statement "...competitive gains in the nearly 9 year window since the 96 Telecom Act was passed highlight slow progress with little to support that acceleration is imminent." Let's examine my statement further and add more competitive analysis context for clarification.

Since Arizona is one of the largest six states[7] in market size within Qwest's RBOC region, Arizona should logically be one of the most competitive six states. The relevant issue, however, is not Arizona's ranking but rather its factual, competitive situation. I believe 9 years should be a sufficient period for CLECs to have gained significant share and established their market intentions. Qwest agrees. As evidenced by Qwest testimony submitted in the TRO case, T-00000A-03-0369, as little as 5 years should be sufficient for an efficient facilities-based CLEC to succeed.

In the TRO case, Qwest Witness Peter Copeland[8] presented a complex computer model to illustrate that an efficient facilities-based CLEC should be able to gain 5% share in five years. If the competitive situation in Arizona is robust, as portrayed by Mr. Teitzel's rebuttal testimony then the obvious question is, why do so few CLECs appear to meet the

[6] 12/28/04 email from Tim Berg, representing Qwest, to Tim Sabo, representing Staff, "Dave Teitzel--Has no workpapers"
[7] Arizona, Colorado, Minnesota, Oregon, Utah, Washington
[8] direct testimony of Peter B. Copeland, 1/9/04, T-00000A-03-0369

5%, 5-year figures suggested by Qwest in the TRO case or 9 years as I point out in this case? Is the model wrong? Is the 5-year period wrong? Is the 5% market share figure wrong? Are most of the facilities-based CLECs not efficient? Any or all of these factors could be contributors. Regardless, Qwest's own TRO testimony supports my position that 9 years is sufficient.

Let's consider the second point in my statement to which Mr. Teitzel takes exception. Wireless systems have been in operation since the early 1980s. Wireless had been in existence for many years when the 96 Telecom Act was passed yet Congress, and the FCC with the understanding of the RBOCs, omitted wireless from consideration as a local exchange service. The natural progression of Wireless competition has been visible for years and even so was not a factor in the current Price Cap Plan. Even the FCC does not consider Wireless a local exchange alternative on a par with CLEC services, as demonstrated by its Triennial Review Order. More significantly, however, Qwest has offered no evidence, other than anecdotal, to demonstrate the degree to which Wireless phones in Arizona are displacing primary lines rather than secondary lines.

I agree with the characterization used by Cox in its direct testimony – "VoIP is a nascent technology…" While the promise of VoIP appears great, there is little factual evidence to suggest that VoIP is the basis on which Qwest should be granted competitive relief in <u>this</u> proceeding. More time is needed to determine the path of VoIP services and their impact on local exchange services. I referenced an article from TechNewsWorld[9] in my direct testimony that suggests VoIP progress has some challenges that need to be fully addressed.

[9] TechNewsWorld.com, 9/28/04, "VoIP Looms Large, But Problems Persist"

Qwest's December 29, 2004 announcement[10] concerning a delay of its Oregon[11] VoIP plans for residence customers illustrates how the path of new technologies is uncertain. Announced "two years ago" with initial plans for a roll-out in the first-half of 2004, Qwest has delayed its service introduction "until early 2005".

The sum of my direct testimony supports the conclusion that CLEC competition is not accelerating. Only VoIP stands-out as an area from which competitive acceleration could result at some unknown point in the future. These points support my direct testimony statement that there is "little to support that acceleration is imminent" with respect to the Arizona competitive landscape at present.

**Q. Is there more that could be learned about the robust competition in Arizona suggested by Mr. Teitzel?**

A. Although Mr. Teitzel reminds parties by his rebuttal testimony that Arizona has a more robust competitive environment than Idaho, Iowa, Montana, New Mexico, North Dakota, South Dakota, and Wyoming, more could be gained by comparing the situations in Phoenix and Tucson with that of the Omaha, Nebraska MSA, where Qwest filed an FCC petition for forebearance on June 21, 2004. A significant and common factor among the Phoenix, Tucson and Omaha MSAs is the competition between Qwest and Cox. On July 9, 2004, Staff asked Qwest for the following information in STF 7.5.

> *"Please explain Qwest's market share position for Phoenix and Tucson in the same context that Qwest's Omaha market share position was explained in its FCC petition."*

[10] Oregonlive.com, 12/30/04, "Qwest puts hold on proposal for calls from home over Internet"
[11] Qwest also has delayed similar service launches in all 14 states within its RBOC region; TelephonyOnline.com, 1/3/05, "Qwest delays residential VoIP"

Without presenting any actual figures, Qwest's August 2, 2004 response indicates that the Omaha MSA has a greater percentage (Qwest uses the term proportion) of lines losses than the Phoenix and Tucson MSAs.

> *"...Qwest access line losses in the Omaha MSA are significant, and when compared to the smaller Qwest retail line base in Omaha, represent a larger proportion of line losses for that MSA than the percentages shown on Confidential Exhibit DLT-17 for the Phoenix and Tucson MSAs."*

Qwest also indicated in its response to data request STF 7.6 that:

> *"There is no specific "trigger" or "criteria" that would lead Qwest to petition the FCC for forebearance from dominant carrier regulation in Phoenix and Tucson."*

Qwest must have used specific criteria to support its Omaha filing, however, has not explained how specific criteria for Phoenix or Tucson compares to Omaha's competitive position.

Mr. Teitzel initially stated in his direct testimony at P. 7 that "Three years ago, Cox was just entering the Phoenix telecommunications market..." He subsequently retracted his statement in a Notice of Errata docketed on July 27, 2004. That Qwest was unable to state when its key competitor entered the Phoenix market helps illustrate how confusing the competitive situation can be. A robust competitive market should be more obvious and more easily confirmed.

**Q. At P. 8, Mr. Teitzel reacts to your use of white pages listings for competitive analysis. Can you comment?**

A. Mr. Teitzel's rebuttal testimony on the subject of customer information listings also requires comment. I did use the term "highly accurate" in my direct testimony but Mr. Teitzel apparently missed the context of my full statement.

> *"The Listings Information is contributed by all wireline providers and, in some cases, wireless providers of local exchange services for end-user customers and is refreshed often to serve end-user needs and therefore is highly accurate."*

I do not believe that Mr. Teitzel was intending to convey that the many Qwest databases and services dependent on the flow of listings information are inaccurate and not refreshed in accordance with CLEC, ILEC and end-user expectations. Mr. Teitzel failed to observe that I requested comprehensive Listings Information, not just listings contained in the White Pages directory. My interest is exhibited in the explanation attached to the data request (STF 3.20) sent to Qwest on June 16, 2004.

> *"This information should be separated by residence and business and include a count of all listings in its comprehensive database(s), not just those published in the white pages directories or available via director(y) assistance."*

Staff further tried to ensure that Qwest was providing <u>all</u> listings information. Qwest affirmed its understanding via email[12] on July 30, 2004. Inclusion of <u>all</u> listings information was also addressed in part by Qwest's response to STF 19.1 by which Staff sought to obtain Foreign Listings thought to be missing in the response to STF 3.20. Qwest affirmed in its response that Foreign Listings had already been provided.

At P. 8, lines 14-16, Mr. Teitzel states that "...it is not accurate to suggest that white pages listings are equivalent to access lines." Mr. Teitzel mischaracterizes my direct testimony. I was careful to explain in my direct testimony at P. 3, lines 2-5, that:

[12] 7/30/04 email from Norm Curtright to Tim Sabo

> *"The Listings information is useful for analysis because it contains records for all Residence and Business main accounts without regard to listing options, such as privacy or premium listings, thereby allowing analysis based on essentially 100 percent of Residence and Business local exchange main accounts in Arizona"*

Not only does my statement explain that all listings information was used in my analysis without regard to the listing preferences suggested by Mr. Teitzel but also clarifies that main accounts are the primary interest. The additional listing information was not used for market share and HHI analyses. Nowhere in my direct testimony do I attempt to portray that listings information analysis is representative of all access lines.

Additionally, I took steps in my direct testimony to include market share and HHI analyses based on access lines or access line estimates. Exhibit AFF-10 in my direct testimony indicates that I was not misleading in my use of listing information and actually provided a concise table to contrast the use of listings and access line information for market share and HHI analyses.

**Q. Has Staff found additional support for the use of Listings Information?**

A. Yes. Although Mr. Teitzel attacks my use of listings information for analysis of competition, Qwest itself appears to use listings information for its internal analysis of competition. In response to STF 36.12 and STF 36.13, Qwest discloses for the first time the existence of a "Market Intelligence & Decision Support" (MIDS) report. Qwest states that the MIDS report uses listings information, and contains[13] "statistical information by state, city, NPA, prefix, line type and carrier type." Qwest also states that the MIDS report

[13] STF 36.12 and STF 36.13, Market Intelligence & Decision Support (MIDS) File, Data types used: Qwest, CLEC, ILEC, RSID and VOIP.

is "provided weekly to the Qwest Market Intelligence group". Therefore, Qwest seems to be using listings information for its own analysis of market conditions.

**Q. Could the Listings Information have been the basis for even more analysis?**

A. Yes. Had Qwest supplied the listings information updates as requested by data request STF 18.1, the recent competitive trend pertaining to main accounts, or main lines, could have been analyzed. This may have added clarity to the continuing customer loss believed by Qwest. Mr. Teitzel states at P. 6, lines 5-7, that "it is noteworthy that the number of White Pages directory listings associated with CLEC end user access lines increased by over 450%" from December 2000 to September 2004. The percent increase sounds dramatic until one gives fair meaning to the relatively low base from which the percent is derived, a base that by December 2000 represented a period of approximately 5 years since the implementation of the 96 Telecom Act.

While Mr. Teitzel protests my use of listing information, he does not hesitate to use listing information within his own rebuttal testimony. I note that the listings information updates requested in August 2004[14] were not made available to Staff while Qwest was able to provide September 2004 listings information for its own use. I further note that Mr. Teitzel does not clarify whether he used main listings, additional listings or both as the basis for his point at P. 6, lines 5-7. I, however, was careful to make such a distinction in my use of listings information. My workpapers and direct testimony make clear that I only used main listings in my market share and HHI analyses. Staff has been unable to verify or in any way examine Mr. Teitzel's calculations since Qwest has repeatedly confirmed that Mr. Teitzel has no workpapers. Mr. Teitzel's calculations are entirely unsubstantiated and should be given no weight.

[14] Staff's data request STF 18.1, 8/12/04

**Q. At P. 9, Mr. Teitzel seems to take issue with your use of the Local Exchange Routing Guide (LERG) for competitive analysis. Can you clarify that misunderstanding?**

A. Mr. Teitzel's objection to the manner in which I used the LERG is peculiar. The manner in which Mr. Teitzel suggests the LERG should not be used is not the manner in which I used the LERG. Nowhere do I suggest in my direct testimony that there is a singular correlation between the location of switches in the LERG data and the location of customers being served by CLECS providing service. I state in my direct testimony at P. 3, lines 19-23:

> *"From the LERG information it is possible to determine WHO has switches, WHAT type of switches are installed, WHERE switches are located, WHEN switches are scheduled to become active, WHICH NPA-NXXs are assigned to specific switches and many related factors, such as number pooling."*

By not commenting on the manner in which I did use the LERG, I assume that Mr. Teitzel does agree with the manner in which I did use the LERG.

**Q. At P. 20, Mr. Teitzel takes issue with the manner in which you addressed market share and HHI analyses. Do you have any response?**

A. I took steps in my direct testimony to present the Commission and all parties with multiple perspectives of market share analysis. I did not rely solely on listings information analysis, using access line information made available from Qwest in response to RUCO data requests and even derived estimates based on wireless substitution for main and additional lines. That none of the results meet with Mr. Teitzel's approval is not surprising since market share metrics are not included in the three measures offered in Qwest's Price Cap Application. Qwest does not seem to be supportive of any market share metrics.

1. A competitor has facilities in place and is marketing or offering services in competition with Qwest; or,

2. A competitor is marketing or offering services through the provision of unbundled network elements provided by Qwest; or,
3. A competitor is marketing or offering services through the resale of Qwest's service.[15]

Dr. Johnson correctly states in his direct testimony, filed on November 20, 2004 on behalf of RUCO, that "The mere fact that a certain number of "warm bodies" have shown up and announced their intention to offer local telephone service is not indicative of the extent to which meaningful "entry" is actually occurring or the extent to which customers are willing to accept these firms' offerings as viable substitutes for those of their existing carrier." If this case is to be determined on the factual existence of competition rather than the potential for competition, some measure of market share is relevant for competitive zone criteria.

**Q. Do you have any response to Mr. Teitzel's specific objections to your market share calculations?**

A. At P. 20, lines 8-19, Mr. Teitzel comments directly on my presentation of Qwest's market share and related HHI estimates. His comments deserve additional context. Staff understands that specific market share parameters do not currently exist within the Commission rules to assist in the designation of competitive zones. For that purpose, I presented analysis testimony meant to convey the range of possibilities and those which could be used in the designation of competitive zones. The Commission may not want to put undue emphasis on any single parameter, but may want to examine the whole range of market share parameters.

Should the Commission choose to use HHI as criteria it is relevant to know that regardless of the number of competitors, the presence of one competitor with 70% share cannot allow

[15] See the attachment to Qwest's May 20, 2004 filing: "Revised Price Cap Plan Terms, Conditions and Operation of the Revised Price Cap Plan."

the HHI to drop below 4,900. If only one competitor has the remaining 30% share, the total HHI is 5,800. If six competitors, however, equally share 30% while one is at 70% the HHI is 5,050. Now, suppose that two competitors each have 50% of the market. The corresponding HHI would be 5,000. This illustrates, mathematically, that having one competitor at 70% with six at 5% results in similar market concentration as two competitors equally sharing the market. These simple estimates help communicate that Qwest's market share is not the only key factor. The presence of measurable competitors is another way for an HHI to be lowered and may be the best way to support the existence of robust competition. As I expressed in its direct testimony, an HHI of 5,000 is one that may have been reached and even exceeded in several zip codes, some that even Qwest did not seem to suspect in its May 20, 2004 testimony[16].

For completeness, one more estimate should be considered. Even if 5 competitors equally shared the market, each at 20%, the HHI would be 2,000, still above 1,800. This provides an idea of the number of aggressive competitors needed to reach the DOJ figure. Staff agrees that the DOJ figure is a rigorous test and that the 1,800 HHI figure should not be taken as absolute. Staff has thus far formed no concrete opinion on the appropriate levels of market share and HHI that should be used if so chosen by the Commission. Staff does believe that some form of market share figures need to be utilized by the Commission in designating competitive zones.

**Q. Can you summarize your position regarding Mr. Teitzel's and Mr. Shooshan's rebuttal testimony pertaining to Competitive Issues?**

A. Yes,

[16] direct testimony of Armando Fimbres, November 20, 2004, page 53, lines 7-17

1 – By Qwest's own complex modeling, submitted in the TRO case, T-00000A-03-0369, efficient facilities-based CLECs should have been able to gain 5% market share in 5 years. The 96 Telecom Act is nearly 9 years old and very few CLECs have met those figures.

2 - The sum of my direct testimony supports the conclusion that CLEC competition is not accelerating. Only VoIP stands-out as an area from which competitive acceleration could be imminent.

3 - As promising as VoIP appears, little factual evidence exists to categorize VoIP as an imminent threat to local exchange services.

4 - Mr. Teitzel has misunderstood my use of listings information in market share and HHI analyses.

5 - Some form of market share and/or HHI analysis criteria must be used in the designation of competitive zones.

6 - Qwest expressed a change in its understanding by a Notice of Errata docketed on July 27, 2004. That Qwest is no longer able to state when its key competitor entered the Phoenix market helps illustrate how confusing the competitive situation can be. A robust competitive market should be more obvious and more easily confirmed.

**CLEC COMPETITION**

**Q. At P. 17, Mr. Teitzel comments on the upcoming FCC decisions regarding the Triennial Review Order. Do you have any comments?**

A. I do have a few comments regarding Mr. Teitzel's reference at P. 17, lines 8-11. CLECs appear to have placed a surprising number of switches over the course of the 9 years since the 96 Telecom Act was enacted. Even though there may be a surprising number of switches, CLEC utilization of these switches is not significant in some cases. The recent decision in which "...the FCC found that the BOCs should no longer be required to provide

local switching (and the UNE-P wholesale service that includes local switching) as an unbundled network element at TELRIC-based prices", as stated by Mr. Teitzel at P. 17, may actually motivate the CLECs to increase their utilization of UNE loops. That would be a welcomed change in the local exchange competitive environment. For now, however, the FCC decision appears to add more uncertainty to an environment already filled with uncertainty. The recent FCC decision to not require the unbundling of fiber-based loops, such as Fiber-To-The-Home ("FTTH"), will ultimately present barriers for UNE loops in new and upgraded communities. One must wonder if the local wireline switches already in place will be used at a time when, as Qwest suggests so strongly in Mr. Teitzel's rebuttal testimony, that a shift or at least an expansion to VoIP should take place. Whether CLECS are really going to commit themselves to two types of switching and network technologies is unclear.

The potential offered by the local switching that appears to be available is promising but unproven. There is really no evidence to suggest that the CLECs will suddenly make use of local switches for local exchange competition when the CLECs have not done so in the last 9 years.

**Q. At P. 18, Mr. Teitzel claims that you believe that AT&T and MCI are abandoning the mass market by virtue your direct testimony on P. 9. Do you have any response?**

A. I assume that Mr. Teitzel actually meant to reference my direct testimony at P. 10, lines 1-7 which addressed announcements by AT&T and MCI. As a point of fact, abandon is not a word used in my direct testimony nor have I found it used by AT&T or MCI in their announcements. Discontinue, however, is a word that has been used by AT&T and MCI. I believe that both CLECs will still attend to their existing base and perhaps even implement a strategy to migrate existing customers to other technologies, such as VoIP.

What is very clear is that AT&T and MCI have expressed intentions not to actively market to new residential customers.

**Q. At P. 19, Mr. Teitzel states that your statement about competition is an opinion and not based on facts. Do you have a response?**

A. Mr. Teitzel is certainly entitled to his opinion. By his statement, however, Mr. Teitzel overlooks key facts which I provided to Qwest in the form of workpapers that totaled 25 Microsoft Excel files, equaling 2,020 printed, 8.5x11 pages and 11.1 MB in electronic storage. My volume of analysis evidences an effort and testimony based on facts.

Mr. Teitzel goes on to state at P. 19 that "Mr. Fimbres' attempt to narrow the focus of this docket to an assessment of wireline CLECs utilizing CLEC-owned loops to compete with Qwest ignores market realities and should be rejected." This statement warrants a response.

Staff's belief that facilities-bypass competition is more credible evidence of sustainable competition than UNE or Resale competition is supported by the sum of facts presented in my direct testimony. The Omaha, Nebraska situation supports that as well. Staff also believes that evidence of facilities-bypass competition should carry more weight than UNE or Resale competition in the designation of competitive zones. The Omaha, Nebraska situation supports that as well. Furthermore, Staff believes that Qwest's criteria for designating competitive zones are weighted in the opposite direction. I note that only one of Qwest's three criteria involves facilities-bypass provider.

Mr. Teitzel seems to believe that I do not give sufficient credence to the number and type of CLECs. I think it's fair to note that my extensive analysis, as illustrated in Exhibits

AFF-1 through AFF-23 in my direct testimony, identified more switches and competitors than those offered by Qwest in its direct testimony. My direct testimony also did a lot more than simply identify CLECs or switches, which in my opinion is not sufficient evidence to warrant regulatory relief in the form of competitive zones. The CLECS must be active and the switches must be utilized.

**Q. Do any of the official FCC reports support the analysis of your direct testimony?**

A. Yes. On December 22, 2004, the FCC's Wireline Competition Bureau released its updated Local Telephone Competition Status Report. The FCC reports that ILECs have 2,415,432 out of 3,229,626 access lines in Arizona[17]. This means that CLECs have only 25% of the access lines, as reported by the FCC and is similar to and consistent with my observation[18] that CLECs have only 21.9 percent of Residence Main Listings. In Arizona, ILECs such as Qwest clearly remain the dominant carriers.

**Q. Can you summarize your position regarding Mr. Teitzel's and Mr. Shooshan's rebuttal testimony pertaining to CLEC Competition?**

A. Yes,

1 – CLECS appear to have a surprising number of local switches available for local exchange competition, however, not all of these switches are being utilized to provide local exchange service.

2 - Facilities-based competition is the most substantial and sustainable form of CLEC competition.

[17] Report at Table 6; "Local Telephone Competition: Status as of June 30, 2004", Industry Analysis and Technology Division, Wireline Competition Bureau, FCC, December 22, 2004

[18] Fimbres direct testimony at P. 7, line 5

3 - Only one of Qwest's three competitive zone criteria concerns facilities-based competition. The other two of Qwest's criteria would allow Qwest competitive relief if there was one Resale or UNE provider.

4 - FCC figures in the December 22, 2004 report support my direct testimony and indicate that ILECs, such as Qwest, clearly remain the dominant carriers in Arizona.

**INTERMODAL COMPETITION**

**Q. Do you have a general response to the many issues raised about Wireless competition?**

A. Yes. I note a general dependency in Mr. Teitzel's rebuttal testimony on the impact of Wireless services. For analysis purposes, Staff included Wireless as a local exchange alternative in this matter as evidenced by the data requests sent to Wireless providers, the related Wireless information requested of Qwest and the zip code approach that has been recommend by Staff for use in designating competitive zones. I have been surprised by Qwest's responses and behavior regarding Wireless providers.

For example, in a July 27, 2004 meeting attended in person or by phone by several representatives from Staff, Qwest, RUCO, Time Warner and AT&T, Qwest was asked if Wireless should be considered a facilities-bypass provider for the purposes of competitive zone designation. At first, Qwest answered yes, however, when informed by AT&T's counsel, Mr. Wolters, that Qwest's position could result in <u>all</u> wire centers passing the first criteria for competitive zone designation offered by Qwest, Mr. Berg, Qwest's attorney, answered that Wireless was not a facilities-bypass provider for the purpose of designating competitive zones[19]. Therefore, how Staff or anyone else in this case should view Wireless against the criteria (stated below) offered by Qwest is not clear.

[19] This position was reaffirmed by Qwest's response to Staff data request STF 36.14.

1. A competitor has facilities in place and is marketing or offering services in competition with Qwest; or,
2. A competitor is marketing or offering services through the provision of unbundled network elements provided by Qwest; or,
3. A competitor is marketing or offering services through the resale of Qwest's service.[20]

By Qwest's own admission, Wireless does not satisfy the 1st criteria. Unless Qwest wishes to present evidence that Wireless is a user of UNEs or Resale services, then the 2nd and 3rd criteria cannot be satisfied either. Once again, how Staff or anyone else in this case should view Wireless against the criteria offered by Qwest is not clear.

Despite the dilemma presented by Qwest pertaining to the inclusion of Wireless, Staff chose to include Wireless in its rigorous analysis. Even so, the Wireless LIS trunk information that Staff requested in STF 26.1.c was provided by Qwest in such a limited fashion it was not usful. Without that information I am unable to speak to the trend in Wireless LIS trunks interconnecting with Qwest. I also requested Wireless MOUs from Qwest in STF 3.18 and again in STF 6.2. In a phone discussion with Qwest on July 28, 2004, Staff was told that Wireless MOUs could only be provided in raw data form. Believing the work would exceed available resources, Staff declined to accept the information in raw form. Even so, Staff continued its search for information directly with Wireless providers. Evidence of that search can be found in my direct testimony at P. 26.

Finally, Staff's recommendation to base competitive zones on zip code parameters was made with the knowledge that if Wireless is deemed by the Commission to be a local exchange alternative on a par with CLECs in a future proceeding, Wireless information

[20] See the attachment to Qwest's May 20, 2004 filing: "Revised Price Cap Plan Terms, Conditions and Operation of the Revised Price Cap Plan."

could more easily be included for competitive zone designation by using zip code parameters than using wire center boundaries.

**Q. At P. 11, Mr. Teitzel states "By any measure, wireless substitution is a present and increasing competitive factor in Arizona and must be considered in a balanced assessment of telecommunications competition in the market."**

A. To that, I offer a simple measure, one that I suggest[21] for anyone inclined to choose Wireless for their main line, local exchange service. In order to reach the critical 911 service, a user must do the following.

1. Press the power-on button on the wireless phone.
2. Wait for the phone to establish proper contact with the wireless network.
3. Key in 9-1-1
4. Press the send key
5. Wait for the phone to first send the proper tones
6. Wait for the phone to establish the connection.

If 911 can be reached in less than 12 seconds and that is satisfactory for local exchange service, then an end-user is at least making an informed decision. End-users should remember that reaching 911, or any dialed number, is dependent on (1) the phone having adequate battery power, (2) adequate signal strength at the user location and (3) an available channel to establish the call, a potential problem during peak Wireless usage periods. Consider the stark difference when considering the same points for wireline local exchange service. Concerns for real-time service availability are such that wireline local exchange service providers have central office battery power supported by emergency generators and each end-user has a dedicated loop (the equivalent of a wireless channel) with strict quality standards.

[21] 911 is a critical service. Calls should only be made to 911 for the purpose of reporting an emergency or confirming the accuracy of information for the desired phone or location upon initiating new service.

As I indicated in my direct testimony "An important fact can be found in footnote 702 of the FCC TRO order " AT&T points out, for example, that wireless service is engineered to provide only roughly 70% call completion rate while wireline call completion rates exceed 99%." A recent report from Consumer Reports[22] helps illustrate how many service issues remain with wireless service. Qwest's wireline service, and any CLEC service, is more reliable, superior, and representative of local exchange service expectations.

**Q. Do you have any reaction to the statements by Dr. Pociask at P. 13-14 in M. Teitzel's rebuttal testimony?**

A. Dr. Pociask is essentially correct but his statements have to be placed in context. Wireless is "functionally equivalent" and "functionally comparable". I said as much in my direct testimony. I was careful, however, not to use the terms "sufficiently equivalent" or "sufficiently comparable" as to equate to local exchange service. CLECs with loop-based networks or cable phone systems are "sufficiently equivalent" or "sufficiently comparable" to Qwest's wireline local exchange service. CLECs are "sufficiently equivalent" because their service meets the same real-time standards of Qwest's local exchange service, which I outlined earlier. Wireless does not.

The approximately 2.8 million Arizona wireless users can be logically divided into five general[23] categories:

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[22] 1/4/04, Reuters, "Consumers: Cell phone service still stinks"; 1/05/05, The Dallas Morning News, "Consumer Reports survey: Verizon is best of a mediocre lot"

[23] Additional categories could be illustrated in which MOUs are added in concert with or following the displacement of main and additional wireline phones. Since those categories do not add to the discussion of the full displacement categories of 4 and 5, additional categories have been omitted for this example.

(1) Full Market Expansion: Those who use a wireless phone without diminishing or changing their wireline phone usage. For these users a wireless phone is fully incremental.

(2) Part Market Expansion & Part Value Displacement: Those who may expand their overall usage but still shift part of their wireline usage to a wireless phone.

(3) Part Value Displacement: Those who do not expand their overall usage but shift some of the wireline usage to wireless phone.

(4) Full Displacement of Additional Line: Those who fully replace their additional wireline phone with their wireless phone.

(5) Full Displacement of Main Line: Those who fully replace their main wireline phone with their wireless phone.

Qwest would have parties in this proceeding believe that sufficient numbers warranting regulatory relief are already present in categories 4 and 5. I believe the overwhelming numbers, as supported by my direct testimony, are in categories 1, 2 and 3. I support Qwest's general concerns, however, since the uncertainty of local exchange mass market behavior could lead to dramatic shifts, with little notice, in users from category 1 to category 2 to category 3 and, finally, categories 4 and 5, the categories of most concern in this proceeding.

I also sought to conduct MOU analysis and even recommended tracking and analysis related to Wireless MOUs. MOU information is one more factor that could be considered by the Commission in determining whether to include Wireless as an alternative.

**Q. At P. 20, Mr. Shooshan states that you chose "...to look the other way..." in your analysis of Wireless competitive information. Do you have any response?**

A. I do not agree with Mr. Shooshan. My direct testimony contained much more extensive analysis of Wireless as a potential competitor than Qwest's direct testimony. However, all of the competitive analysis and corresponding testimony submitted by Qwest and by Staff eventually leads to answering a final question – is the Wireless competitive impact sufficient to warrant competitive zone consideration on a par with CLEC competition? I believe my direct testimony is responsive to that key question. I note that neither Mr. Teitzel nor Mr. Shooshan has presented any data or analysis in their Direct or rebuttal testimony that links the competitive impact of Wireless to any geography below the state level. Therefore, how parties in this case are supposed to understand where the wireless impacts have occurred is not clear. As proposed by Qwest, competitive zones are geographically defined by wire centers. However, Qwest has not presented data that measures Wireless users by wire center or any other boundary below the state level. Staff, at least, has offered a zip code boundary proposal that offers the potential for inclusion of Wireless, and VoIP.

For the multitude of fact based reasons presented in my direct testimony[24], supported by extensive analysis, I affirm my position that the Wireless evidence is not sufficient to warrant competitive zone consideration on a par with CLEC competition. The most relevant examples may be – (1) Wireless is not yet deemed to be an adequate substitute for local exchange service by the FCC and (2) Wireless users cannot be confirmed by wire centers.

**Q. Do you have a general response to the many issues raised by Mr. Teitzel about VoIP competition?**

[24] Pages 26, 27, 30, 31

A. As with Wireless, I devoted considerable analysis time and effort but did not find substantial evidence of VoIP users. Even Qwest, with its responses to AFF 1.1-1.5, indicated it could not provide supporting information. VoIP has potential but its inclusion in this proceeding for the purposes of competitive zone designation is unsupported. As pointed out in my direct testimony, the number of VoIP users is very low[25] and the future of VoIP service is uncertain[26].

**Q. Can you summarize your position regarding Mr. Teitzel's and Mr. Shooshan's rebuttal testimony pertaining to Intermodal Competition?**

A. Yes,

1 – Intermodal competition appears to have grown in importance without explanation compared to Qwest's direct testimony of May 20, 2004.

2 - Competitive zone criteria proposed by Qwest does not allow for the inclusion of Wireless as a local exchange competitive alternative.

3 - Qwest's wireline local exchange service, and that of any CLEC, is more reliable, superior, and representative of local exchange market expectations than Wireless.

4 - As stated in my direct testimony, I believe that Wireless usage, or MOU information, should be tracked, analyzed and made available for the Commission's use as one more indicator of the competitive situation.

5 - Qwest has not presented data that defines Wireless users by wire center or any other boundary. Staff, at least, has offered a zip code boundary proposal that offers the potential for inclusion of Wireless, and VoIP.

6 - VoIP has potential but its inclusion in this proceeding for the purposes of competitive zone designation is unsupportable at this time.

[25] Pages 34 - 36
[26] Pages 38 - 40

**COMPETITIVE ZONES**

**Q. At P. 21, Mr. Teitzel expresses concerns about the use of zip codes as recommended in your direct testimony. Do you have any comments?**

A. My direct testimony included comments supporting the use of zip codes as referenced in the testimony of Staff witness Matt Rowell. I will limit my comments for that reason to areas of competitive impact.

I am sensitive to causing undue expense for Qwest as it seeks regulatory flexibility with competitive zones. I am also concerned, however, with ensuring that rules pertaining to competitive zones are equal for all parties and that information used to designate competitive zones is also based on input from the diverse set of participants who will be impacted by competitive zones. In fairness, as Qwest gains regulatory relief other participants will be faced with a much more competitive environment.

Mr. Teitzel expresses Qwest's concern for increased expense at P. 21 without including estimates[27]. Without knowledge of the expenses that might be incurred by Qwest using zip code competitive zone designations, I am unable to comment on the reasonableness of such expenses. In the competitive context, however, I believe that expenses involving the use of zip code information are already borne within the sophisticated marketing departments and billing systems of all telecommunications providers. Sophisticated use of zip code information appears to be a standard operating procedure of all telecommunications providers.

Staff also notes that Qwest[28] has been able to report broadband data to the FCC[29] for several years on a zip code basis. Qwest also reports other competitive data[30] to the FCC

[27] Qwest provided no expense figures in response to Staff data request STF 35.3
[28] Qwest admits in response to STF 38.5, "Qwest does report broadband information on a zip code basis to the FCC"

on a zip-code basis. Reporting local exchange information for use in designating competitive zones would seem to be no more difficult.

**Q. At P. 22, Mr. Teitzel expresses concern that more confusion will result from competitive zone designated by zip code than wire centers, as proposed by Qwest. Do you have any comments?**

A. Customer use and understanding of zip code information is far greater than conveyed by Qwest[31]. Many websites appear to be driven by zip code searches. For instance, customers wishing to determine if Cox digital cable service is available in their area need only enter the zip code - http://www.cox.com/DigitalCable/. The wireless firm with whom Qwest is partnering, Sprint PCS, allows customers shopping for service plans to enter a zip code – http://www.sprintpcs.com/. Even, Qwest's own website requires customers searching for new phone service to enter their zip code – https://iot.qwest.com/iot/control/newnameaddr. Conversely, I would be very surprised to learn that many customers know the Qwest wire center in which they are served or could be served. Nowhere on Qwest's website is a customer seeking new service required or asked to enter a wire center name.

Telecommunications is long past the time when customers understood that phone numbers, such as MA5-4444, meant Main 5-4444 and roughly understood that their service came from the Main telephone office, perhaps just down the street.

**Q. At P. 24, Mr. Teitzel suggests using prefixes as an alternative to zip codes for competitive zone boundaries. Is that a practical approach?**

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[29] e.g., FCC 00-290, August 2000
[30] See "Local Telephone Competition: Status as of June 30, 2004", Industry Analysis and Technology Division, Wireline Competition Bureau, FCC, December 22, 2004 at page 3 and footnote 12 (describing zip-code based reporting requirement).
[31] Qwest admits in response to STF 38.1, "Qwest uses zip codes in marketing activities"

A. Given the many changes that have occurred in telephone number assignments and which are likely to continue, this proposal is impractical. To begin, I am going to assume that Mr. Teitzel means a "Qwest area code and prefix" rather than just a "Qwest prefix" since prefixes are commonly used in more than one area code. That clarification helps illuminate the problem. Prefixes are not unique to areas, providers or even types of telecommunications services. Is a prefix that was once a Qwest prefix going to remain a Qwest prefix? Number portability has basically untied phone numbers from geographies. Number pooling further complicates the numbering distinction that once existed between providers and types of telecommunications services. Consider a simple example. Which of the following prefixes in the 480 area code might customers believe are assigned to Qwest and which are assigned to Cox: 350, 471, or 663? Perhaps not surprisingly, it appears that both Qwest and Cox have thousands blocks within all three prefixes. Adding more confusion, it appears that number portability has resulted in at least 11 providers (including Qwest) having customers using numbers in 480-350, 5 providers in 480-471 and 12 providers in 480-663[32]. Therefore, how customers will understand who is the provider is for any area code and prefix is unclear.

**Q. At P. 49, Mr. Teitzel responds to Mr. Lee's testimony from November 18, 2004 representing the Department of Defense ("DOD"). Do you have any reaction to the position taken by DOD and rebutted by Teitzel regarding separate business and residence competitive zones?**

A. With complexity of the competitive situation, anyone can become confused by the information and its meaning. In its direct testimony, Qwest appeared to believe that Cox had entered the Phoenix market "serving primarily business customers"[33]. That statement was subsequently retracted by Mr. Teitzel in a Notice of Errata docketed on July 27, 2004.

[32] Information based on June 18, 2004 data provided by Qwest
[33] Teitzel direct testimony, May 20, 2004, page 7, lines 17-18

While a competitive zone for all customers would be easier to determine and manage, separate business and residence competitive zones are worthy of full discussion. All CLECs are not competing equally in business and residence. For example, my direct testimony states at P. 21-22, that XO, Eschelon, Xspedius and McLeod are focused on business services. As supported by Exhibit AFF-7 in my direct testimony, Cox is the only CLEC with significant residence presence[34]. Staff Witness Rowell's direct testimony also supported the use of separate business and residence competitive zones.

**Q. Can you summarize your position regarding Mr. Teitzel's and Mr. Shooshan's rebuttal testimony pertaining to Competitive Zones?**

A. Yes,

1 – In response to Staff's proposal to use zip codes as the basis for competitive zone, Mr. Teitzel expresses Qwest's concern for increased expense without providing any supporting data.

2 - Qwest already appears to be reporting broadband information to the FCC on a zip code basis.

3 - Video cable and Wireless providers already use websites in which users search for the availability of services by zip code. At least one of Qwest's websites requires that customers enter their zip codes when searching for new phone service.

4 - Mr. Teitzel's proposal to use prefixes is more confusing to customers than zip codes and not practical since prefixes are no longer unique to geographic areas or providers.

**Q. Does this conclude Staff's surrebuttal testimony?**

A. Yes, it does.

[34] Exhibit AFF-7 presents indexed information to protect confidential numbers.

# D. SMITH

**BEFORE THE ARIZONA CORPORATION COMMISSION**

JEFF HATCH-MILLER
Chairman
WILLIAM A. MUNDELL
Commissioner
MARC SPITZER
Commissioner
MIKE GLEASON
Commissioner
KRISTIN K. MAYES
Commissioner

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| IN THE MATTER OF QWEST CORPORATION'S FILING OF 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 |

SURREBUTTAL

TESTIMONY

OF

DEL SMITH

UTILITIES ENGINEER SUPERVISOR

UTILITIES DIVISION

ARIZONA CORPORATION COMMISSION

JANUARY 12, 2005

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**EXECUTIVE SUMMARY**
**QWEST CORPORATION**
**DOCKET NOS. T-01051B-03-0454 & T-00000D-00-0672**

My surrebuttal testimony responds to the rebuttal testimony of Mr. Scott A. McIntyre and Mr. George Pappas as it relates to service quality standards and the penalty provisions of Qwest's Service Quality Plan Tariff and the Alternate Form of Regulation Plan. Contrary to the allegations of Mr. McIntyre that Staff's recommended changes to the Service Quality Plan Tariff penalty/offset thresholds would be punitive to Qwest and that the current standard is cumbersome and unnecessary, I believe that the fine-tuning recommended in my direct testimony is beneficial to Qwest's customers. Similarly, I do not concur with Mr. Pappas that it is appropriate to discontinue the Service Quality Plan Tariff penalties for held order and out-of-service failures. I also do not concur that it is appropriate to terminate the $2.00 one-time credit penalty that is a part of the current AFOR plan.

INTRODUCTION

**Q. Please state your name and business address.**

A. My name is Del Smith. My business address is 1200 West Washington Street, Phoenix, Arizona 85007.

**Q. By whom are you employed and what is your position?**

A. I am employed by the Arizona Corporation Commission ("Commission") in its Utilities Division. My title is Utilities Engineer Supervisor.

**Q. Have you filed testimony previously in this case?**

A. Yes. I filed direct testimony on November 18, 2004.

REBUTTAL TESTIMONY OF MR. SCOTT A. MCINTYRE

**Q. Was a change to the performance objective for the residence, business and repair centers proposed in Staff's testimony as suggested by Mr. McIntyre's rebuttal restimony?**

A. No. The objective would remain at 80 percent of the calls to be answered within 20 seconds. What Staff did recommend was a change in the ranges for determining the applicable penalty or offset for the objective.

**Q. If Staff's recommendations are implemented, will meeting the objective for these centers result in an increased penalty for Qwest as alleged in the rebuttal testimony of Mr. McIntyre on page 20 at lines 21 and 22?**

A. No. There would continue to be no penalty to Qwest if the centers met the objective that 80 percent of the calls be answered within 20 seconds.

**Q. Does Staff agree with the suggestion by Mr. McIntyre in his rebuttal testimony that the penalties for poor answer time performance by these centers be eliminated altogether?**

A. No. As long as Qwest continues to perform well, there is no penalty impact to the Company. Staff believes that the possibility of penalties is an incentive to Qwest to maintain its performance levels which is a continuing benefit to consumers.

**Q. In his rebuttal testimony, Mr. McIntyre states a variety of reasons why it could be difficult to appropriately staff the centers. He also identifies certain other factors he believes can impact center answer time performance. Does this lead Staff to make a change to their recommendation on penalty/offset threshold adjustments?**

A. No. While these factors may in fact influence center answer time performance, they are not new challenges for center management. Qwest is, for the most part, addressing them appropriately as suggested by the Company's answer time results. Staff does not believe a modification to the penalty/offset thresholds would negatively impact how the Company manages its workforce in the centers or responds to events such as inclement weather.

**Q. In his rebuttal testimony, Mr. McIntyre recommends a 60-second average wait time instead of the current objective. Did Qwest address this proposal in direct testimony or provide any objective data in rebuttal testimony that would substantiate his recommendation?**

A. No. Qwest did not recommend any changes to the Service Quality Plan Tariff in its Direct Testimony. Mr. McIntyre also does not provide any supporting objective data to substantiate his assertion that average wait time would be a better measure of customer satisfaction for answer time response.

**Q. Does Staff support a change in the answer time objective as recommended by Mr. McIntyre in his rebuttal testimony?**

A. Not at this time. Staff does not believe such a change would be appropriate given the absence of objective data to substantiate such a change. Further, it is Staff's understanding that previously Qwest has voluntarily reported parallel results (% answered within 20 seconds and average wait time measures) for the centers to Staff at the Idaho Commission and that no clear correlation between the results was evident to Idaho Staff. In Staff's opinion, an objective that ignores the length of time it takes for a call to be answered and instead only measures average customer wait time after a customer's last selection from an automated response system menu is not intuitively a better measurement of customer satisfaction; especially when the duration for meeting the objective is longer.

**Q. Do other states within Qwest's service territory utilize a percent answered with 20 second objective for the centers as is the current objective for Arizona comparable?**

A. Yes. For example, it is Staff's understanding that Minnesota requires that 90 percents of the calls be answered within 20 seconds, in a rule making Montana is proposing 85 percent within 20 seconds, retail repair in Nebraska is 90 percent within 20 seconds and that Oregon is 85 percent within 20 seconds.

REBUTTAL TESTIMONY OF MR. DENNIS PAPPAS

**Q. In his rebuttal testimony, Mr. Pappas recommends elimination of the $2.00 additional one-time credit. Does Staff agree with his recommendation?**

A. No. The $2.00 additional one-time credit was agreed to by Qwest as a condition for moving towards an alternate form of regulation ("AFOR"). Staff does not believe that it is appropriate to eliminate this performance penalty after only one term of the AFOR plan.

The existence of the potential penalty serves as an ongoing incentive to Qwest to maintain its service quality performance.

**Q. In his rebuttal testimony, Mr. Pappas also recommends that the Service Quality Plan penalty provisions for out-of-service and held orders be eliminated. Does Staff agree with his recommendation?**

A. No. Staff believes the existence of these penalties serve as an ongoing incentive to Qwest to maintain its service quality performance and, as a result, consumers benefit. The penalties only become an issue if, and should, Qwest service quality deteriorate to unacceptable levels.

**Q. Did Qwest argue for elimination of service quality penalties in either its original filing in this matter or in its previously filed direct testimony?**

A. No, the Company did not.

**Q. Mr. Pappas suggests in his surrebuttal testimony that the existence of local competition and consumer choice are a sufficient alternative to continuance of service quality penalties. Do you agree with his position?**

A. No. Staff witness Fimbres explains that that Qwest remains the primary provider of wireline service in its service territory[1]. The Service Quality Plan Tariff, and its associated penalties, was established to address Qwest past performance issues and attempt to insure they do not repeat in the future. In Staff's opinion, it is appropriate for the penalties to remain a part of the Service Quality Plan Tariff. Whether or not the penalties are imposed remains determined by the commitment Qwest makes toward maintaining the necessary levels of service quality.

[1] Direct testimony of Armando Fimbres, November 18, 2004, discussing CLEC Competition.

**Q. Mr. Pappas suggests in his rebuttal testimony that because Qwest provides individual bill credits for the same service failures that are covered by the service quality penalties that the penalties are unnecessary. Does Staff agree with his position?**

A. No. First, as indicated in Staff's direct testimony, Qwest's Service Quality Plan Tariff requires Qwest to pay both penalties and bill credits (the same bill credits that Mr. Pappas describes in his rebuttal testimony) for its service failures. Staff does not agree that because Qwest is required to pay bill credits to customers that the penalties should be eliminated; the Service Quality Plan Tariff was designed to provide both. The bill credit is as an individual customer specific remedy that applies for a specific service failure whereas; the annual penalties are based on Qwest's cumulative service results. The penalties were designed to kick-in when on a cumulative basis year end service results for a category overall drop below an acceptable level and thus provide an incentive for the Company to improve its service quality.

CONCLUSION

**Q. Would you please summarize Staff's surrebuttal testimony.**

A. Yes. Contrary to the allegations of Mr. McIntyre that Staff's recommended changes to the Service Quality Plan Tariff penalty/offset thresholds would be punitive to Qwest and that the current standard is cumbersome and unnecessary, Staff believes that the fine-tuning recommended in their direct testimony is beneficial to Qwest's customers. As long as Qwest continues to meet the objectives contained in its tariff no penalties will be incurred by Qwest. This remains the case even with Staff's recommended threshold revisions. A continued possibility of penalties should performance decline at some point in the future is an incentive for Qwest to continue its focus on service quality and thus is an ongoing benefit to Arizona consumers that should remain in place.

Similarly, Staff does not concur with Mr. Pappas that it is appropriate to discontinue the Service Quality Plan Tariff penalties for held order and out-of-service failures. Staff also does not concur that it is appropriate to terminate the $2.00 one-time credit penalty that is a part of the current AFOR plan.

**Q. Does Staff continue to advocate that the Commission adopt the recommendations contained within their direct testimony?**

A. Yes, Staff does.

**Q. Does this conclude Staff's surrebuttal testimony?**

A. Yes, it does.

# REIKER

**BEFORE THE ARIZONA CORPORATION COMMISSION**

JEFF HATCH-MILLER
Chairman
WILLIAM A. MUNDELL
Commissioner
MARC SPITZER
Commissioner
MIKE GLEASON
Commissioner
KRISTIN MAYES
Commissioner

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| IN THE MATTER OF QWEST CORORATION'S FILING AMENDED RENEWED PRICE REGULATION PLAN. | ) | DOCKET NO. T-01051B-03-0454 |
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SURREBUTTAL

TESTIMONY

OF

JOEL M. REIKER

SENIOR PUBLIC UTILITIES ANALYST

UTILITIES DIVISION

JANUARY 12, 2005

**EXECUTIVE SUMMARY**
**JOEL M. REIKER**
**DOCKET NOS. T-01051B-03-0454, T-00000D-00-0672**

The surrebuttal testimony of Staff witness Joel M. Reiker addresses the following issues:

Response to the rebuttal testimony of Peter C. Cummings

*Hamada Methodology* – Staff responds to Mr. Cummings' assertion that Staff inappropriately used book-value capital structures when applying the Hamada leverage adjustment methodology.

Staff does not take issue with the prescribed application of the Hamada methodology. Corporate finance states that a firm's weighted average cost of capital ("WACC") is appropriately calculated using the market-value capital structure. However, *regulatory* finance determines a fair rate of return ("ROR") as a weighted average of the embedded cost of debt and the opportunity cost of equity, measured at *book value*. Hence, it is the book value of debt and equity which is of interest to the regulator.

Mr. Cummings' capital structure/financial risk adjustment, which compares market-value capital structures to a book-value capital structure, unnecessarily introduces a known inconsistency to the required return estimate for Qwest. An appropriate adjustment procedure would compare book values to book values rather than market values to book values.

Mr. Cummings' testimony regarding Qwest's market value is inconsistent with the testimony of Company witness Philip Grate, and supports Staff's position that it is appropriate to unlever and relever beta using book-value capital structures in this proceeding.

*Adjusted Betas* – Staff responds to Mr. Cummings' testimony that published betas should not be unadjusted before they are unlevered and relevered.

The relative effect of unadjusting and readjusting beta is the result of simple mathematics and not an ad hoc attempt to trim Staff's estimate of Qwest's required return, as Mr. Cummings suggests.

The relevered beta provided by the Hamada methodology is an estimate of the OLS slope, or statistical regression, of an adjusted rate of return time series. Accordingly, if the result of unlevering and relevering beta estimates using Hamada's methodology is a classical, or raw estimate, it makes sense to begin with a classical, or raw, estimate rather than a Bayesian estimate.

A reasonableness check on Staff's capital structure/financial risk adjustment based on modern capital structure theory set forth by Franco Modigliani and Merton Miller confirms the reasonableness of Staff's recommendation in this case.

Response to the rebuttal testimony of Philip E. Grate

*Fair Value/Earnings Requirement* – Staff responds to Mr. Grate's assertion that the ROR must be multiplied by the Company's fair value rate base ("FVRB") to determine dollar earnings, rather than multiplying the ROR by the OCRB and solving for a ROR that, when applied to the FVRB, produces the same dollar level of earnings.

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## INTRODUCTION

**Q. Please state your name and business address.**

A. My name is Joel M. Reiker. My business address is 1200 West Washington Street, Phoenix, Arizona 85007.

**Q. Are you the same Joel M. Reiker who previously filed direct testimony in this proceeding?**

A. Yes.

**Q. What is the purpose of your surrebuttal testimony?**

A. The purpose of my surrebuttal testimony is to respond to criticisms of Staff's direct testimony contained in the rebuttal testimony of Qwest Corporation ("Qwest" or "Company") witness Mr. Cummings. I also respond to Company witness Philip Grate's rebuttal testimony concerning fair value.

## I. RESPONSE TO THE REBUTTAL TESTIMONY OF PETER C. CUMMINGS

### Capital Structure/Financial Risk Adjustment

*Hamada Methodology*

**Q. How does Staff respond to Mr. Cummings assertion that the levered and unlevered beta equations developed by Professor Hamada specify the use of market values of debt and equity, rather than the book values used by Staff? (See rebuttal testimony of Peter C. Cummings. p. 6 at 16 – 20 & p. 7 at 1 – 4.)**

A. Staff agrees that Hamada indeed specifies the use of market values of debt and equity in his leveraging equations. Staff does not take issue with Hamada's specification. In the realm of unregulated corporate finance the weighted average cost of capital ("WACC") is properly calculated using *market* values of debt and equity. It, therefore, follows that a

leveraging equation such as Hamada's would, in turn, call for market values rather than book values of debt and equity. However, Mr. Cummings' position and statement that Staff "used the wrong input for equity capital... the book value percentage of equity capital instead of the market value..." (see rebuttal testimony of Peter C. Cummings. p. 7 at 13 – 15) ignores the fact that in the realm of *regulatory* public utility finance, a fair rate of return ("ROR") is a weighted average of the embedded cost of debt and the opportunity cost of equity, *measured at book value.*[1] Hence, it is the mix of outstanding debt and equity securities used to finance the utility's original investment, i.e., the *book* value of debt and equity, which is of interest to the regulator when setting rates.

**Q. Is it appropriate to compare the capital structure of a utility, measured at book value, with the average capital structure of a sample group, measured at market value, as Mr. Cummings does in his financial risk adjustment and Exhibit PCC-3 of his direct testimony?**

A. No. As stated on page 7 (line 13) of Staff's direct testimony, the cost of equity is determined by the market. Therefore, market-based models such as the DCF model and the CAPM are used to estimate the cost of equity. Staff agrees with Mr. Cummings' statement that inherent in rate of return regulation "is the potential for some mismatch in the application of financial theory and models to the construct of rate base regulation." (See rebuttal testimony of Peter C. Cummings. p. 8 at 1 – 3.) However, cost of capital estimation is subject to significant estimation error without introducing additional and unnecessary *known* inconsistencies. Mr. Cummings unnecessarily introduces a known inconsistency to his final cost of capital estimate for Qwest by unlevering beta with a market-value capital structure and relevering it with a book-value capital structure. An

[1] See Myers, Stewart C. "The Application of Finance Theory to Public Utility Rate Cases." *Bell Journal of Economics and Management Science.* Spring 1972. p. 92.

appropriate adjustment procedure would compare book values to book values rather than market values to book values.

**Q. Is it normal practice in utility rate cases to compare the book-value capital structure of the subject utility to the market-value capital structures of proxy companies for the purpose of making a financial risk adjustment to the allowed return on equity ("ROE")?**

A. No. Staff regularly processes rate applications for utilities of all sizes. It is not normal practice to compare the book-value capital structure of the subject utility to the market-value capital structures of proxy companies. Staff's approach in this case is the same approach previously approved by the Commission. For example, in Decision No. 67093, dated June 30, 2004,[2] the Commission adopted a ROE based on the same relevering methodology used by Staff in this case. Staff's approach in this case is consistent with that of previous cases, and has been approved by the Commission. In contrast, Mr. Cummings' approach is not consistent with prior Commission orders or with his own testimony in prior cases.

**Q. Did Mr. Cummings use the same methodology in Qwest's last rate proceeding.**

No. Mr. Cummings' testimony before the Commission in Qwest's (then US West) previous rate case[3] made no argument for a capital structure/financial risk adjustment to US West's ROE when the average capital structure of his sample telephone company group, derived from market equity values, exhibited a significantly higher percentage of equity (approximately 82%) than US West's proposed capital structure (52% equity) in that case.

[2] Docket No. WS-01303A-02-0867 *et seq*. Application of Arizona-American Water Company.
[3] Docket No. T-01051B-99-0105

**Q. On pages 8 and 9 of his rebuttal testimony Mr. Cummings argues the absence of any inconsistency in his financial risk adjustment by stating that because "[Qwest] – Arizona is not publicly traded and is regulated; we may infer that, under rate of return regulation, the value of the rate base is the best surrogate available for the market value of the entity." (See rebuttal testimony of Peter C. Cummings. p. 8 at 17 – 19.) How does Staff respond?**

A. Mr. Cummings' testimony supports Staff's position that it is appropriate to unlever and relever beta using capital structures measured at book value in this proceeding.

**Q. How does Mr. Cummings' statement an on page 8 (lines 17 – 23) of his rebuttal testimony support Staff's position that it is appropriate to unlever and relever beta using capital structures measured at book value in this proceeding?**

A. Mr. Cummings' statement and related testimony supports Staff's position because carried to its logical conclusion, a market-to-book ratio in excess of 1.0 suggests that a utility is expected to earn more than its cost of equity. Therefore, investors expect the sample companies to earn book/accounting returns in excess of the return they (investors) require. As a result, they have bid the stock prices (market values) of the sample companies up to the value of the expected future cash flows (dividends and capital gains) discounted at the return they (investors) require. James Claus of Barclays Global Investors and Jacob Thomas of Columbia Business School discussed this basic proposition in finance in a recent *Journal of Finance* article:

> This relation indicates that the [market-to-book] ratio is explained by expected future profitability ($roe_t - k$). Firms expected to earn an accounting return on equity equal to the cost of [equity] should trade currently at book values ($p_0/bv_0 = 1$).[4]

[4] Claus, James and Jacob Thomas. "Equity Premia as Low as Three Percent? Evidence from Analysts' Earnings Forecasts for Domestic and International Stock Markets." *The Journal of Finance*. October 2001. pp. 1629 – 1666.

If the market values of the sample companies reflect the expectation that they will over-earn, and the goal of regulation is not satisfied when a regulated utility over-earns, then the market-value capital structures used by Mr. Cummings to unlever beta cannot reasonably be compared to the capital structure of a regulated public utility. As stated previously, an appropriate financial risk adjustment procedure would compare book values to book values rather than market values to book values.

*Adjusted Betas*

**Q. On page 9 (lines 6 – 15) of his rebuttal testimony Mr. Cummings discusses the fact that unadjusting the published betas provided by Merrill Lynch and Value Line has a small effect on the calculation of the average unlevered beta of the proxy group while readjusting beta has a very large effect, and suggests that the procedure "...appears to be the cloaking of an ad hoc downward trimming of the required return for [Qwest]..." How does staff respond?**

A. The relative effect of unadjusting and readjusting beta is the result of simple mathematics and not an ad hoc attempt to trim Staff's estimate of Qwest's required return. The Merrill Lynch and Value Line adjustments are averaging techniques – they push high betas (betas in excess of 1.0) down toward 1.0 and low betas (betas below 1.0) up toward 1.0. As a result, the adjustment is smaller for raw betas that are closer to 1.0. For example, if we average the number 200 with the number 100, we get 150, which is a 50 point adjustment to the number 200. However, averaging the number 150 with the number 100 results in 125, which is only a 25 point adjustment.

**Q. On page 10 (lines 5 – 16) of his rebuttal testimony Mr. Cummings argues against unadjusting published beta estimates before unlevering them and readjusting them**

**after they are relevered. Why did Staff unadjust the published beta estimates before unlevering and readjust after relevering?**

A. As stated on page 35 (lines 1 – 16) of Staff's direct testimony, the beta estimates published by Value Line and Merrill Lynch are "Bayesian" estimates. Bayesian statistics provide a method of formally taking prior, often subjective, information or belief about a parameter (such as the presumed long-term tendency for betas to converge toward 1.0) into account in the estimation procedure. Unadjusting published beta estimates out of Bayesian mode and back into their classical (and objective) raw estimates gives us the original ordinary least squares ("OLS") slope, or beta. The classical estimate of the raw beta shows us how a particular security moved in relation to the market over some time period. Because the purpose of the Hamada methodology is to estimate how a security *would* have moved in relation to the market given different degrees of leverage, it makes sense to "unadjust" beta estimates out of their published Bayesian mode and back into their classical (and objective) raw beta estimates before unlevering and relevering them. After unlevering and relevering the raw beta estimates, they can then be readjusted back into Bayesian mode for comparison with betas published by Value Line and Merrill Lynch. In contrast, unlevering and relevering Bayesian estimates introduces a distortion that fails to preserve the relative relationship between a security and the market.

**Q. In support of his argument against unadjusting published beta estimates before unlevering them Mr. Cummings states "there is no statistical regression or observed data in the calculated relevered beta." (See rebuttal testimony of Peter C. Cummings. p. 10 at 9 – 10.) How does Staff respond?**

A. As stated previously, the purpose of the Hamada methodology is to estimate how a security *would* have moved in relation to the market given different degrees of leverage. In other words, the Hamada methodology provides us with the classical raw estimate of the OLS slope, or beta, given different degrees of leverage. Hamada states the following:

> The last approach, which will be used in this study, is to assume the validity of the [Miller & Modigliani] theory from the outset. Then the observed rate of return of a stock can be adjusted to what *it would have been* over the same time period had the firm no debt and preferred stock in its capital structure. The difference between the observed systematic risk, $_B\beta$, and the systematic risk for this *adjusted rate of return time series*, $_A\beta$, can be attributed to leverage, if the [Miller & Modigliani] theory is correct.[5] (latter emphasis added)

The relevered beta provided by Hamada's methodology is an estimate of the OLS slope, or statistical regression, of an adjusted rate of return time series. Accordingly, if the result of unlevering and relevering beta estimates using Hamada's methodology is a classical, or raw estimate, it makes sense to begin with a classical, or raw, estimate rather than a Bayesian estimate.

*Reasonableness Check on Staff's Capital Structure/Financial Risk Adjustment*

**Q. Is there a simplified calculation that can act as a reasonableness check on Staff's capital structure/financial risk adjustment?**

A. Yes. Schedule JR-S1 is a simplified estimate of the effect that leverage has on a firm's cost of equity. The basis for the calculation is modern capital structure theory set forth by Franco Modigliani and Merton Miller ("MM") in their now famous 1958 article on the subject.[6] Under MM's proposition, the overall WACC remains constant while the cost of equity increases with financial risk (leverage). This theory is demonstrated in Schedule JR-S1. The top portion of Schedule JR-S1 shows Staff's estimate of the WACC for the sample telcos. The average capital structure of the sample telcos consists of approximately 50 percent debt and 50 percent equity. In its direct testimony, Staff estimated the average cost of equity to the sample telcos to be approximately 10.9 percent.

[5] Hamada, Robert S. "The Effect of the Firm's Capital Structure on the Systematic Risk of Common Stocks." *Journal of Finance*. May 1972. pp. 435 – 452.
[6] Miller, Merton and Franco Modigliani. "The Cost of Capital, Corporation Finance and the Theory of Investment." *American Economic Review*. June 1958. pp. 261 – 297.

The cost of debt shown in the schedule is the average effective cost of debt for the sample telcos reported by Value Line. Based on this information, the average WACC to the sample telcos is approximately 8.86 percent. In the bottom portion of Schedule JR-S1, Staff simply calculated an adjusted WACC to reflect a capital structure representative of Qwest's, consisting of approximately 75 percent debt and 25 percent equity. Holding the overall WACC constant, Staff calculated the resulting adjusted cost of equity estimate to be approximately 14.97 percent.

Staff's recommended ROE for Qwest in this proceeding is 14.6 percent. The 14.97 percent cost of equity calculation shown in Schedule JR-S1 is closer to Staff's recommended 14.6 percent ROE than it is to the Company's proposed 21.4 percent ROE, and therefore confirms the reasonableness of Staff's ROE recommendation in this case.

## II. RESPONSE TO THE REBUTTAL TESTIMONY OF COMPANY WITNESS PHILIP E. GRATE

### Fair Value

*Earnings Requirement*

**Q. What is Mr. Grate's recommendation regarding the rate base to which the ROR is applied when determining the dollar earnings requirement?**

A. Based on a legal argument, Mr. Grate asserts that the ROR must be multiplied by the Company's FVRB to determine dollar earnings, rather than multiplying the ROR by the OCRB and solving for a ROR that, when applied to the FVRB, produces the same dollar level of earnings. (See rebuttal testimony of Philip E. Grate. pp. 132 – 134.)

**Q. If Mr. Grate's recommendation was adopted would the Company and its investors receive a windfall gain?**

A. Yes. Because Qwest's FVRB is greater than its OCRB, applying the market-based ROR to the FVRB to determine dollar earnings provides the Company and its investors with a windfall gain at the expense of Arizona consumers.

**Q. Is Mr. Grate's recommendation consistent with the widely accepted capital attraction standard?**

A. No. If Mr. Grate's recommendation was adopted and the FVRB, for whatever reason, was smaller than the OCRB, the Company would expect to earn *less* than the cost of capital on its investment. Mr. Grate's recommendation is therefore confiscatory and violates the widely accepted capital attraction standard when the FVRB is smaller than the OCRB.[7]

**Q. Can you give an example demonstrating why OCRB should be used to determine the dollar earnings requirement?**

A. Yes. Here is a simple example that reveals the fallacy of Mr. Grate's recommendation: Assume a rate base of $100 that is entirely financed with debt at a cost of 5.0 percent. The OCRB is $100 and the utility's cost of capital/allowed ROR is 5.0 percent. Applying the 5.0 percent ROR to the $100 OCRB yields the $5 in earnings the utility needs to repay its debt – no less and no more. However, if a FVRB were determined, through whatever means, and that FVRB were $200, and dollar earnings were determined by multiplying the ROR by the FVRB, then the utility would be authorized $10 (5.0% times the $200 FVRB) in rates to cover its cost of capital, or twice its need. This is surely unfair to the consumer. If the FVRB happened to be $50, and dollar earnings were determined by multiplying the ROR by the FVRB, then the company would be granted $2.50 (5.0% times the $50 FVRB). This is surely unfair to the utility. Only multiplying the ROR by the OCRB yields the correct earnings.

[7] Myers. 1972. p. 80.

**Q. When would a utility expect to be able to earn the cost of capital on its investment if dollar earnings were determined by multiplying the market-based ROR by the FVRB?**

A. A utility would expect to be able to earn the cost of capital on its investment if dollar earnings were determined by multiplying the ROR by the FVRB only when the FVRB is equal to the OCRB. Windfall gains (losses) would result whenever the FVRB is greater (less) than the OCRB if the Commission multiplied the ROR by the FVRB to determine dollar earnings.

**Q. If Qwest's FVRB was smaller than its OCRB and the market-based ROR was multiplied by the FVRB to determine dollar earnings, would the Company expect to be able to maintain its credit?**

A. No. For a utility to expect to maintain its credit there must be a relationship between corporate earning power and the annual revenue requirement imposed by fixed charges on the outstanding securities that were used to finance the OCRB.[8] If a utility's dollar earnings were determined by multiplying a market-based ROR by a FVRB that was less than its OCRB, the utility would be unable to expect to pay fixed charges on the outstanding securities used to finance the OCRB. The utility would thus be unable to maintain its credit.

**Q. Have experts commented on this subject?**

A. Yes. Recognized experts in regulation including one of Mr. Grate's own authorities, Professor Charles Phillips of Washington and Lee University, agree:

> The use of an original cost rate base enables public utilities to maintain their credit standing and to attract new capital. Investors

[8] Bonbright, James C., Albert L. Danielsen, and David R. Kamerschen. *Principles of Public Utility Rates*. 1988. pp. 225 – 226.

> receive a rate of return on the money that they have invested in the utility.[9]

**Q. Does Mr. Grate offer any sound economic reason for applying the market-based ROR to the FVRB of a regulated utility to determine the dollar earnings requirement?**

A. No, Mr. Grate does not offer any kind of economic reasoning or theory to support the application of a market-based ROR to the FVRB to determine the dollar earnings requirement of a regulated utility. His assertion is based entirely on legal interpretation of the Arizona Constitution and court decisions.

**Q. Has the Commission recently ruled on the subject of which rate base the market-based ROR should be multiplied by when determining dollar earnings?**

A. Yes. In Decision No. 67093, dated June 30, 2004, in response to the company's proposal to determine dollar earnings by multiplying the market-based ROR by its estimated reconstruction cost rate base, the Commission stated:

> The rate of return methodology and resulting revenue increase proposed by Arizona-American would produce an excessive return on FVRB. There has been no legitimate basis presented for departing from the traditional ratemaking methodology of applying a fair value rate of return to the Company's FVRB in this proceeding. We find that applying a fair value rate of return to the FVRB is just, reasonable, and in accord with the mandates of the Arizona Constitution, and will adopt it in this case.[10]

**Q. Does this conclude your surrebuttal testimony?**

A. Yes.

---

[9] Phillips, Charles Jr. *The Regulation of Public Utilities*. 3rd ed. 1993. p. 337.
[10] Decision No. 67093, dated June 30, 2004 (Arizona-American Water Company). Page 32, lines 25 – 28 & page 33, line 1.

Qwest Corporation
Resonableness Check on Staff's
Capital Structure/Financial Risk Adjustment
Incorporating Modigliani & Miller Capital Structure Theory

Estimated Weighted Average Cost of Capital ("WACC") for Sample group

| | Capitalization Ratio | Cost[1] | Weighted Cost |
|---|---|---|---|
| Debt | 0.50 | 6.83% | 3.41% |
| Equity | 0.50 | 10.90% | 5.45% |
| | | | 8.86% |

Adjusted WACC

| | Capitalization Ratio | Cost[2] | Weighted Cost |
|---|---|---|---|
| Debt | 0.75 | 6.83% | 5.12% |
| Equity | 0.25 | 14.97% | 3.74% |
| | | | 8.86% |

Notes:

[1] Average embedded cost of long-term debt per Value Line, July 2, 2004
Average cost of equtiy estimated by Staff - Reiker direct Schedule JR-1

[2] Assumes no change in debt cost but increases the cost of equity to reflect more financial risk. If lenders demand higher interest payments as the firm borrows more, the rate of increase in the cost of equity will slow down and the capital structure/financial risk adjustment would not be as high

**BEFORE THE ARIZONA CORPORATION COMMISSION**

| | | |
|---|---|---|
| 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 |

# SURREBUTTAL TESTIMONY

**OF**

**STEVEN C. CARVER**
**AND**
**MICHAEL L. BROSCH**

**ON BEHALF OF THE STAFF OF THE ARIZONA CORPORATION COMMISSION**

**PUBLIC VERSION**

("Highlighted" Text Denotes Confidential Material)

**JANUARY 12, 2005**

**BEFORE THE ARIZONA CORPORATION COMMISSION**

| | | |
|---|---|---|
| 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 |

# SURREBUTTAL TESTIMONY

**OF**

**STEVEN C. CARVER**

**ON BEHALF OF THE STAFF OF THE ARIZONA CORPORATION COMMISSION**

**PUBLIC VERSION**

("Highlighted" Text Denotes Confidential Material)

**JANUARY 12, 2005**

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**BEFORE THE**
**ARIZONA CORPORATION COMMISSION**
**SURREBUTTAL TESTIMONY OF**
**STEVEN C. CARVER**

**QWEST CORPORATION**
**DOCKET NOS. T-01051B-03-0454 & T-00000D-00-0672**

Q. Please state your name and business address.

A. My name is Steven C. Carver. My business address is 740 NW Blue Parkway, Suite 204, Lee's Summit, Missouri 64086.

Q. Are you the same Steven C. Carver that filed direct testimony in this proceeding?

A. Yes.

Q. What is the purpose of your testimony?

A. My surrebuttal testimony will exclusively respond to the rebuttal testimony of Company witness Philip E. Grate.

Q. Have you made any changes to the adjustments as proposed in your direct testimony, following the review of the Company's rebuttal filing?

A. No.

Q. Please describe how the remainder of your testimony is organized.

A. My surrebuttal testimony is arranged by topical section, following the table index presented previously.

## ADEQUACY OF OVERALL REVENUE REQUIREMENT

Q. At rebuttal page 139, Mr. Grate indicates that Qwest's overall revenue requirement, as set forth on PEG-R1, is now $271.258 million. How does that amount compare with the revenue requirement recommendations previously filed by Company and Staff?

A. On June 21, 2004, the Company filed revised R14-2-103[1] schedules supporting an overall intrastate revenue deficiency of $318.5 million (original cost) and $458.8 million (fair value).[2] This revised Company filing (June 21, 2004) served as the starting point for Staff's direct testimony, which supported a revenue deficiency of approximately $3.5 million. Staff Adjustments B-1 and C-1 incorporated various Company proposed revisions to the June 21, 2004 filing that Qwest had indicated were necessary. As a result, most of Qwest's revisions have already been considered in Staff's overall recommendation.

Q. The $271.258 million revenue requirement set forth on PEG-R1 is about $47.3 million less than the $318.5 million revenue requirement supported by Qwest's revised filing of June 21, 2004. Could you briefly describe the primary change contributing to this reduction?

A. Although Qwest has revised the revenue requirement impact of virtually every adjustment, some as a result of Staff's review, since the revised filing submitted on June 21, 2004, there appear to be ten (10) new or revised Company adjustments to rate base and/or operating income that incrementally change (i.e., increase or decrease) revenue requirement in excess of $1 million, representing a cumulative $47.4 million change in overall revenue requirement. Of these 10 adjustments, Qwest has revised its depreciation adjustment (PFA-01), which decreases revenue requirement by $45.6 million.

Q. Since Staff's $3.5 million revenue requirement recommendation is significantly less than Qwest's rebuttal recommendation of $271.258 million, is Staff's recommendation inadequate to support the rate change Qwest has requested?

A. No, not in my opinion. And, Qwest witness Grate stated in the passage quoted below that any of the revenue requirements proposed by the parties, including Staff, would be sufficient. In addition, at page iii of his "Summary of Rebuttal Testimony," Mr. Grate states: "Revenue requirement is less important in this case than it would be in traditional rate case because Qwest is not asking for recovery of most of its revenue requirement."

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[1] Qwest Corporation filing pursuant to A.A.C. R14-2-103(B)(7) or "R14-2-103" filing.
[2] See Qwest Schedule A-1, filed June 21, 2004.

This concept is further developed in the following questions and answers appearing at pages 6-7 of Mr. Grate's rebuttal testimony:

**Q. IS QWEST ASKING FOR RATES TO RECOVER ITS REVENUE REQUIREMENT?**

A. No. Given the intensity of competition Qwest now faces in Arizona as described by Mr. Teitzel, and the pace of Qwest's Arizona access line loss as shown above, Qwest does not believe the revenue requirement computed in the schedules of its Rule 103 filing is fully recoverable from its Arizona customers.

My direct testimony explained that Qwest was not proposing rates to fully recover its revenue requirement and that instead, Qwest was proposing modifications to its price regulation plan that will allow the Company to compete on a more equal footing with its competition in Arizona. Qwest's position remains unchanged.

**Q. THEN OF WHAT RELEVANCE IS QWEST'S REVENUE REQUIREMENT IN THIS DOCKET?**

A. Given the intense pressure on Qwest's revenues and the relatively fixed cost nature of its business, revenue requirement has substantially less relevance than in the traditional rate case of a traditional monopoly utility because the recoverability of cost-of-service rates is uncertain. By Qwest's calculation, Qwest's revenue requirement now stands at $271.3 million on an original cost rate base and $351.7 million on a fair value rate base. By RUCO's calculation Qwest's revenue requirement is $160 million. Staff claims it is $3.5 million. <u>Any of these revenue requirements would be sufficient to provide for the rates Qwest has requested in this case. Consequently, the debate over Qwest's revenue requirement is, in some respects, academic</u>.

Accordingly, I have prepared a more limited rebuttal than might be called for were revenue requirement critical to this case. The fact that I am not commenting specifically on every adjustment proposed by Staff and RUCO does not necessarily mean that I agree with their methods or their results. <u>My testimony does not attempt to address every potentially contestable ratemaking issue. Instead, it focuses principally on issues that have broad Arizona regulatory accounting and ratemaking significance beyond this case</u>.

[emphasis added]

Q. Do you have any comments regarding Mr. Grate's representation that "[a]ny of these revenue requirements would be sufficient to provide for the rates Qwest has requested in this case"?

A. Yes. In spite of this statement, Mr. Grate's rebuttal filing consists of 142 pages of testimony and 88 pages of exhibits – even though the Company appears to conclude that the overall revenue requirement recommendations of any party including Staff are sufficient to support Qwest's proposed rate changes. Notably, the direct testimony of both RUCO and Staff present positive valuations of overall revenue requirement. Rather than simply agree to disagree on any number of ratemaking issues that do not impact the overall level of rate relief sought by Qwest and narrow the scope to address only those issues that actually require a Commission finding to successfully conclude this proceeding, Mr. Grate instead burdens the record and the limited resources of the parties with a lengthy debate of what he calls, in large part, "academic" issues.

Citing to "the intensity of competition Qwest now faces in Arizona," Mr. Grate states that "Qwest does not believe that its proposed revenue requirement is fully recoverable from its Arizona customers."[3] Instead, it would seem that the lengthy rebuttal testimony offered by Mr. Grate largely focuses "principally on issues that that have broad Arizona regulatory accounting and ratemaking significance beyond this case."[4]

Assuming for discussion purposes that the Commission's final decision in this proceeding rejected each and every revenue requirement issue raised in Qwest's rebuttal testimony, one would have to question what remedy the Company would seek on appeal. After all, as indicated by Mr. Grate, the Staff's revenue requirement is "sufficient to provide for the rates Qwest has requested in this case."

Q. How will Staff respond to Mr. Grate's rebuttal testimony?

A. Mr. Brosch and I are primarily responsible for responding to Mr. Grate's rebuttal testimony, with surrebuttal testimony also offered by Messrs. Dunkel, Reiker and Regan.

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[3] Grate rebuttal, page 6, line 13.
[4] Grate rebuttal, page 8, line 1.

Nevertheless, given the limited time available to review, analyze and finalize our testimony, the surrebuttal testimony offered by Mr. Brosch and myself will be limited and will not necessarily address each and every point discussed in Mr. Grate's rebuttal testimony. While it is simply not feasible for us to respond to every point raised by Mr. Grate with which we disagree, Staff has made a concerted effort to address the major areas of disagreement with Mr. Grate's rebuttal testimony. However, Staff's silence on any specific point raised by Mr. Grate should not be construed as concurrence in or agreement with said representation.

## REGULATORY ACCOUNTING METHODS

Q. Beginning at page 8, Mr. Grate dedicates about 25 pages of his rebuttal testimony to a discussion of "regulatory accounting methods" citing to Commission rules and past Arizona rate cases. At page 9, Mr. Grate quotes from Arizona Administrative Code (A.A.C.) R14-2-510 G and concludes on page 14 that "It is clear that absent a Commission order to the contrary, an accounting method change incorporated into the USOA is (and consistently has been) automatically incorporated into Arizona regulatory accounting by operation of Rule R14-2-510 G." How do you reply?

A. In this section of rebuttal testimony, Mr. Grate appears to attempt to dispose of two revenue requirement issues (SOP 98-1 and FAS106 OPEB costs) representing about $57.7 million[5] of the difference in overall revenue requirement between the Company and Staff. Mr. Grate does accurately quote Rule R14-2-510(G), at rebuttal page 9:

> 2. Each utility shall maintain its books and records in conformity with the Uniform Systems of Accounts for Class A, B, C and D Telephone Utilities as adopted and amended by the Federal Communications Commission …

Other than requiring Qwest to maintain its books and records in conformity with the FCC USOA, this Rule does not address nor is it dispositive of the ratemaking treatment to be afforded any specific accounting change for Arizona regulatory purposes. In fact, Qwest has maintained an offbook accounting system for many years to recognize differences in jurisdictional accounting that exist between the FCC and the state jurisdictions in which

[5] See Schedule E of the Staff Joint Accounting Schedules, Staff Adjustments B-6 & C-11 (SOP 98-1) and B-8 & C-18 (FAS106 OPEB costs).

the Company provides regulated telecommunications service. Further, I do not believe that this rule should be interpreted, nor to the best of my knowledge has it been in the past with respect to Qwest, as ceding any authority to the FCC regarding accounting methodologies used for Arizona revenue requirement purposes.

I have not claimed that R14-2-510(G) requires Arizona utilities to seek ACC approval prior to recognizing an FCC adopted change in accounting method for Arizona accounting and reporting purposes. Nor do I believe that the cited Rule provides for the automatic recognition of any FCC interstate accounting change for Arizona intrastate ratemaking purposes. Instead, R14-2-510(G) provides a common accounting framework as a base line for accounting purposes, thereby avoiding undue regulatory oversight or requiring an administratively burdensome accounting approval process, whereby each FCC ordered accounting change would need to be individually taken up by this Commission for approval, modification or rejection.

Subsequent to the filing of his direct testimony in this proceeding, Mr. Grate has altered Qwest's interpretation of R14-2-510(G) as requiring the adoption of SOP 98-1 (internal use software) in 1999, a matter that will be subsequently addressed in more detail. In any event, Qwest has inconsistently applied and considered this rule over the years.

Q. On what do you base your contention that Qwest has inconsistently applied this rule over the years?

A. In Docket No. E-1051-88-146,[6] Company witnesses referred to various Commission rules, including R14-2-510(G), in opposition to adjustments[7] that I sponsored on behalf of the Arizona Staff. Attachment SCC-S1 represents excerpts from my rebuttal testimony disagreeing with Company arguments concerning Commission rules and FCC GAAP accounting, similar to those currently offered by Mr. Grate.

[6] Docket No. E-1051-88-146 was resolved by negotiated settlement.

[7] Company witnesses Monte Shriver and Thomas Flaherty addressed ACC rules in the context of Staff adjustments regarding the exclusion of short-term TPUC from rate base and limited rejection of the capital to expense shift resulting from adoption of FCC Part 32 (USOAR).

Carver Rebuttal Testimony, page 9, Docket No. E-1051-88-146:

Q. On page 36, Mr. Shriver references two Commission rules [i.e.,R14-2-510(G)(2) and R14-2-103(A)(3)(a)] and concludes that the Staff's recommended treatment for Short-Term TPUC is inappropriate and precludes the capitalization of interest on Short-Term TPUC. Do you have any comments on that testimony?

A. Yes. Mr. Shriver proposes essentially the same argument in his rebuttal testimony dealing with Part 32. In that section of my testimony, I address these allegations in detail and will not restate or reiterate them here. Nevertheless, Mr. Shriver's argument on this issue is without merit.

Carver Rebuttal Testimony, pages 40-41, Docket No. E-1051-88-146:

Q. On page 44 of his rebuttal testimony, Mr. Shriver alleges that Staff's proposed capitalization of general overheads and pay-as-you-go ratemaking treatment for compensated absences violate the rules of this Commission. Do you agree with that allegation?

A. No. In support of his position, Mr. Shriver cites the following ACC rules: R14-2-510(G)(2), R14-2-510(I)(1), and R14-2-103(A)(3)(a). Essentially, Mr. Shriver argues that since the Commission Rules require the Company to maintain its books and records in conformity with the FCC USOA and the filing requirements make reference to the accounting methods prescribed by the Commission, then the Commission cannot deviate from the accounting required under the FCC's USOA unless the Company files a verified application seeking a variance or exemption from the Commission Rules. While Staff does not believe that these rules, in any form, restrict or limit the evidence this Commission may consider or findings which may be held from such evidence, I will nevertheless address each alleged rule violation raised by Mr. Shriver and demonstrate how Staff's adjustments do not violate such rules.

In contrast, at page 51 of my direct testimony in the current proceeding, I discuss the Company's opposition to the adoption of SOP 98-1 in Qwest's last rate case, Docket No. T-1051B-99-105. In that proceeding, Company witness Redding recommended that the "best solution is to ignore this accounting change for ratemaking purposes."[8] At rebuttal page 24, Mr. Redding continued that theme with the following testimony in the context of his discussion of a possible "rider" treatment for the SOP 98-1 accounting change:

Q. IS A RIDER THE BEST OPTION?

[8] Redding rebuttal, page 20, Docket No. T-1051B-99-105.

A. No, it is not. The best option is the one set forth by the Company, namely, not to adopt this accounting change for ratemaking purposes. Adoption of this accounting change for ratemaking purposes will cause rate shock of its own. Customers will be delighted with the first year decrease, but will be less enthusiastic about the yearly increases that would follow and the permanent rate level that will be higher than if the Commission ignored the accounting change. In total those increases would total $49M to enable the customers to enjoy a first year decrease of $(39)M.

As evidenced by the various responses to Staff discovery submitted in Docket No. T-1051B-99-105 included in Attachment SCC-S2,[9] Qwest's approach in 1999 was to "ignore" the effects of SOP 98-1 for Arizona intrastate ratemaking purposes and to establish and maintain offbook records to account for the difference between financial GAAP (adopted by the FCC) for Arizona intrastate regulatory accounting purposes. Qwest's subsequent accounting for SOP 98-1 has been consistent with those representations, until late 2004 when Mr. Grate reversed course, indicating Qwest will adjust its accounting records to reflect the adoption of SOP 98-1 effective January 1, 1999.[10]

Now, Mr. Grate has taken the position that SOP 98-1 should have been adopted for Arizona regulatory accounting purposes -- in 1999. Qwest's shifting proposals present the worst possible scenario for ratepayers:

- Oppose any regulatory recognition of SOP 98-1 in Docket No. T-1051B-99-105, denying ratepayers the opportunity to enjoy the transition benefits of such adoption;
- Establish and maintain offbook accounting records for Arizona intrastate accounting purposes as if SOP 98-1 had never been implemented; and
- Now that Mr. Grate has concluded that SOP 98-1 should be recognized for Arizona intrastate regulatory purposes, adopt the accounting change retroactively to 1999.

This latest development in the SOP 98-1 saga is disingenuous at best. Unlike the scenario painted by Mr. Redding in the last rate case, Mr. Grate's creative accounting

[9] These discovery responses clearly document that Qwest did not intend to adopt SOP 98-1 in 1999 for Arizona regulatory purposes.

[10] Grate rebuttal testimony, page 29 and Qwest response to Data Request UTI 4-1S1.

will deny, not delight, ratepayers with the early year benefits of SOP 98-1 adoption and jump right to the higher "permanent rate level" opined by Mr. Redding.

It is interesting, though I suppose not surprising, that the Company consistently seeks to deny ratepayers any participation in the positive benefits of transitioning between accounting method changes but pulls out all the stops to make sure that any transition costs (e.g., prospective amortization of the FAS106 transition benefit obligation) are fully reflected in overall revenue requirement. So much for the "goose and gander" barb Mr. Grate casts at Mr. Brosch and myself in footnote 29 at page 41 of his rebuttal testimony.

Q. Do you have any additional comments regarding Mr. Grate's statement at rebuttal page 14 that "It is clear that absent a Commission order to the contrary, an accounting method change incorporated into the USOA is (and consistently has been) automatically incorporated into Arizona regulatory accounting by operation of Rule R14-2-510 G."

A. Yes. I have been advised by Counsel that the Arizona courts have held that the Arizona Constitution and the Arizona Statutes convey broad discretion to the Commission over ratemaking. However, Mr. Grate's citation to Rule R14-2-510(G) seems to attempt to construct a regulatory theory that, while not explicitly stated, Qwest is required to follow FCC accounting rules, which the Arizona Corporation Commission is obliged to adopt for ratemaking purposes. In my experience, this is simply not appropriate.

Following the issuance of Decision No. 58927,[11] the Company appealed several issues, including the denial of the accounting change from cash to accrual basis for FAS106 OPEB costs. As discussed in the following excerpt, the Arizona Court of Appeals has deferred "...to the Commission's constitutionally granted power to determine appropriate 'systems of keeping accounts.'"

> [9] US West also argues that the Commission's disallowance of the adjustment for its OPEB expenses was arbitrary, unreasonable, and unsupported by substantial evidence. Again we disagree. US West essentially attacks the long-range fiscal prudence of the Commission's

[11] Docket No. E-1051-93-183.

> decision, and we will not subordinate the Commission's fiscal judgment to our own. Whether to subject present ratepayers to the substantial cost of transition to accrual accounting or to subject future ratepayers to the foreseeably increasing costs of cost accounting is uniquely a policy decision, constitutionally entrusted to the Commission, and not one that the courts have authority to preempt. Article 15, section 3, of the Arizona Constitution provides:
>
> > The Corporation Commission shall ... make reasonable rules, regulations, and orders, by which [public service] corporations shall be governed in the transaction of business within the State, *and may prescribe* the forms of contracts and *the systems of keeping accounts* to be used by such corporations in transacting such business. (Emphasis added.)
>
> We defer to the Commission's constitutionally granted power to determine appropriate "systems of keeping accounts."
> [U S West Communications, Inc. v. The Arizona Corporation Commission, 185 Ariz. 277, 915 P.2d 1232]

It defies logic to imply that both Qwest and the ACC must blindly follow for ratemaking purposes the accounting policies established by the FCC when the Arizona Court of Appeals clearly recognizes and defers to this Commission's constitutional authority to make such determinations.

## HISTORY OF ACCOUNTING METHOD CHANGES IN ARIZONA

Q. At pages 10 through 15 of his rebuttal testimony, Mr. Grate discusses his assessment of the regulatory adherence to Commission Rule R14-2-510(G) during the 1980's and 1990's. Referring to the period 1982-1992, he makes the following statement beginning at line 15 of page 10:

> My review of these cases found no evidence that an accounting method change incorporated as an amendment into the Uniform System of Accounts (USOA) was not automatically incorporated into regulatory accounting and ratemaking in Arizona. So far as I can discern, the following USOA accounting method changes were incorporated into Arizona regulatory accounting and ratemaking without the Company, Staff, RUCO or the Commission taking any action:

He then proceeds to list seven (7) accounting changes followed by a discussion of four additional accounting changes in the 1990's. What is the purpose of this portion of Mr. Grate's rebuttal testimony?

A. It appears that Mr. Grate has attempted to develop an overview of the history of the Commission's consideration of accounting method changes to support his revenue requirement recommendations on SOP 98-1 (Internal Use Software) and FAS106 OPEB costs.

Q. Do you concur with Mr. Grate's conclusion that the seven accounting method changes were incorporated into Arizona regulatory accounting and ratemaking without the Company, Staff, RUCO or the Commission taking any action?

A. It is true that during the period 1982-1992, the Commission issued decisions in six (6) dockets involving the Company.[12] Three of those dockets were resolved by negotiated settlement while the remaining three were litigated. It is also true that the seven accounting changes[13] listed in his testimony were not discussed in the decisions he identifies at page 10 of his rebuttal testimony. However, this conclusion is misleading in its brevity.

Q. Why is that?

A. As discussed at page 18 of my direct testimony, Docket No. E-1051-88-146 arose from a Commission initiated investigation of the Company's rates and charges, which resulted in the issuance of a complaint against a predecessor company, US West, directing the Company to show cause why its rates should not be reduced. In interim Decision No. 56363 (issued February 22, 1989), the Commission concluded that Staff had met its burden that a $33.4 million interim rate decrease was warranted. Subsequent to that interim order, the Commission issued Decision No. 56471 making the interim decrease permanent, with an additional $3.9 million reduction to touch tone rates, and rescinded Decision No. 56363 pursuant to an agreement between the Company and Staff.

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[12] Grate rebuttal, page 10.

[13] FCC Part 32 capital to expense shift; change from the cash to accrual method of accounting for compensated absences, merit awards and medical/dental expenses; increase in capitalization rules from $200-$500; increase in the capitalization rules from $500-$2,000; adoption of FAS87 accrual method of pension accounting; June 1992 change from cash to accrual method for public telephone revenue; and March 1993 change in the method of accruing for billing and collection revenue.

While Mr. Grate's rebuttal testimony accurately portrays Docket No. E-1051-88-146 as a settled proceeding, it is also true that my direct testimony in that docket presented several issues for the Commission's consideration, including:

- exclusion of Short-Term TPUC from rate base;
- continue PAYGO in lieu of adopting FAS106 accrual accounting for OPEB costs;
- reverse a Company adjustment to the 1987 test year amortizing the change in accounting from the cash method to the accrual method for compensated absences adopted by the FCC (effective January 1988) over a prospective ten-year amortization period;
- reverse the Company's proposed three-year amortization of an asserted depreciation reserve deficiency and increase rate base to eliminate the Company's prospective depreciation reserve adjustment; and
- reverse a portion of the Company's pro forma adjustment to shift to expense previously capitalized general overhead costs associated with the implementation of FCC Part 32 (uniform system of accounts) that became effective January 1988.

Q. Did interim Decision No. 56363 address any of these issues?

A. Yes. Decision No. 56363 (pages 8-9) included the following language: "The Commission finds that Staff has prevailed in this record on the issues of the publishing fee revenue reinstatement, the post-retirement medical benefits reversal, the Phoenix metropolitan pricing revenue adjustment, the uniform system of accounts rewrite – capital to expense shift, the compensated absences reversal, the corporate advertising disallowance, and the elimination of non-employee service concessions." While the Commission ultimately approved a negotiated settlement of Docket No. E-1051-88-146 and rescinded Decision No. 56363, Mr. Grate's history of Arizona regulation ignores the fact that this complaint proceeding was hotly contested and involved numerous issues, but was ultimately settled subsequent to the Commission's issuance of an interim rate reduction.

Q. Mr. Grate also discusses four additional accounting changes that occurred in the 1990's.[14] Do you have any comments on that discussion?

A. Yes. In the context of Docket No. E-1051-93-183 (the 1994 rate case), I filed testimony on behalf of Staff opposing: the inclusion of short-term TPUC in rate base; the inclusion of the FAS87 pension asset in rate base; and the ten-year catch-up amortization of the

[14] Grate rebuttal testimony, pages 11-13.

compensated absence transition recorded by the Company during the test year. In Decision No. 58927, the Commission adopted Staff's recommendations on the first two items, but allowed recovery of the compensated absence transition amortization.

**SOP 98-1 (Internal Use Sofware)**

Q. In rebuttal testimony,[15] Mr. Grate lists eight accounting method changes, discusses an analysis he has undertaken regarding the regulatory adoption of these changes in Arizona (memorialized as Qwest rebuttal Exhibit PEG-R7), and concludes that Qwest was non-compliant with Rule R14-2-510(G) by failing to adopt SOP 98-1 in 1999.[16] What was the origin of lists of accounting method changes appearing at pages 10-11 and 25-26 of Mr. Grate's rebuttal testimony?

A. In general terms, both lists included in Mr. Grate's rebuttal testimony overlap with a similar list appearing at pages 64-65 of my direct testimony in Docket No. T-1051B-99-105. However, the two lists in Mr. Grate's rebuttal are not identical nor are they identical with the list from my direct testimony in the last rate case.

Q. Would it be accurate to state that the analysis of accounting method changes set forth in Qwest rebuttal Exhibit PEG-R7 originated from Mr. Grate's review of pages 64-65 of your testimony in the last rate case?

A. Yes, at least in part. It appears that Mr. Grate claims his direct testimony on the SOP 98-1 issue (i.e., initially recommending adoption in the 2003 test year) was based on Qwest's own accounting for SOP 98-1 costs as well as my testimony in Qwest's last rate case.[17] Based on my understanding of Mr. Grate's rebuttal testimony,[18] it appears that his PEG-R7 analysis was undertaken as a result of my testimony from the last rate case, Qwest's offbook accounting for SOP 98-1 and Data Request UTI 4-1 in the current case that is quoted at page 26 of his rebuttal testimony.

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[15] Grate rebuttal testimony, pages 10-11 and 25-28.
[16] Grate rebuttal testimony, page 28.
[17] Grate rebuttal testimony, page 26 and Carver direct testimony, pages 64-65, Docket No. T-1051B-99-105.
[18] Grate rebuttal testimony, page 25.

At page 25 of his rebuttal, Mr. Grate also quotes the following phrase from my prior testimony indicating that the Company had "previously sought regulatory approval and ratemaking treatment" of accounting method changes. Since this passage from my testimony in the last rate case seems so central to Mr. Grate's discussion of Arizona accounting method changes, I believe it is very important for the Commission to understand the full context of the testimony from which that passage was extracted. The following excerpt provides that context:

> Q. Do you have any information which addresses why USWC has not sought ACC approval to capitalize internal-use software?
>
> A. Yes. Data Request No. UTI 13-21(d) specifically requested USWC's position regarding whether this change should be reflected in Arizona revenue requirements. The Company's response to this portion of that discovery request is reproduced below.
>
> > The company has not petitioned the Arizona Corporation Commission to adopt the software capitalization accounting. Since the life for the capitalized software is very short, the effect of this accounting on ratemaking is to produce a first year dip in revenue requirements followed by a near term turnaround of revenue requirements and over time, higher revenue requirements. Furthermore, the change from expensing of software to capitalization is not cash affecting, while the ratemaking effect would be cash affecting. Given both the short term revenue requirement profile and the fact that software capitalization is not cash affecting the Company does not intend to petition the Arizona Corporation Commission to adopt this accounting.
> > [Data Request No. UTI 13-21(d)]
>
> Q. Do you have any comments on the Company's position, as stated in the response to Data Request No. UTI 13-21(d)?
>
> A. Yes. The Company's "not cash affecting" position is specious. As indicated in the response to Data Request No. UTI 20-12(a), the phrase "not cash affecting" simply means that the change in accounting method will not result in any change in the amount or timing of USWC's cash payments to fund software development and modification efforts. Further, the response to Data Request No. UTI 20-12(b) confirms that changes otherwise "not cash affecting" become "cash affecting" merely by recognizing those accounting changes for ratemaking purposes.
>
> While these statements are technically true, it is important to recognize that this same "not cash affecting" label applies to a variety of other accounting

> changes for which USWC has previously sought regulatory approval and ratemaking treatment. Such items include:
>
> - capital to expense shifts resulting from the adoption of the "new" uniform system of accounts prescribed by the FCC (i.e., Part 32);
> - change in accounting from the cash method to the accrual method of accounting for compensated absences, merit awards and medical/ dental expenses;
> - increase in the capitalization rules from $200 to $500, allowing the expensing of qualifying "small value" assets;
> - increase in the capitalization rules from $500 to $2,000, allowing the expensing of qualifying "small value" assets;
> - adoption of revisions to depreciation accrual rates and depreciation reserve deficiency amortizations;
> - adoption of the FAS87 accrual method of accounting for pension costs; and
> - adoption of FAS106, which implemented a change from cash to accrual method of accounting for post-retirement benefits other than pensions.
>
> All of these items, but the adoption of FAS87, had the effect of initially increasing the rates charged USWC's ratepayers. Although those changes were "not cash affecting" until included in the ratemaking process, the Company still sought regulatory approval and rate treatment.

While the passage "previously sought regulatory approval and ratemaking treatment" does appear in my testimony filed over four years ago, I believe that Mr. Grate has taken that passage out of context and has attempted to deflect responsibility for Qwest's past accounting decisions.

Q. Why do you believe that the passage has been taken out of context?

A. It is clear from the above quote that my testimony addressed Qwest's arguments for <u>not</u> recognizing SOP 98-1 in the 1999 test year. While the phrase of Mr. Grate's focus was admittedly worded inartfully, the purpose was not to establish a definitive work on the Commission's accounting rules. Instead, the testimony was intended to highlight the fact that many accounting changes (i.e., typically accounting changes that caused revenue requirement to increase) had previously been recognized in the ratemaking process. My testimony in the last case sought to make the Commission aware of the fact that SOP 98-

1 had just the opposite effect (initially decreasing revenue requirement), which Qwest desired to shield from ratemaking recognition. In the correct context, the purpose of my testimony was to draw analogies to other accounting method changes previously implemented by the Company over the years.

Q. Can you understand how the phrase "previously sought regulatory approval and ratemaking treatment" could be misinterpreted?

A. Yes. However, when read in context, I believe that it is clear how that phrase was intended. Qwest Data Request 10-11[19] to Staff referred to the list of accounting changes on pages 64-65 of my testimony in the last rate case and sought citations to the ACC decision or order evidencing that Qwest sought and the Commission approved these accounting changes, to which I responded as follows:

> Objection, this question seeks publicly available information which is as readily accessible to Qwest as it is to Staff. The question would appear to require Mr. Carver and the Staff to research the Arizona regulatory history of issues that were not raised in Mr. Carver's testimony in the pending proceeding. Qwest is able to access publicly available information and research past regulatory decisions of the Commission, without imposing the burden to conduct such research upon the Staff. Qwest may obtain copies of all prior ACC decisions from the ACC Docket Control Center during normal business hours.

While the unnecessary research requested by Qwest has still not been undertaken, Qwest failed to ask the right question, if the desire was to fully understand the purpose of my reference to past accounting method changes in testimony from the last rate case. Instead, the Company should have asked: What was the source of your claim that the Company had previously sought regulatory approval and ratemaking treatment of the listed accounting method changes?

Q. How would you have answered that question?

A. To the best of my recollection, knowledge and belief, that listing was compiled from a review of various ratemaking adjustments (e.g., annualization, normalization or pro

[19] Staff's responses to Qwest's Tenth Set of Data Requests is attached to Mr. Grate's rebuttal testimony as Exhibit PEG-R16.

forma) the Company has included in its various R14-2-103 Filings over the years. While the Company may not have filed a formal application seeking Commission approval of those accounting method changes pursuant to R14-2-510(G) or any other Commission Rule, I do consider such ratemaking adjustments to represent a request for "regulatory approval and ratemaking treatment." As is typical in rate case proceedings, there will be no regulatory decision or order specifically discussing or approving those adjustments, unless the accounting method change was presented to the Commission as a litigated issue or the Company specifically requested the Commission to address the accounting change in a formal decision or order.[20]

Q. At page 26 of his rebuttal testimony, Mr. Grate states: "Relying on the Company's accounting records and on Mr. Carver's testimony, I wrongly assumed that the Company was required to seek the Commission's approval before incorporating accounting method changes into regulatory accounting and ratemaking in Arizona." To your knowledge, have you ever represented to any Arizona utility or this Commission that 14-2-510(G) or any other Commission Rule requires a regulated utility to formally seek Commission approval before an accounting method change can be recognized for regulatory accounting or ratemaking purposes in Arizona?

A. No. Qwest Data Request 10-4 to Staff referred to R14-2-510(G) and asked a series of questions, including the following questions and answers:[21]

> a. Is it your position that Arizona utilities are required to seek and receive Arizona Corporation Commission approval to incorporate a change in accounting method, mandated by the Uniform System of Accounts, for Arizona regulatory accounting purposes?
>
> Response: Objection, this question calls for a legal analysis, conclusion or opinion. Without waiving the objection, a review of Mr. Carver's testimony reveals that he does not cite to or rely upon A.C.C R14-2-510(G). Mr. Carver's testimony addresses various regulatory accounting issues in the context of how and when changes in accounting should be

[20] Company sponsored pro forma adjustments for compensated absences and FCC Part 32 USOA transition costs in Docket No. E-1051-88-146, as discussed previously. Although that proceeding was ultimately resolved by negotiated settlement, the Company pro forma adjustments served as the foundation for my testimony in Docket No. T-1051B-99-105 that the Company had sought regulatory and ratemaking treatment of those costs.

[21] Staff's responses to Qwest's Tenth Set of Data Requests is attached to Mr. Grate's rebuttal testimony as Exhibit PEG-R16.

recognized for revenue requirement purposes. Through revised responses to Staff discovery, Qwest appears to have relied upon a revised interpretation of Arizona accounting requirements to support an accounting convention benefiting the Company by dramatically increasing overall revenue requirement – an interpretation at variance with the position of Qwest witness Redding in Docket No. T-1051B-99-105 and Qwest's actual accounting for SOP 98-1 and FAS106 for Arizona regulatory reporting purposes.

Other than requiring Qwest to maintain its books and records in conformity with the FCC USOA, Mr. Carver does not believe that this Rule addresses or is dispositive of the ratemaking treatment to be afforded any specific accounting change for Arizona regulatory purposes. In fact, Qwest has maintained an offbook accounting system for many years to recognize differences in jurisdictional accounting that exist between the FCC and the state jurisdictions in which the Company provides regulated telecommunications service. Further, Mr. Carver does not interpret the cited rule as ceding any authority to the FCC regarding accounting methodologies used for Arizona revenue requirement purposes.

In the context of the above discussion, Mr. Carver does not believe that A.C.C R14-2-510(G) requires Arizona utilities to seek ACC approval prior to recognizing an FCC adopted change in accounting method for Arizona accounting and reporting purposes. However, Mr. Carver also believes that the cited Rule does not automatically adopt any FCC accounting change for Arizona regulatory reporting or ratemaking purposes. Instead, A.C.C R14-2-510(G) provides a common accounting framework as a base line for accounting purposes, thereby avoiding undue regulatory oversight or requiring an administratively burdensome accounting approval process.

b. If your answer to subpart (a) of this request is yes, please identify (and include specific citations to) any and all provisions of the Arizona Revised Statues, Arizona Administrative Code and/or the Arizona Corporation Commission order that supports your response.

Response: Objection, this question calls for a legal analysis, conclusion or opinion. Without waiving the objection, Mr. Carver believes that ratemaking determinations of changes in accounting methodology that significantly impact revenue requirement are reasonably expected to be resolved within rate case proceedings. This belief is not predicated on any statutory, constitutional or rulemaking authority, but rather an understanding that rate case issues can, and often do, arise from accounting changes that have been adopted by the FCC and/or have become GAAP.

Unfortunately, Mr. Grate has found it necessary to produce a "red-herring"[22] of his own, by citing to and relying on my testimony from prior a rate case to devise an argument to distract attention from the real impact of the SOP 98-1 issue – Qwest desires to deny any revenue requirement recognition of the favorable benefit of the transition to capitalization accounting of internal use software pursuant to SOP 98-1.

Q. Do you have any final comments regarding Mr. Grate's rebuttal testimony concerning the SOP 98-1 issue?

A. Yes. At rebuttal page 32, Mr. Grate states:

> Adjustments B-6 and C-11 are premised on Mr. Carver's erroneous belief that SOP 98-1 was not adopted in 1999. Staff is the only party that maintains this incorrect position. Nothing in the settlement agreement or the Commission's order in Qwest's last rate case provides for non-adoption. Moreover, it has long been the Commission's practice to follow its rule and automatically incorporate into ratemaking changes in accounting method under the rule. Accordingly, adjustments B-6 and C-11 must be rejected.

I find this passage to be particularly offensive. Through various discovery responses and filed testimony,[23] it has been clearly established that Qwest did not recognize SOP 98-1 in its Arizona regulatory results of operations during calendar years 1999, 2000, 2001, 2002 or 2003. With the waive of a magic wand, Qwest claims to have adjusted its regulatory books in November 2004 to retroactively recognize SOP 98-1 as if it had been adopted in 1999 – as I proposed should have been done in Docket No. T-1051B-99-105, but was opposed by Mr. Grate's colleague (Mr. Redding) in that rate case. After developing this elaborate scheme to re-write history, I am very disappointed that Mr. Grate takes the next step alleging that my testimony and "Adjustments B-6 and C-11 are premised on Mr. Carver's <u>erroneous</u> belief that SOP 98-1 was not adopted in 1999." [emphasis added] Suffice it to say that my view of this issue could not be more different from the position offered by Mr. Grate.

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[22] Mr. Grate accuses myself and RUCO witness Diaz Cortez of fashioning arguments tantamount to a "red-herring." See Grate rebuttal testimony, pages 136, 138 and 140.

[23] See Attachment SCC-S2; Grate direct, page 58; and Carver direct, pages 51-52.

**FAS106 OPEB Costs**

Q. The question beginning at page 15, line 15 of Mr. Grate's rebuttal testimony reads as follows:

> Q. MR. CARVER'S TESTIMONY [footnote omitted] ARGUES THAT IN THE COMPANY'S LAST RATE CASE THE COMMISSION ORDERED THE COMPANY TO BEGIN USING ACCRUAL ACCOUNTING FOR OPEBS EFFECTIVE JANUARY 1, 1999. DO YOU AGREE?

Mr. Grate's two and one-half page response begins with "No." The omitted footnote referred to pages 56-71 of your direct testimony in this proceeding. Does your referenced testimony state or represent that "the Commission ordered the Company to begin using accrual accounting for OPEBs effective January 1, 1999."

A. No. I did not and have not represented that the Commission issued such an Order. It is curious that the footnote referenced in the question cites to all sixteen pages of my direct testimony on this issue – curious in the sense that even the Company could provide no pinpoint reference to any such statement in my testimony. Yet, Mr. Grate's rebuttal testimony proceeds to respond to the question as if the premise were true, which it is not.

Q. Mr. Grate also states: "Mr. Carver argues that it was the "regulatory intent" of Staff and Qwest to adopt FAS 106 for ratemaking purposes, [footnote omitted] and that, therefore, Qwest is pretending that the Commission did not adopt FAS 106 in Qwest's last rate case. I disagree."[24] Do you have any comments?

A. Yes. Although some of the line number citations in Mr. Grate's footnote 9 are incorrect, it is accurate to state that my direct testimony refers to "Staff's position that it was the regulatory intent of the parties to adopt accrual basis accounting in Qwest's last rate case."[25] At rebuttal page 16 (line 18), Mr. Grate accurately quotes from page 61 of my direct testimony acknowledging that the settlement agreement and the Commission's order were both silent on the transition from PAYGO to accrual accounting for OPEB costs. However, my direct testimony (pages 56-71) provides a detailed discussion of the basis for my reference to the "regulatory intent" of the parties, specifically at pages 65-

[24] Grate rebuttal testimony, page 16 & footnote 9.
[25] Carver direct testimony, page 56.

67. I will not burden the record by duplicating that discussion and rationale in surrebuttal testimony.

It is worth noting that Mr. Grate's rebuttal testimony does not challenge my representation that both RUCO and Staff accepted the accrual accounting adjustment sponsored by Qwest witness Redding in the last rate case. He can only point to the settlement language and the opposition of ATT witness Gately to Qwest's OPEB adjustment – both of which I clearly and openly discuss in my direct testimony.[26] Just as the settlement agreement was silent on FAS106, Mr. Grate aptly points out that the Decision No. 58927 continued PAYGO accounting for ratemaking purposes but did not explicitly address how the Company was to maintain its books and records.[27] With 20/20 hindsight, this was an unfortunate oversight, but so too was the silence in the settlement agreement in the last rate case (Docket No. T-1051B-99-105).

In my view, the premise underlying the ratemaking adjustment sponsored by Mr. Grate is that Qwest has never recovered any FAS106 accrual basis costs from its Arizona ratepayers. I disagree. If the Commission concurs with my discussion of the "regulatory intent" of the parties, then fairness and equity would dictate adoption of these Staff adjustments.

Q. Mr. Grate also describes Qwest's diverse regulatory accounting adopted by the states in which the Company operates and discusses the process it has followed to account for OPEB costs.[28] How do you respond?

A. Mr. Grate offers no new information other than what was available at the time my direct testimony was finalized. Mr. Grate does not contend that Qwest has maintained its Arizona regulatory books in strict conformance with PAYGO accounting for OPEB costs. Instead, he confirms that the only difference between the OPEB costs recorded on the Company's Arizona records and full FAS106 accrual accounting is the elimination of

[26] Carver direct testimony, pages 64-67.
[27] Grate rebuttal testimony, page 19.
[28] Grate rebuttal testimony, pages 19-21 & Exhibit PEG-R8.

the TBO amortization – consistent with representations set forth at page 70 of my direct testimony.

## RATEMAKING METHODS

Q. Beginning at page 33, Mr. Grate dedicates 30 pages of his rebuttal testimony to a general discussion of ratemaking methods and addresses five adjustments sponsored by Staff or RUCO. Mr. Grate states: "Parties need to be clear about the ratemaking methods in Arizona. Such clarity seems to be lacking at present." How do you respond?

A. Mr. Brosch and I, as well as other firm members, have participated in the Arizona regulatory process as consultants to the ACC Staff or RUCO since the 1980's. During that time, I have not reviewed or otherwise been presented with any explicit practices, policies, or guidelines governing Arizona ratemaking methods. However, I do not recall having ever seen such "practices" in any of the State jurisdictions in which I have participated in the regulatory process. Nevertheless, the absence of any specific practices, policies, or guidelines does not mean that the Commission or its Staff have acted in an arbitrary or cavalier manner in their approach to quantifying overall revenue requirement in utility rate cases. The tenor of Mr. Grate's rebuttal testimony regarding the lack of "clarity" seems to imply otherwise. If that was the intent of Qwest through Mr. Grate's rebuttal testimony, I believe that such an assertion is as inaccurate as it is untrue.

While I have participated in a few generic or rulemaking proceedings over the years, it has been my experience that regulators typically do not predetermine specific ratemaking methodologies, practices or approaches. I recognize that the FCC has taken this route, but the regulatory responsibilities of this Commission are not restricted to one industry. Typically, regulatory agencies like this Commission are required to base their rate case decisions on the evidence presented by the parties in each rate case. If the Commission were to provide the clarity that Mr. Grate claims is lacking, I have been advised by Counsel that such an undertaking would likely take the form of an extensive multi-industry rulemaking proceeding that could take years to notice, receive comments or testimony, hold hearings and issue final rules. In the absence of an extensive rulemaking

process, I would anticipate an uproar from individual utilities still under traditional regulation, who are typically allowed to present whatever issues they feel are appropriate in support of a requested rate increase.

It is not correct to imply that there is absolutely no guidance. While maybe not in a form perfectly acceptable to Mr. Grate, the primary form of guidance exists in past ratemaking decisions of the Commission. In any event, the Commission's decision in a particular rate case must be based on the unique facts, circumstances and evidence of that case.

Q. At rebuttal page 34, Mr. Grate quotes from two Commission rules[29] referring to rate base, implying a conflict between those rules, then stating: "The use of an end-of-period rate base instead of the rate base during the test year gives rise to two ratemaking methodology issues most states don't have." How do you comment?

A. First, I do not believe that there is any inherent inconsistency in those rules. One merely specifies the use of an historic test year that, by definition, covers a twelve month period. The other prescribes that rate base should be valued at year-end levels and a brief description of what is includable.[30]

Second, in the State jurisdictions in which Utilitech provides regulatory consulting, many of those jurisdictions (e.g., Ariziona, Indiana, Kansas, Missouri, Oklahoma, Nevada) employ an end-of-period rate base. So, the ratemaking methodology issue about which Mr. Grate complains is not as uncommon as he implies. Mr. Grate then proceeds to discuss what he characterizes as a "ratemaking method issue" that focuses on matching, or mismatching, that can arise from use of end-of-period rate base and operating income.[31]

Q. Mr. Grate states:

> I do not believe the Commission should assume that any one methodology is superior to the others or that it should prescribe any particular

[29] A.A.C. R14-2-103(A)(3)(p) and R14-2-103(A)(3)(h).
[30] R14-2-103(A)(3)(h) also requires property to be "used and useful" which, by definition, TPUC is not.
[31] Grate rebuttal testimony, pages 34-37.

> methodology. I am suggesting that the Commission instruct parties to use a single annualization methodology applied consistently to all significant elements of operating income.[32]

Do you agree?

A. No. Mr. Grate appears to be suggesting that the Commission should instruct the parties in a rate case to develop and blindly apply a single mathematical or formulistic technique to each and every "significant" element of the income statement. If the selected methods are defective by design or fail to assess true cause and effect relationships, the best thing that can be said is that the method was consistently wrong or only wrong on certain "significant" elements of operating income.

In the current proceeding, Mr. Grate chose to employ a linear regression technique applied to the 36-month period ending December 2003.[33] Mr. Grate's technique employed 19 different variables as potential drivers for the individual revenue and expense accounts. However, he was not surprised to find that the regression revealed that none of the drivers were correlated to changes in expense accounts over time, concluding that "[m]any business expenses are not particularly sensitive to changes in business volumes within a relevant range."[34]

Q. Are you surprised that Mr. Grate's study revealed no correlation between changes in expense levels and changes in business volume?

A. No. In fact, I would have been surprised if any correlation between changes in business volume and changes in expense levels by FCC account had been identified. There is a common thread to the revenues and expenses recorded by any company, whether regulated or not – that is, quantity and price/cost. Revenues are driven by the price charged for the good or service provided to customers and the number of units sold. The sales units could be minutes of use, access lines provided, number of access lines subscribing to an enhanced service, etc.

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32 Grate rebuttal testimony, page 36.
33 Grate direct testimony, pages 76-78.
34 Grate direct testimony, pages 83-84.

Similarly, expenses are also driven by quantities and price. However, the quantities and prices that drive expenses are different from revenues. With regard to salary and wage expense, there are several quantity drivers: number of employees, number of hours/ days/ weeks worked, work requirements in relation to available employees, the number of overtime hours worked, etc. Over time, wage and salary pay rates tend to increase based on bargaining unit agreements or other competitive considerations. However, increases in rates of pay may be partially offset by reorganization, downsizing and restructuring plans that tend to target productivity improvements and change the mix of employee compensation rates.

Postage expense can be largely driven by the number (quantity) of customer billings and the ability to consolidate or minimize the number of mailings to each customer. Changes in postage rates are obviously outside the control of the company, but nevertheless represent a key element of recorded postage expense.

Non-labor repair and maintenance expenses can be influenced by any number of factors. Success with past maintenance work, normal changes or significant fluctuations in weather conditions, and age of facilities can contribute to the need to patch, repair or test facilities. The extent of the maintenance work drives the quantity component of the non-labor expense. The prices charged by vendors, quantity discounts and competitive bidding can all influence the price for the consumable materials used by repair and maintenance crews.

Changes in overall employee levels or revisions to company policies and practices can affect the number of authorized periodical subscriptions or professional and recreational memberships. The magazine/ newspaper prices and membership dues are set by the provider, but still factor into the expense level recorded by the company.

Medical and dental expenses are also driven by their own unique set of facts and circumstances. Changes in employee levels can influence the overall costs charged by the providers. The offering of various provider options (PPO, HMO, etc.) and employee

participation rates can impact the quantity component. Changes in employee copayments, deductibles and coverage levels can impact both the per unit charge from the provider and the company's out of pocket cost.

These items represent but a few high level examples of the tension between quantities and prices that underlie many of the expenses recorded by a company. In the typical ratemaking process, an annualization or normalization adjustment could be presented for any identifiable changes in quantities or prices that are known, measurable and material to the Company's operations. Under Mr. Grate's formulistic approach, many of the more typical rate case adjustments might never be made, as Mr. Grate's unique technical method might not identify a correlation sufficient to support an adjustment.

Q. At page 36 of his rebuttal, Mr. Grate refers to "Qwest's comprehensive annualization of test period operating income." Referring to page 40 of his rebuttal, Mr. Grate states: "My disagreement with adjustment C-16 is that it is not based on a methodology used consistently and uniformly." Do you care to comment on this concept of consistency?

A. Yes. Again, Mr. Grate would have this Commission blindly endorse and adopt a common approach for the sake of consistency and ignore known and measurable changes. What is curious about this proposal is that the Company has been consistently inconsistent in its annualization approach since at least the 1994 rate case.

- Docket No. E-1051-93-183: USWC witness Jerrold Thompson, then Director – Regulatory Finance, sponsored the Company's overall revenue requirement. Mr. Thompson's direct testimony addressed the approach used to quantify the requested rate relief, the components of the ratemaking equation, test year selection and the approach to test year annualization adjustments. In that case, Mr. Thompson supported the following annualization methodologies applied to the test year ended March 1993:[35]
    - Operating revenues were annualized "at test year end levels by taking the first quarter of 1993 levels and multiplying those levels by four." Mr. Thompson also analyzed revenue trends for the last three years and concluded that this approach produced reasonable results. March 1993 revenues were not used for annualization, because his analysis suggested some seasonal and monthly volume activity that did not meet his goals of "internal consistency, comparability and representation of ongoing financial conditions."

[35] USWC witness Jerrold Thompson direct testimony, pages 45-46 & 49.

- Wages, salaries, employee taxes and benefits were calculated at the level of employees as of March 31, 1993.
- Plant related expenses (i.e., depreciation and property taxes) were annualized based on the March 31, 1993 plant balances.
- Management and non-management wage increases were annualized to reflect the wage change the Company was obligated to make in 1993. This adjustment was based on "end of period employee levels, to provide an internally consistent, comparable and representative test year."

- Docket No. T-1051B-99-105: USWC witness George Redding, then Director – Regulatory Finance, sponsored the Company's overall revenue requirement in his supplemental direct testimony, based on a calendar 1999 test year. Mr. Redding's supplemental testimony also sponsored the overall revenue requirement and described the Company's approach to test year annualization adjustments. In that proceeding, Mr. Redding discussed the following annualization approach:[36]
  - Revenues, wage and non-wage related expenses and taxes were generally annualized by multiplying the last month of the test year by twelve.
  - December 1999 amounts were analyzed to remove one-time or unusual transactions. The adjusted amounts for December 1999 were compared to a trend of recent months to test for reasonableness prior to annualization.
  - An alternative annualization method was used for wage related expenses, as the December normalized amount was not in alignment with the months of October 1999 through February 2000. After further modifying the adjusted December amount for customer operations, the adjusted December amount was annualized using a similar "times twelve" multiplier.
  - Pro forma adjustments were made to reflect the new depreciation rates ordered by the Commission, wage and salary increases expected to occur within twelve months following the test year, and accrual accounting for FAS106 OPEB costs.

As discussed previously, Mr. Grate employed a linear regression technique applied to the 36-month period ending December 2003, using 19 different variables as potential drivers for the individual revenue and expense accounts.[37]

Q. In each of these proceedings, do you believe that Staff has consistently applied the known and measurable concept, seeking to match both prices and quantities at or near test year-end?

A. Yes. I believe that Utilitech, on behalf of Staff, has sought to consistently annualize known and measurable changes in these proceedings. I would note, however, that it

[36] USWC witness George Redding supplemental direct testimony, pages 5-9.
[37] Grate direct testimony, pages 76-78.

appears Mr. Grate and I disagree on the meaning and application of the consistency concept.

**Year-End Wage & Salary Annualization**

Q. Mr. Grate states:

> My disagreement with adjustment C-16 is that it is not based on a methodology used consistently and uniformly. Instead, it singles out just seven EXTCs and adjusts just those seven. It fails to consider whether significant changes might also be occurring in the other 446 active EXTCs to which the Company records expenses and whether those changes might offset the changes in the seven that Mr. Carver singles out for adjustment. In the colloquial vernacular of ratemaking, adjustment C-16 is "sharp-shooting" the revenue requirement.

Do you agree?

A. Certain elements of Mr. Grate's cited testimony are accurate, but I strongly disagree with his criticism and conclusion. In direct testimony,[38] I discuss Staff Adjustment C-16, which revises test year basic wages and salaries to consistently recognize ongoing Arizona employee counts with the effective salary levels and wage rates at test year-end. The only Company adjustment to test year payroll expense (PFN-05) was limited to annualizing the effect of certain pay increases granted in the first quarter of 2003. In contrast to Mr. Grate, I believe that it is clearly inappropriate to recognize an annualization adjustment for wage rate levels (prices) that increase during the test year and ignore Qwest's downward trend in employee staffing levels (quantities) that occurred during the test year.

As noted in Footnote (a) on Staff Adjustment C-16, Staff's payroll annualization adjustment was limited to basic wages and salaries, including the seven EXTC's set forth on page 40 of Mr. Grate's rebuttal testimony, plus related benefit loadings. However, Mr. Grate claims that all expense related EXTCs must be consistently annualized or normalized just in case there might be offsetting changes, regardless of any identified need for an adjustment. I disagree.

[38] Carver direct testimony, pages 31-36.

Prior to preparing Staff Adjustment C-16, I reviewed Company supplied data from a variety of sources, including: Mr. Grate's direct testimony, Qwest's ratemaking adjustments, employee headcount data, expense data for all salary and wage EXTCs, as well as all non-labor EXTC information (e.g., benefits, rents, etc.). During this review, I made several observations specifically concerning salary and wage data, including:

- Qwest Adjustment PFN-05 represents the sole Company adjustment relating to test year wages and salaries. This adjustment increases expense by recognizing a March 2003 management wage rate increase (prices) and related payroll taxes in isolation, ignoring headcount declines (volumes) that more than offset the wage increase.

- Although Qwest would have the Commission focus its attention solely on monthly headcount data during the 2003 test year,[39] the Company has dramatically reduced its employee level during the 36-month period ending December 2003, but for the aberration that occurred in late 2003.[40]

- Although Mr. Grate's direct testimony (page 92) and Qwest's response to Data Request UTI 8-42 focused on the poor R-Squared (0.1697 revised) resulting from restricting the regression analysis of employee counts to the 12-months of the test year, a similar regression analysis for the 36-months ended December 2003 yielded a statistically significant R-Squared of 0.8661, showing a strong correlation between time and headcounts.[41]

- Basic wages and salaries result from three primary elements: rates of pay (monthly wage or hourly rate), time worked (days, months or hours), and number of employees. Over time, the rates of pay for employees have increased, while the number of employees has decreased. Staff Adjustment C-16 consistently recognizes changes in both rates of pay (price) and number of employees (quantity).

- Contrary to Mr. Grate's assertion, wage and salary data for EXTCs other than "basic" wages and salaries were also reviewed, including but not limited to the information supplied in the confidential response to Data Request UTI 9-4. Based on the review of wage and salary data during the period 2001-2003, I reached the following conclusions regarding test year compensation levels: overtime/ premium pay (EXTCs 121 & 122) and special payments (EXTCs 191, 194, 195, 197, 19B & 19E) were not unreasonable; OIS hours paid-not worked-per CWA contract (EXTC 123) was immaterial; and incentive compensation costs (EXTCs 19C, 19D, 193 & 199) did not require any annualization treatment, but were separately adjusted (Staff

[39] Grate direct testimony, page 92 & Exhibit PEG-D6.
[40] This historical trend is shown in the confidential chart appearing at page 33 of my direct testimony and not refuted by Mr. Grate.
[41] Carver direct testimony, pages 31-34.

Adjustment C-17).

- Mr. Grate discusses the 36-month regression analyses performed by Qwest on individual revenue and expense accounts to identify appropriate trend-related cost drivers and quantify any pro forma normalizing adjustments necessary to test year operating results.[42] Mr. Grate also indicates that he was not surprised that the correlation matrix revealed possible revenue drivers but no expense drivers.[43] I reviewed the regression analyses provided in Qwest's confidential responses to Data Request UTI 2-3 (36 months ended December 2003) and Data Request UTI 8-42 (12 test year months) and concurred with Mr. Grate that neither analysis revealed any trend-related expense drivers.

- Qwest's R14-2-103 Filing (revised 11/04) contains 29 adjustments that impact revenue requirement of which 21 include components that adjust operating expense – in spite of the absence of cost drivers resulting from the regression analyses.

- Additionally, both Staff and the Company have sponsored payroll annualization adjustments in prior cases that addressed wage rates and employee levels. Staff's methodology in this proceeding is patterned after work done in prior cases. For example, see my direct testimony (pages 32-38) and Staff Adjustment C-11 in Docket No. T-1051B-99-105.

Regardless of regression results, I believe that the calculation of overall revenue requirement should recognize identifiable and quantifiable adjustments to test year revenues, expenses and rate base – regardless whether the results of any regression or other formulistic analyses identify expense drivers. Staff Adjustment C-16 falls into that area, where both price (wage/ salary rates) and quantities (headcounts) should be annualized at test year-end levels.

Q. Beginning at the bottom of page 40 of his rebuttal testimony, Mr. Grate states that you failed to "consider whether significant changes might also be occurring in the other 446 active EXTCs … and whether those changes might offset the changes in the seven that Mr. Carver singles out for adjustment." Could you elaborate on your earlier statement about having reviewed charges to other non-labor EXTCs?

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[42] Grate direct testimony, pages 76-91.
[43] Grate direct testimony, pages 84-85.

A. Yes. In response to Data Requests Qwest 11-3 and/or 11-7, I provided a copy of my analysis of costs charged to 39 benefits EXTCs during calendar years 2001, 2002 and 2003. While I did not use Mr. Grate's regression methodology, I did observe that the increase in total benefits expense during this three-year period was primarily driven by OPEB/PRB costs. After removing the OPEB/PRB and pension EXTCs from the data set, the remaining benefit costs declined during the three year period.

Q. Were you at all concerned total benefit costs, including pension and OPEB costs, had increased during this period?

A. No. The amount of negative pension costs recorded by Qwest during the test year had declined in relation to the prior two years, causing test year levels to produce a higher revenue requirement. In addition, the amount of OPEB costs were separately adjusted by both Qwest and Staff, although we disagree on the amount of the TBO amortization.

Q. Earlier, you discussed the other labor-related EXTCs that were not considered in Staff Adjustment C-16 and the benefits-related EXTCs. Are there other EXTCs that do not fall within these two categories?

A. Yes. I also provided Qwest with a copy of a similar analysis of the charges to 163 non-labor/ non-benefits EXTCs, in response to Data Requests Qwest 11-3 and/or 11-7. Although the total charges to these EXTCs between 2002 and 2003 did increase, the entire increase was attributable to corporate charges flowing through a single EXTC. After removing this one EXTC from the comparison, the charges to the remaining 162 EXTCs actual declined between 2002 and 2003.

Q. You have thus far identified 20 labor related EXTCs, 39 benefits EXTCs and 163 non-labor/non-benefit EXTCs. That accounts for 222 EXTCs. At page 41 of his rebuttal testimony, Mr. Grate refers to "the 446 active EXTCs to which the Company records expenses…" What happened to the rest of the EXTCs?

A. I do not know. Staff Data Request UTI 2-23 requested a copy of the Company's monthly expense matrix for calendar years 2001-2003 by EXTC and by FCC account. In

response, Qwest provided three confidential attachments in the form of extremely large Excel workbooks that contained monthly expenses by EXTC by FCC account and by matrix category (i.e., benefits, depreciation & amortization, rents, salaries, other, etc.). My analyses focused on sorting the tens of thousands of lines of data Qwest supplied by EXTC and by matrix category for only the FCC expense accounts. At first, I expected the total number of non-labor EXTCs included in my review to match Mr. Grate's 446 EXTC count, since his rebuttal testimony seems to characterize that number as related to only expense accounts. However, our counts clearly do not tie. Presuming that Qwest provided all of the data requested in response to Data Request UTI 2-23, I am left to wonder whether Mr. Grate's EXTC count might also include non-operating expense accounts.

Q. Turning to page 41 of Mr. Grate's rebuttal testimony, he refers to your use of regression analysis to develop year-end headcounts that represents 374 less employees than the average of the last three test year months and lower than the actual level during any month of the 36-month regression period. How do you respond to this criticism?

A. Quite frankly, I am a little surprised by the criticism. The confidential chart appearing at page 33 of my direct testimony clearly shows the actual monthly headcounts and the results of the regression fit.[44] By definition, if the data points in the time series are decreasing, the slope of the regression trend line will be downward, as shown on the confidential chart. What Mr. Grate seems to overlook is the impact of the very data that caused me to use the linear regression technique to begin with.[45] As more clearly illustrated by the reproduction of Mr. Grate's test year headcount chart on page 32 of my direct testimony, there is an aberrational "uptick" in equivalent headcounts in late 2003. Because of this year-end aberration, it is not at all surprising that the regression produced lower headcounts than the average of the last three months.

Notably, I employed the 36-month regression analysis for the sole purpose of removing

[44] In order to avoid reintroducing the same confidential chart in rebuttal testimony, please refer to page 33 of Mr. Carver's direct testimony.
[45] Carver direct testimony, pages 32-34.

the aberration in Arizona equivalent employee levels that occurred in late 2003 and smoothing other fluctuations in employee headcount data. The chart on page 33 of my direct testimony merely shows the closeness of the regression "fit" in a visual chart that is indicated by the statistically significant 0.8661 R-Squared. It leaves me to wonder if Mr. Grate's acceptance of the regression methodology turns on whether he likes the result.

In any event, Staff Adjustment C-16 does not otherwise use trend analysis to annualize basic salary and wage dollars. To my knowledge, neither Staff nor Qwest annualized any operating expenses based on regression or trend analyses

Q. At rebuttal page 41, Mr. Grate also states:

> Using this statistically derived change in equivalent employee counts he computed his downward adjustment in wage and salary expense. However, he failed to first establish that changes in employee counts are a statistically reliable indicator of overall expense levels.

How do your respond?

A. There are several comments to be made. First, I did not use equivalent headcounts to annualize any non-labor related expenses. Had I done so, I could understand and appreciate the concern that I had failed to establish that employee counts were a statistically reliable indicator of those expenses – but, that is not the case.

Second, I did establish that headcounts were a statistically reliable indicator of those labor EXTCs that comprise basic wages and salaries. Over the same 36-month period, I prepared a regression analysis that resulted in a 0.5708 R-Squared and 6.72 T score, both of which exceed the 0.5000 R-Squared and 1.96 T score levels Qwest found acceptable.[46]

Q. Mr. Grate also compares your headcount regression results with Mr. Brosch's approach to Staff Adjustments C-4 and C-5 and claims that the two of you are inconsistent. He further claims that, had you been consistent with Mr. Brosch in this regard, Staff

[46] Grate direct testimony, page 86, and Qwest response to RUCO Data Request 3-8.

Adjustment C-16 "would have yielded an adjustment of less than a tenth of a million instead of $12.5 million."[47] Do you have any comments on this rebuttal?

A. Yes. I disagree with Mr. Grate. He implies that Mr. Brosch and I went about our work on this project in separate universes, never meeting or discussing theory, application or approaches to our work. Such a claim, if intended, is simply untrue. Mr. Brosch and I discussed Qwest's regression analysis on multiple occasions, including the Company's revisions to its revenue regression results based on concerns raised by Mr. Brosch as well as the aberration in employee headcounts that occurred in late 2003. After much discussion and coordination, we both agreed that Mr. Brosch's concerns (as duly noted by Mr. Grate) with the revenue data was distinguishable from the headcount data. It is my understanding through the discussions with Mr. Brosch that the headcount trend and the aberration occurring in late 2003 does not exist in the data underlying the two revenue categories about which Mr. Grate complains.

Q. Also, at rebuttal page 43, Mr. Grate states: "I am attaching Qwest Corporation—Exhibit PEG R9 to show the corrected calculation of Adjustment C-16, which the Commission should use should it choose, against my recommendation, to annualize year-end wage and salaries on the basis of equivalent employee counts." Have you reviewed Exhibit PEG-R9?

A. Yes. In the context of Mr. Grate's claim, Exhibit PEG-R9 is flawed in two respects. First, it appears to employ the same headcounts that were used in the quantification of Staff Adjustment C-16. Whatever revisions Qwest has made on lines 1-16 of PEG-R9 have an imperceptible impact on the net intrastate expense adjustment, when compared to Staff Adjustment C-16.

Second, the only material change that I can discern between PEG-R9 and Staff Adjustment C-16 is the fact that Qwest included overtime pay in quantifying the average occupational pay per employee on lines 18-21. As such, Qwest's revised annualization is not limited to basic pay, but also includes overtime pay. Consequently, the quantification of the adjustment amount should compare the "annualized" level of regular pay and

[47] Grate rebuttal testimony, pages 42-43.

overtime pay to the test year amount of both regular pay and overtime pay. But, Qwest failed to increase the test year regular pay on line 25 by the amount of test year overtime pay in quantifying the revised adjustment, thereby significantly overstating the amounts on lines 26-33.

If the Commission were to adopt Qwest's alleged correction of the overtime omission, the amount of test year pay of $265.2 million on line 25 of PEG-R9 would need to be increased by about $33.5 million. Instead of a payroll increase of $14.1 million (before allocation and benefit loading) on line 26 of Mr. Grate's exhibit, the correct adjustment should be about $(19.3) million (before allocation and benefit loading) – a larger expense reduction than the comparable amount proposed by Staff Adjustment C-16.

Q. Do you have any further comments regarding Mr. Grate's allegation of inconsistency and Staff's piecemeal ratemaking adjustments at pages 43-48 of his rebuttal testimony?

A. No. In one form or fashion, I have already addressed most, if not all, of the allegations made in this portion of his rebuttal testimony. I consider his criticisms to be unfounded and without merit.

**Pro Forma Depreciation & Reserve Adjustments**

Q. Mr. Grate dedicates eleven pages of his rebuttal testimony to the discussion of Staff Adjustments B-7 and C-22, concerning depreciation reserve and depreciation expense.[48] With regard to Staff Adjustment B-7, reversing the Company's proposed depreciation reserve adjustment, Mr. Grate states, in part:[49]

> Mr. Carver's argument is tautological. It never explains why 1) a pro forma adjustment to test year expenses (to reflect the effect of reducing depreciation rates well after the end of the test year) does not distort the test year but 2) an adjustment to test year rate base for the that same depreciation rate reduction does. Mr. Carver has simply decided that the rate base effect of post-test-year changes is to be ignored while the expense effect of those changes is not.

[48] Grate rebuttal testimony, pages 51-61.
[49] Grate rebuttal testimony, pages 52-53.

> When depreciation rates are reduced sometime after the 2003 test year (probably sometime in 2005), the reduced accruals to depreciation expense (which is included in operating income) will cause a corresponding reduction in accruals to the accumulated depreciation expense account (which is included in rate base). Recognizing one of these effects but not the other distorts the test year. Failing to match the rate base effects of a post test year change with the operating income effects of that change does not avoid a mismatch, it creates one. It does not avoid test year distortion, it is test year distortion. It is a failure to synchronize the operating income effect with the rate base effects of a pro forma post-test-year change.

Do you agree?

A. No. I strongly disagree with Mr. Grate's characterization of my adjustment as "simply [deciding] that the rate base effect of post-test-year changes is to be ignored while the expense effect of those changes is not." Qwest's implication is that Staff Adjustment B-7 was made in a vacuum, which is inaccurate and misleading. Mr. Grate's criticism failed to acknowledge the following text appearing on page 26 of my direct testimony, which further explains the rationale supporting the need for Staff Adjustment B-7:

> Qwest's update also included a rate base adjustment recognizing a pro forma depreciation reserve and deferred income tax reserve effect attributed to the decrease in depreciation expense associated with the Company's proposed technical update. <u>Because Qwest will not commence booking any rate base effect associated with revised depreciation rates the Commission might approve until well beyond the 2003 test year, Staff Adjustment B-7 excludes the pro forma effect of any capital recovery adjustment from rate base</u> (i.e., accumulated depreciation reserve and accumulated deferred income tax reserve).
> [Emphasis Added]

Stated more simply, the components of rate base generally represent recorded balances obtained from the Company's balance sheet at test year-end, with the exception of lead lag study valuations of cash working capital. While there are circumstances that require further adjustments to those year-end balances (e.g., disallowances, corrections, normalizations, etc.), post-test year adjustments to a historic rate base are typically limited to discrete known and measurable events that materially impact utility operations or represent one of the primary factors contributing to the filing of a rate case, such as completed construction projects or asset sales that are matched with related revenue gains, improved efficiencies, added costs or cost reductions. Each such situation is different and must be evaluated in the context of its unique facts and circumstances.

However, this is not the situation with regard to Qwest's proposed depreciation reserve adjustment. It is impossible for the full annual effect of any prospective change in ACC-authorized depreciation accrual rates to impact year-end 2003 historical depreciation reserve balances unless the Commission orders those rates to become effective January 1, 2003 and directs the Company to record the effect of any authorized depreciation rate change retroactive to that date. I have not seen any recommendation by Company or Staff witnesses recommending such retroactive accounting.

Mr. Grate alleges that "Failing to match the rate base effects of a post test year change with the operating income effects of that change does not avoid a mismatch, it creates one." I disagree. Contrary to assertions otherwise, it is not uncommon for depreciation rate changes to be proposed in the context of a filed rate case or a docket involving review of overall revenue requirement. While a separate depreciation docket may be a preferred and convenient approach to consider and implement such changes, a separate docket is not solely or uniformly applied.

In order to implement changes in depreciation accrual rates proposed within the context of a pending revenue requirement investigation, a pro forma adjustment to depreciation expense must be recognized in the quantification of overall revenue requirement. Otherwise, any change in book depreciation rates would not be reflected in cost of service until the next rate case, which could be years later. If the utility is allowed to commence recording the newly authorized book rates, but those rates are not considered in the determination of overall revenue requirement, the utility could subsequently over-earn (if depreciation rates are decreased) or under-earn (if depreciation rates are increased) its authorized return, all else remaining constant.

In contrast, a rate base depreciation reserve adjustment is only appropriate if the regulator orders the subject utility to retroactively record the new depreciation rates to the first day of the historic test year. Otherwise, Mr. Grate's consistency argument really becomes an inconsistency argument – a situation Staff's proposal avoids.

Q. In your experience, is it common for regulators to order a utility to retroactively record new book depreciation rates, authorized in a revenue requirement docket, effective with the first day of the historic test year?

A. No. In my experience with historic test year jurisdictions, regulators typically authorize any new book depreciation rates to become effective with the effective date of the rate order or some other post test-year date that might be convenient for the utility. In a forecast test year environment, a depreciation reserve adjustment similar to that proposed by Qwest may be appropriate if the new depreciation rates were to become effective on or before the start of the forecast year. However, forecast test years often require an average rate base, which would impact the depreciation reserve adjustment calculation.

Interestingly, Mr. Grate seems to agree that the Commission will not retroactively implement any revised book depreciation rates effective January 1, 2003:

> However, I do not now anticipate the Commission reaching back more than two years to January 1, 1993 to change retroactively the Company's depreciation rates. Instead, I anticipate the Commission making the new depreciation rates effective when the rest of its Decision becomes effective which is likely to be some time after it is issued. If I am correct, then the argument in the preceding paragraph supports approving Staff Adjustment C-22.[50]

Q. Mr. Grate also dedicates several pages of his rebuttal testimony to a discussion of Arizona history associated with the depreciation reserve rate base adjustment dating back into the early to mid 1980's.[51] At page 57 of his rebuttal testimony, Mr. Grate concludes that Staff Adjustment B-7 should be rejected in light of: "the careful reasoning of the Staff and Commission" in the rate case dockets processed in the 1980's; no discussion of the absence of a rate base adjustment in the 1994 rate case; and "the lack of a persuasive argument in Mr. Carver's testimony opposing it". How do you respond?

A. I have reviewed Mr. Grate's rebuttal testimony, Qwest's discovery responses (Data Request UTI 15-17(c) and RUCO Data Request 4-1), and the relevant portions of the

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50 Grate rebuttal testimony, page 61.

51 Grate rebuttal testimony, pages 54-57, and Exhibit PEG-R11, consisting of Qwest's 29-page response to RUCO Data Request 4-1.

ACC orders (Decision No. 53849, Docket No. E-1051-83-035 and Decision No. 54843, Docket No. E-1051-84-100) issued in the 1980's. The Commission did agree with the depreciation reserve adjustment proposed by the Staff witnesses; but this was over twenty years ago. However, with all due respect to the witnesses sponsoring Staff's testimony and the Commission's past findings over twenty years ago, I do not concur with and have consistently opposed that approach, regardless of the rate base impact (i.e., increasing or decreasing rate base).

In past Arizona proceedings, I have presented rate base adjustments similar to Staff Adjustment B-7 either removing post-test year depreciation reserve adjustments, similar to Qwest's recommendation in the current proceeding, or recognizing actual depreciation reserve balances at test year-end. I have also sponsored similar adjustments in prior Arizona rate proceedings involving Qwest's predecessor company (ACC Docket Nos. E-1051-88-146 and T-1051B-99-105). Although both proceedings were ultimately resolved by negotiated settlement, these adjustment recommendations were consistent with my current testimony, but had the affect of increasing overall rate base because the Company's reserve adjustments in those Dockets decreased rate base.

Prior to finalizing my testimony on this issue in the current proceeding, Utilitech confirmed that Staff Adjustment B-7 was consistent with current ACC Staff policy and practice. Contrary to Mr. Grate's assertion, I believe that Staff Adjustment B-7 is necessary, represents proper ratemaking treatment and avoids the distortion Qwest proposes to introduce into the ratemaking equation.

Q. Mr. Grate's rebuttal testimony also makes the following observation in the context of the Company's 1994 rate case:

> Neither the Company nor Staff proposed a pro forma adjustment to rate base to reflect the effect of pro forma depreciation expense adjustments and the Commission made no comment on it. Neither the Staff nor any party made any observation about the apparent change in method. It

> appears the parties and Commission simply acquiesced in the change without comment.[52]

Having been involved in the 1994 rate case, can you provide any clarification as to Mr. Grate's confusion over the absence of any discussion by the Company or Staff about this "apparent change in method"?

A. Yes. Mr. Grate is quite correct that Company witness Jerrold Thompson did not sponsor a similar depreciation reserve adjustment in the 1994 rate case. While I cannot speak to the motivations of the Company over ten years ago, there are several factors that may have influenced the decision to not offer a rate base adjustment. First, Mr. Thompson sponsored only one adjustment to annualize depreciation expense to end-of-period levels (Exhibit JLT-8, page 5). The depreciation expense adjustment was relatively modest (about $6.1 million). It is possible that the Company decided that the rate base impact was immaterial.

It is also possible that such an adjustment was not made, because the Company desired to streamline the regulatory process. In describing the "Commission Adjustments" he sponsored (including the EOP Depreciation Adjustment), Mr. Thompson stated: "Esoteric debates on accounting adjustments, however theoretically correct, would detract the Commission's attention from the urgent and critical need for U S WEST Communications to improve its' serious earnings deficiency."

Although Mr. Grate accurately observed that the Commission adopted Staff recommendations to recognize depreciation reserve adjustments in Docket Nos. E-1051-83-035 and E-1051-84-100, Mr. Thompson may have anticipated Staff's opposition to such an adjustment in the 1994 rate case, after reviewing my testimony filed on behalf of Staff in the immediately preceding earnings investigation (Docket No. E-1051-88-146) sponsoring a similar disallowance adjustment (ACC Adjustment Schedule B-3), as evidenced by the following excerpt from my testimony in that proceeding:

> In general, the Company adjustments addressed herein do not represent actual test year costs and activities but rather reflect the prospective,

[52] Grate rebuttal testimony, page 56.

> estimated impact of events for which inclusion in rate base would distort the test year relationship between revenues, expenses and rate base.
>
> For example, Staff has attempted to annualize income statement values at year-end 1987 levels and has valued rate base as of December 1987. The annualization of depreciation expense using rates effective January 1, 1988 is properly recognized in the cost of service; however, the growth in the depreciation reserve associated with the annualized depreciation expense will not fully be realized until December 1988. It is not appropriate to project reserve growth due to accrual rate changes while ignoring the many other factors impacting depreciation reserve balances such as retirements, salvage and removal costs.[53]

As a final matter, I would like to clear up any confusion as to why Staff's testimony in the 1994 rate case did not discuss what Mr. Grate characterizes as an "apparent change in method." Rate cases take many months to process, require the dedication of significant resources and involve any number of complex issues. When the Company sponsors an adjustment that Staff does not contest or does not sponsor an adjustment Staff has previously contested, there is no need to expend limited resources discussing non-issues, unless directed otherwise by the Commission. This is the very situation that existed in the 1994 rate case.[54] As a consultant to Staff in that proceeding, I did not see any need to engage in the academic exercise of presenting written testimony on an adjustment the Company did not make, but Staff would have opposed had the Company proposed the rate base adjustment.

## DISALLOWANCE STANDARDS

Q. At pages 62-63 of his rebuttal testimony, Mr. Grate observes that he devoted about 20 pages of his direct testimony to a discussion of disallowance standards. He also dedicates about 24 pages of his rebuttal testimony to this subject. Will your surrebuttal address the various arguments raised by Mr. Grate?

A. Mr. Brosch will respond to certain of the policy issues and the marketing/ advertising issue discussed in this portion of Mr. Grate's rebuttal testimony. My testimony on this section of rebuttal testimony will be limited to the subject of incentive compensation.

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[53] Carver direct testimony, pages 5-6, Docket No. E-1051-88-146.

[54] This same logic applies to the FAS106 OPEB accrual basis accounting issue in Docket No. T-1051B-99-105.

**Incentive Compensation (Staff Adjustment C-17)**

Q. In reference to your direct testimony[55] indicating that Company efforts to enhance consolidated financial results may not be consistent with the interests of Qwest's Arizona customers, Mr. Grate states: "Mr. Carver's speculation is not evidence. He has not shown that the criteria in Qwest's bonus plan are harmful to Qwest's ratepayers."[56] How do you respond?

A. There are several key pieces of information directly relating to this portion of my direct testimony that Mr. Grate fails to address or refute. First, a significant portion of Qwest's Bonus Plan is linked to the corporate-wide financial results of Qwest Communications International, Inc. ("QCII"). Second, Qwest's Arizona employees have limited ability or opportunity to materially affect the consolidated financial results of QCII.[57] Third, during calendar years 2001 through 2003, the consolidated financial results of QCII were dismal – generating over $40 billion dollars of net losses during this three year period. Fourth, QCII was only able to show positive net income in 2003 because of the sale of its directory publishing business, while reporting a loss from continuing operations.[58]

Finally, I would note that Mr. Grate has offered no evidence to show that Qwest's Arizona employees do have the ability to materially impact the consolidated financial results of QCII or that efforts to enhance the consolidated financial results of QCII are consistent with or beneficial to the interests of Qwest's Arizona customers.

Q. Referring to page 73 of his rebuttal testimony, Mr. Grate also states that you are not an incentive compensation expert. Is that true?

A. As I indicated in response to Data Request Qwest 16-4 and 16-5, it is true that I am not and have never claimed to be a "Certified Compensation Professional" or a "Certified Benefits Professional." Referring to my direct testimony as well as Attachments SCC-1 and SCC-2 appended thereto, my expertise is in the field of utility regulation, with

[55] Carver direct testimony, page 39.
[56] Grate rebuttal testimony, page 72.
[57] Carver direct testimony, page 39.
[58] Carver direct testimony, pages 41-42

considerable experience in the evaluation of utility expenses for potential ratemaking cost recovery. Over my professional career dating back to 1977, I have reviewed multiple incentive benefit plans of many regulated utilities and conducted interviews of utility compensation and benefit professionals. In light of this experience, having filed testimony on this issue in seven jurisidictions in fourteen regulatory proceedings and having reviewed the testimony of various utility witnesses on the matter, I believe that my regulatory experience is highly relevant as a consultant to Staff and qualifies me to offer my opinion on the regulatory recovery of Qwest's incentive plan costs – costs that are largely driven by QCII consolidated financial metrics.

Q. At page 40 of your direct testimony, you discuss the concept that regulators need not allow recovery of all discretionary costs incurred by a utility, absent a showing that such costs provide direct, tangible benefits to ratepayers. In rebuttal, Mr. Grate contends that "the direct tangible ratepayer benefit standard is unjust and unreasonable…does not allow Qwest to recover its commercially reasonable, prudently incurred costs [and] … cannot be applied to all of the discretionary costs that utilities incur…"[59] Do you agree?

A. No. As discussed in the surrebuttal testimony of Mr. Brosch, Utilitech has not proposed to apply this approach to all costs Qwest incurs, instead limiting its disallowance recommendations to areas that regulators often find problems with rate case recovery. In my opinion, the ratemaking treatment of discretionary costs, such as incentive compensation, are properly addressed within the context of ratemaking proceedings. Once a ratemaking adjustment is proposed, Qwest then has an opportunity and responsibility to respond in order to support the reasonableness of rate case recovery of such costs.

Over the years, the Commission has issued various decisions that generally support the approach cited at page 40 of my direct testimony.[60] At page 17 of Decision No. 58360 (Citizens Utilities Company, Docket No. E-1032-92-073), the Commission disallowed the costs of Citizens' management incentive deferred compensation plan, stating:

[59] Grate rebuttal testimony, page 75.

[60] The following quotes from Commission orders were previously provided to Qwest in response to Data Request Qwest 16-1.

> Staff and RUCO recommended adjustments to remove this expense because Citizens failed to show that the awards were based on or related to attainment of cost reductions or other specific goals, which Citizens had cited as a benefit to ratepayers.
>
> We agree with Staff and RUCO that no expense should be allowed for the MIDCP in place during the TY and we will adopt RUCO's adjustment to exclude $62,775.

Similarly, at pages 32-33 of Decision No. 57745 (Southwest Gas Corporation, Docket No. U-1551-90-322), the Commission also denied the request of Southwest Gas to recover the test year bonuses paid under that utility's management incentive plan, stating:

> We concur with Southwest Gas that it is absolutely none of this Commission's business if the Company pays its management with beads or McDonald's coupons. We also concur that it is absolutely none of this Commission's business if the Company wishes to reward management with bonuses for higher earnings with one little provision. That provision is simply that shareholders should bear the burden of management bonuses for higher earnings. That reason along with the fact that the Company's requested amount does not relate to amounts either previously paid or expected to be paid provide justification to deny the Company's request. It is also noted that once an amount in included in rates, it provides the Company with an additional return without any increased effort.

Also in Decision No. 57745 (Southwest Gas Corporation, Docket No. U-1551-90-322), the Commission provided the following statement regarding the burden borne by utility management to justify cost recovery at page 17, in the context of excluding the pension asset from rate base:

> Staff recommended the prepaid pension fund balance in the amount of $855,901 be removed from the prepayment category which the Company had included in rate base. We concur with Staff. The Company has simply provided no adequate justification for inclusion of prepaid pension funds in rate base.

At pages 21-23 of Decision No. 58664 (Citizens Utilities Company, Docket No. E-1032-93-111), the Commission exercised its discretion and agreed with Citizens that certain costs were allowable and with RUCO that certain other costs incurred at the Stamford Administrative Office and allocated to Arizona operations should be disallowed:

> We agree with RUCO that the payment to the general counsel should be removed as it is a nonrecurring expense; that depreciation needs to be

> adjusted to reflect the SAO plant disallowances; and that the 'SOAC Other' expenses, as well as the consulting, video, photography, executive chef salary, and individual and per diem charges should be disallowed.

The same Decision No. 58664 (pages 26-28) also disallowed certain incentive compensation costs, as indicated by the following passages:

> Staff believes that the expense should be removed because the Company is not meeting the goals of the IDCP, which are to: emphasize customer service and employee satisfaction; lower overall compensation from that which would have been achieved under a traditional system of cost of living and merit increases; and force employees to achieve certain objectives in order to 're-earn' their merit increases of previous years...
>
> We agree with Staff and RUCO that expenditures for IDCP during the TY should not be included in operating expenses. Contrary to Citizens' assertion in its Opening Brief, the record evidence does not establish that 'total compensation has been reduced since 1989 as a result of changes instituted by Citizens' new top management.' The evidence indicates that between 1989 and 1992, total payroll increased by almost $13 million. The evidence indicates that under the IDCP, no employee received a pay reduction, so the per employee payroll amount decrease has to be an effect of the increased number of employees [footnote omitted], not a result of the IDCP.

Also within Decision No. 58664 (pages 28-29) the Commission disallowed the costs of a "Target: Excellence" program, stating as follows:

> RUCO proposed an adjustment to remove Target: Excellence expense from operating expense. RUCO believes that the expenditures have provided no specific, quantifiable, benefits to ratepayers, and that any future benefit is not known and measurable and would not be matched to the present expenditures. Staff made no adjustment to the Target: Excellence expense.
>
> We agree with RUCO that the goals of Target: Excellence and the benefits Citizens believes it will provide are nebulous. We agree with the Company that it should strive to improve its quality of service to its customers. What we cannot agree to is that only one of its 'customers' should have to bear the entire cost of such and expensive program which has yet to demonstrate any savings. Accordingly, we believe that the costs of the Target: Excellence program should be shared equally between Citizens' ratepayers and its shareholders, and we will adjust the Target: Excellence expense by ($50,000)."

While these decisions do not necessary use the phrase "direct, tangible benefits to ratepayers", I believe that the intention is clear: the utility is expected to demonstrate that certain discretionary costs do result in tangible benefits to ratepayers or should otherwise provide adequate justification to support cost recovery.

Q. In the context of discretionary costs and direct, tangible benefits, Mr. Grate's rebuttal testimony is also critical of your reference to Part 65 of the FCC rules prescribing components of rate base and net income for dominant carriers,[61] stating:

> Mr. Carver fails to mention that the 1987 FCC Order on Part 65 that he is citing to support the disallowance of incentive compensation never once applies the "used and useful" standard or the "benefit burden" test to employee compensation. The Order primarily addresses the treatment of rate base items – though it also addresses net income issues. While employee compensation is a key determinant of net income, it is never addressed in the FCC Order that Mr. Carver is citing. In fact, if anything, the absence of any mention of incentive compensation in the Order supports the proposition that the FCC had no problem with incentive compensation plans under rate of return regulation.[62]

Do you have any comments on this rebuttal testimony?

A. Yes. It was neither the intent nor design of my direct testimony to claim that the FCC applied these standards or tests to employee compensation. In citing the passage from the FCC's Report and Order (CC Docket No. 86-497), it was my intent to simply provide additional support for the proposition that cost incurrence does not automatically translate into cost recovery. Further, my direct testimony does not claim that the FCC relied on the benefit-burden test as justification to disallow incentive compensation costs for ratemaking purposes. In any event, the concept of the benefit-burden test, as discussed at pages 42-43 of my direct testimony, is consistent with the concepts applied in the above excerpts from previous ACC regulatory decisions.

## OTHER REVENUE REQUIREMENT ISSUES

Q. At pages 86-136 of his rebuttal testimony, Mr. Grate discusses eight revenue requirement issues raised by Staff or RUCO. Which of these "other" issues will your surrebuttal address?

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[61] Carver direct testimony, pages 42-43.
[62] Grate rebuttal testimony, pages 75-76.

A. Of those "other" issues that relate to Staff recommendations, I will only address FCC Deregulated Products and Telephone Plant Under Construction. Mr. Brosch, Mr. Dunkel or other Staff witnesses will respond, as necessary, to the remaining Staff issues discussed in this portion of Mr. Grate's rebuttal testimony.

**FCC Deregulated Products (Staff Adjustment C-19)**

Q. Have you reviewed Mr. Grate's rebuttal testimony responding to Staff Adjustment C-19, imputing additional revenue for certain FCC Deregulated Services?

A. Yes. I have read pages 114 through 118 of Mr. Grate's rebuttal testimony. It is so replete with inaccuracies and misguided assertions that I hardly know where to begin in response.

Q. At page 114, Mr. Grate states that the FCC deregulated services "have an earnings surplus." Do you agree?

A. No. Throughout Mr. Grate's rebuttal testimony, it appears that he may not sufficiently understand Staff Adjustment C-19 to be able to respond clearly. Maybe a review of what Staff Adjustment C-19 is designed to do and how it accomplishes that objective would help clarify any confusion that might currently exist in the record.[63] First, I must confirm that Mr. Grate is correct in one respect. It is my opinion that the FCC deregulated services do earn a much lower return than the 9.5% return on investment that Staff has recommended the Commission adopt in this proceeding. Because Qwest has included the FCC deregulated services above-the-line for purposes of determining its Arizona intrastate operating results, this treatment causes the Company's overall revenue requirement to be higher than if their related revenues, expenses and rate base amounts were simply excluded (or recognized below-the-line). Staff Adjustment C-19 conservatively seeks to minimize the revenue requirement overstatement and mitigate a portion of the resulting cross-subsidy.

Q. At rebuttal pages 114 and 115, Mr. Grate states:

[63] This discussion of Staff Adjustment C-19 will be presented later in this testimony section.

> According to Staff, the aim of adjustment C-19 is to prevent ratepayers from cross subsidizing FCC deregulated services (FCCDS). However Staff's adjustment C-19 does not identify cross subsidy between FCCDS and Qwest's other intrastate regulated services. Instead adjustment C-19 imputes sufficient additional revenues for intrastate regulatory purposes so that, in the aggregate, the test year earnings of the FCC deregulated services (FCCDS) equal the overall 9.5% return on investment that Staff recommends ACC ultimately adopt for Qwest's intrastate regulated services.

Does Staff Adjustment C-19 impute sufficient additional revenues so that the FCC deregulated services would earn the same 9.5% Staff recommends that the Commission adopt for Qwest's intrastate regulated services?

A. No. Referring to confidential Schedule C-19 included in the Staff Joint Accounting Schedules, the $6.6 million of additional revenues is only 50%[64] of the computed amount that would be required to generate a comparable 9.5% return on investment.[65] The confidential return on investment rates set forth in Column (J), Line 28, of Schedule C-19 illustrates the negative return on investment for the FCC deregulated services after recognizing the $6.6 million of additional revenues.

Q. Also on rebuttal page 115, Mr. Grate indicates that Staff made "exactly three adjustments" to the FCC deregulated services and then refers to Staff adjusting "the test year with dozens of adjustments proposed by Staff and by Qwest" to arrive at Staff's overall revenue requirement of $3.5 million. He further indicates that without these adjustments, the achieved return on investment would be far below 9.5%. How do you respond?

A. With some difficulty, given the complexity of the issue. Mr. Grate confuses "as recorded" operating results with the realities of the ratemaking/ revenue requirement process. I agree with Mr. Grate that on an unadjusted basis, Qwest's per book operating results generated a negative return on investment. After including the FCC deregulated services above-the-line, as proposed by Qwest, the negative return becomes a larger negative result.[66]

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[64] In deference to the Commission Decision No. 58927, Staff Adjustment C-19 imputes only 50% of the computed revenue deficiency.

[65] Carver direct testimony, page 96, and footnote (d) of confidential Schedule C-19.

[66] Source: Qwest tab "Interface-1990Financials" of spreadsheet "az1203_Revised 10-27-04.xls".

Once the FCC deregulated services are included above-the-line, Mr. Grate then proceeds to make adjustments to the "as recorded" amounts to quantify overall revenue requirement. In order for Staff Adjustment C-19 to present a proper "apples to apples" comparison Mr. Grate complains about at page 117 of his rebuttal, it is necessary to recognize the impact of the various Company adjustments on the "as recorded" loss associated with the FCC deregulated services, excluding payphone. Otherwise, the true impact of Qwest's above-the-line treatment of these services would go undetected. Columns (D) and (G) of confidential Schedule C-19 are designed to give recognition to the other Qwest adjustments that alter the "as recorded" amounts attributable to FCC deregulates services, excluding payphone.

- Column (D) recognizes Qwest's proposed correction to reclassify certain expense and rate base amounts from one FCC deregulated services category (i.e., planning for enhanced services) to the payphone category that Qwest did not include in its calculated "per book" starting point.
- Column (G) recognizes the portion of Qwest Adjustments PFN-1 and PFN-3 that significantly decrease the FCC deregulated service revenues included in the Company's "per book" calculation.

If these Company adjustments were not recognized on confidential Schedule C-19, the calculation of the needed revenue imputation would be materially misstated.

Q. What other adjustments are recognized on Schedule C-19?

A. At page 87 of my direct testimony, I identify each FCC dereg product category and indicate whether any services provided in those categories are offered pursuant to tariffs approved by the ACC and included in any Arizona Price Cap "baskets." Column (E) of confidential Schedule C-19 removes three FCC deregulated product categories (i.e., premises services, E911 nonregulated, and national directory assistance) included in Baskets 1 and 3 from the imputation calculation. Column (F) also removes voice messaging for two reasons. First, it currently falls into Basket 3 and the direct testimony of Staff witness Rowell recommends that this service be deregulated.

The net effect of Columns (B) through (G) of confidential Schedule C-19 is to quantify the net operating income and rate base amounts that remain above-the-line for the FCC deregulated services that: (a) are not provisioned pursuant to ACC approved tariff or included in one of the Arizona Price Cap Plan "baskets;" (b) have not been separately excluded by Qwest; and (c) have not been separately removed due to Staff's recommended deregulation by the ACC . In so doing, the amounts in Column (H) of Schedule C-19 reflect the residual values that remain above-the-line in Staff's proposed rate base and operating income, producing the proper "apples to apples" result over which Mr. Grate frets.

Q. At rebuttal pages 116-117, Mr. Grate refers to various pro forma adjustments, such as those to depreciation expense and directory imputation, and appears to claim that Staff Adjustment C-19 should have attributed some portion of these adjustments to the FCC deregulated services, thereby providing "an additional lift to the test year earnings of FCCDS." Is he correct?

A. No. Staff's approach in quantifying overall revenue requirement was carefully crafted so that a larger portion of the various adjustments to rate base and operating income were not attributed to Arizona intrastate regulated operations by virtue of Qwest's above-the-line inclusion of the FCC deregulated services. Staff Adjustments B-10 and C-20 collectively increase revenue requirement by about $3.4 million to help achieve this result.

Along this line, Staff's revenue requirement calculation does not take credit for any portion of the depreciation expense reductions that Qwest claims should be allocated to the FCC deregulated services. However, if the FCC deregulated services are included above-the-line, the reduced depreciation expense Qwest might record as a result should also be recognized in quantifying overall revenue requirement. Further, although this could more fully be addressed by Mr. Brosch, I would contend that none of the $72 million of the directory revenue imputation would be assignable or allocable to the FCC deregulated services.

Q. At rebuttal pages 117-118, Mr. Grate states that Staff Adjustment C-19 should be revised to include "an aliquot share all of Qwest's and Staff's test year adjustment would need to be assigned to the FCCDS so that the 'apples' (results) being compared are 'fertilized' (adjusted) by the same set of adjustments" and recommends a simpler remedy before concluding that he does not believe any adjustment is appropriate. How do you respond?

A. As discussed previously, I disagree with his criticisms of Staff Adjustment C-19 as well as his conclusion. Similary, the alternate imputation amount he quantifies on page 3 of his Exhibit PEG-R15 is driven by the negative 4.48% return he computes on page 1 of the same exhibit. Unless Mr. Grate is recommending that Qwest's overall revenue requirement should be determined by that (4.48)%[67] return rather than a positive 11.18%,[68] I could not disagree more.

**Telephone Plant Under Construction (Staff Adjustment B-5)**

Q. In rebuttal testimony, Mr. Grate states that you sponsored the Staff adjustment removing TPUC from rate base, in Docket No. E-1051-93-183, that was adopted by the Commission.[69] Is that correct?

A. Yes. Mr. Grate and I agree on this point.

Q. He also indicated that Company witness Thompson included TPUC in rate base in that docket. Correct?

A. Yes. Although the Company did not affirmatively remove TPUC from rate base in Docket No. E-1051-93-183, the following excerpt from my surrebuttal testimony in that proceeding summarizes the position on this issue offered by the Company at hearing:[70]

> Q. On page 81 of his rebuttal testimony, Mr. Thompson states that he finds that your proposal to exclude Short-Term TPUC from rate base "...is acceptable provided the calculation of AFDC is allowed to be done in the manner outlined by Mr. Carver." Do you have any comments with regard to that statement?

[67] Grate rebuttal Exhibit PEG-R15.
[68] See Schedule D included in the Staff Joint Accounting Schedules.
[69] Grate rebuttal testimony, pages 121-122.
[70] Docket No. E-1051-93-183, Carver surrebuttal testimony, page 10.

> A. Yes. As noted by Mr. Thompson, the Staff has proposed that Short-Term TPUC be removed from rate base. On pages 13 through 15 of my direct testimony, I outline the Staff's proposal to allow the off-book capitalization and depreciation of AFDC on Short-Term TPUC. During cross-examination, Mr. Thompson stated that while USWC had not removed Short-Term TPUC from its updated revenue requirement calculation the issue was not being contested by the Company. Instead, the Company is looking for a Commission decision on this issue that can be relied upon in the future. [Tr. 440]

What a difference ten years make. In Decision No. 58927 (pages 5-6), the Commission adopted Staff's recommendation and provided the "decision" sought by Mr. Thompson that could "be relied upon in the future." In Docket T-1051B-99-105, Qwest did not seek to include TPUC in rate base. However, in a proceeding in which Qwest is not even seeking rate relief for any significant portion of its asserted revenue deficiency, the Company has reversed course and is once again litigating the inclusion of TPUC in rate base – ignoring the most recent ACC precedent directly relevant to this issue.

Q. Mr. Grate contends "that including plant under construction in rate base is an acceptable accounting method and appropriate under the Arizona Constitution and Arizona Revised Statutes. There is no accounting or legal impediment to the inclusion of telephone plant under construction in rate base in Arizona."[71] Is he correct?

A. Yes. I am not aware of any finding that would serve as a legal impediment to including TPUC in rate base, as exists in the State of Missouri. In an April 1994 decision by the Arizona Court of Appeals involving an appeal of a Commission order by Litchfield Park Service Company,[72] the Court's decision included the following findings regarding the Commission's exclusion of TPUC from rate base:

> [12] ... In decision 57944, the Commission agreed with its staff's removal of $218,000 from the rate base for construction work in progress ("CWIP") on Well 23A because the well was not used or useful during the test year. The Commission stated:
>
> > To include Well No. 23A in rate base without a corresponding inclusion of new customers and revenues results in a violation of the matching concept implicit in the use of a historical test

[71] Grate rebuttal testimony, page 122.

[72] According to the Court of Appeals order, Litchfield Park Service Company was a subsidiary of SunCor Development Company, whose parent Company was Pinnacle West.

> year. Second, even if the well were in service during the test year, we are not convinced that it is necessary to serve the Company's customers. It is clear that LPSCO has been able to provide service to its customers without Well No. 23A.
>
> [13] Generally, although CWIP is not included in the rate base because it is not yet part of the fair value of property devoted to public use, *see Arizona Water Company,* 85 Ariz. at 202, 335 P.2d at 414, it is within the Commission's broad discretion to consider a plant under construction in determining a utility's fair value...*Arizona Corporation Commission v. Arizona Public Service Company,* 113 Ariz. 368, 371, 555 P.2d 326, 329 (1976). Although the Commission properly could have considered the cost of Well 23A, construction of which was subsequent to the test year, *see id.,* the record does support the Commission's exclusion of the construction of this well from the rate base. LPSCO has not cleared its hurdle on review of a satisfactory demonstration that the Commission acted unreasonably or unlawfully in determining LPSCO's just and reasonable rates.
> [178 Ariz. 431, 874 P.2d 988]

As recently as 1994 the Arizona Court of Appeals found that it is within the Commission's broad discretion to include or exclude plant under construction from rate base. In Decision No. 57944, the Commission clearly expressed concern that rate base inclusion would violate the matching concept. I concur. In my opinion, the Commission reached the right conclusion in Decision No. 58927 and Qwest has not presented any compelling evidence to demonstrate that a change should be made.

Q. At pages 123 through 125 of his rebuttal testimony, Mr. Grate refers to your use of the phrases "inherent mismatch" or "inherent distortion" and then attempts to define these terms. Do you agree with his definition?

A. In general terms, I do agree, but his definition falls short. At page 13, lines 11-29 of my direct testimony, I explain why TPUC should be excluded from rate base. This discussion refers to the fact that the completion of a construction project may yield improved efficiencies, cost savings and/ or additional revenues – benefits that cannot be attained until the project is completed and placed in service. The inclusion of TPUC will result in an "inherent mismatch" because of the resulting inconsistency with the other elements of the ratemaking equation – that is, no recognition of related benefits. So, the

"mismatch" concern goes beyond the fact that the construction projects comprising TPUC are not yet in service.

Q. Mr. Grate concedes that your "mismatch" concern exists with the "rate base method" but does not exist with the "revenue offset method" proposed by Qwest, because the related AFUDC is included in current income.[73] Do you agree?

A. No. First, as indicated at page 22 my direct testimony, the amount of the pro forma AFUDC earnings Qwest alleges will remedy the matching concern is immaterial. Referring to Qwest Adjustment PFA-04, the immaterial AFUDC revenues proposed by Qwest are dwarfed by the current return that will result from inclusion of the TPUC balance included in rate base, causing an increase to revenue requirement of about $4.1 million.

Second, Mr. Grate's alleged remedy, recognizing immaterial AFUDC revenues, does not capture any improved efficiencies, cost savings and/ or additional customer revenues. Qwest Adjustment PFA-04 does not recognize any of these pro forma benefits that will only be realized after the construction projects are completed and placed in service.

Q. In rebuttal, Mr. Grate states:

> Apparently, Mr. Carver does not realize that in the period leading up to the adoption of the revenue requirement offset method, the FCC was using the rate base method for STPUC. Today, Arizona requires Qwest to use the capitalization method (other utilities may be using other methods). So, in Qwest's case, the conversion to the revenue requirement offset method is from the capitalization method, not the rate base method. Converting to the revenue requirement offset method from the rate base method instead of the capitalization method accounts for the differences in the jurisdictions.[74]

Is he correct?

A. No. It was very clear that the FCC's prior TPUC accounting method was the rate base method. The only difference between the rate base method and the revenue requirement offset method is the former does not involve AFUDC, while the latter does. It is Mr.

[73] Grate rebuttal testimony, pages 124-125.
[74] Grate rebuttal testimony, page 126.

Grate, not Staff, who relies on the FCC Report and Order in CC Docket No. 93-50 to substantiate the recommendation that Arizona depart from the capitalization method and follow the FCC's lead to the revenue requirement offset method for TPUC. Mr. Grate's perceived "revelation" does nothing to alter my direct testimony and conclusion regarding the FCC's adoption of the revenue requirement offset method.[75]

Q. Mr. Grate's rebuttal testimony continues at page 126:

> When the Commission accepted Mr. Carver's proposal to adopt the capitalization method for STPUC in the Company's 1994 rate case, the adjustment reduced revenue requirement over $4.84 million.[103] Compared to Qwest's proposal in this docket the revenue requirement effect of Mr. Carver's proposal in the 1994 rate case was 56% larger.[104]
>
> [103] $29,282,000 * 9.75% *1.695.
>
> [104] Using Staff's own calculation: "Adoption of the revenue requirement offset method would increase overall revenue requirement by about $2.7 million (see Staff Schedule E, based on Staff proposed capital structure and cost rates)" Response of Steven Carver to Qwest Data request 14-5. $4.839M / $2.698M = 55.8%.

Do you concur with this representation?

A. Mr. Grate has offered a "red herring" of his own in that the calculation is inaccurate and his conclusion misleading. First, the revenue requirement impact of excluding TPUC from rate base in the 1994 rate case was not $4.84 million. Mr. Grate's calculation appearing in footnote 103 improperly applies the 1.695 revenue conversion factor to the entire 9.75% weighted cost of capital adopted by the Commission in Decision No. 58927.[76] Because the Commission adopted the interest synchronization methodology, only the equity component should have been grossed up to a pre-tax return level. Properly applying the revenue conversion factor to only the equity component (7.03% weighted equity cost * 1.695 = 11.916% plus 2.72% weighted cost of debt = 14.636% effective rate of return) yields an approximate revenue requirement effect of $4.286 million ($29,282,000 * 14.636%), not Mr. Grate's $4.84 million.

[75] Carver direct testimony, pages 20-23.

[76] The authorized weighted cost of capital appears at page 69 of Decision No. 58927, while the Commission's adoption of interest synchronization appears at page 61.

Second, although I do not concur with how he characterizes or applies the result, no matter how many times I divide $4.839 million by $2.698 million as shown in his footnote 104, I get a mathematical result of 79.3%, not 55.8%.

Third, Mr. Grate's footnote 104 cites to my response to Data Request Qwest 14-5 for support of the $2.7 million revenue requirement effect of adopting the revenue requirement offset method. While his partial quote is accurate, he fails to note that the $2.7 million is based on Staff's recommended weighted cost of capital of 9.5%. As Mr. Grate is well aware, the Company and Staff have significantly different recommendations on the appropriate cost of common equity.[77] As I also observed in my response to Data Request Qwest 14-5, the revenue requirement effect using Qwest's proposed capital structure was "$4.1 million (based on Qwest's recent R14-2-103 update)."

Fourth, using the more accurate $4.286 million estimate of the revenue requirement effect of the TPUC issue in the 1994 rate case, Mr. Grate's percentage comparison would be 58.9% ($4.286 million / $2.698 million) using Staff's weighted cost of capital, but only 4.5% ($4.286 million / $4.1 million) using the Company's weighted cost of capital. Although I believe these percentage comparisons do not provide useful information to assist the Commission in resolving this issue, Qwest's calculations produce misleading information, unless the Company has acquiesced to Staff's capital structure recommendation unbeknownst to me.

Q. At pages 127 and 128 of his rebuttal testimony, Mr. Grate agrees with your comments in direct testimony that the two page analysis, attached as Exhibit PEG-D4 to his direct testimony, is inconsistent with the Company's other recommendations in this case and fails to accurately quantify the relative revenue requirement effect of the three TPUC alternatives he analyzes. He then proceeds to criticize you for not correcting his model and then concludes that the Commission should adopt the revenue requirement offset

[77] Original Staff Joint Accounting Schedules, Schedule D: Staff equity return of 14.6% vs. Qwest 21.4%. The overall revenue requirement effect of the capital structure difference is about $46.8 million on Qwest's original cost rate base. (See Staff Schedule E, line 2).

method if it desires "to fairly balance the interest of ratepayers and the Company's investors." Do you agree?

A. Not in the least. First, it is Mr. Grate who sponsored a flawed revenue requirement model to support his proposal to abandon the TPUC capitalization method the Commission adopted in the 1994 rate case. I find it quite amusing that Mr. Grate elected to submit over 140 pages of rebuttal testimony in something of an "academic" exercise, but was unwilling to correct his own work.

Second, Mr. Grate seems to miss the point of my direct testimony at pages 23-25, which could have been more clearly stated. By failing to present an accurate model analysis, Mr. Grate's Exhibit PEG-D4 marginalizes the true difference in revenue requirement between the three methods he attempts to analyze. As a consequence, his Exhibit PEG-D4 inaccurately illustrates a relative small difference between the revenue requirement affect of the various alternatives. It is Qwest that carries the burden of proof, not Staff.

Third, rather than expend Staff's limited resources to correct a flawed model to support a more accurate comparison of the revenue requirement differential of these alternatives, I simply stated the obvious at page 24 of my direct testimony.

Fourth, rather than distract attention away from the real cost to ratepayers by quibbling over revisions to Mr. Grate's Exhibit PEG-D4, the Commission should focus attention on the real impact of the Company's recommendation on overall revenue requirement: $4.1 million (based on Qwest's recent R14-2-103 update) using Qwest's proposed weighted cost of capital or $2.698 million using Staff's recommended capital structure and cost rates.

Finally, Mr. Grate appeals to the Commission to adopt the revenue requirement offset method if it desires "to fairly balance the interest of ratepayers and the Company's investors." Mr. Grate has not demonstrated that the current capitalization method adopted in the 1994 rate case fails to fairly balance the interests of ratepayers and investors. The current methodology has been applied in the utility industry for decades.

Although Qwest's offbook accounting method generously applies the weighted cost of capital to all TPUC amounts, rather than apply short-term debt cost rates as the first source of assumed bridge financing, the concept is comparable to the AFUDC rules applied by Federal Energy Regulatory Commission. For decades, the capitalization method has been widely used for electric, gas, telephone and water/wastewater utilities. Typically the plant under construction debate focuses on rate base inclusion or exclusion with AFUDC capitalization. Because of the FCC treatment Mr. Grate proposes that this Commission adopt, the revenue requirement offset method would primarily serve to benefit investors under normal circumstances.

## UNADDRESSED REBUTTAL ISSUES

Q. You previously indicated that your surrebuttal testimony would not necessarily address each and every point discussed in Mr. Grate's rebuttal testimony. Is that correct?

A. As I indicated earlier, Mr. Grate sponsors 142 pages of rebuttal testimony. Given the limited time available for Staff to review and respond to the Company's rebuttal testimony, it was not feasible for Mr. Brosch or myself to respond to every point raised by Mr. Grate with which we disagree. However, Staff has made a concerted effort to address the major areas of disagreement, noting any identified areas of agreement. Staff's silence with regard to any areas or other points raised by Mr. Grate should not be construed as our concurrence in or agreement with said representations.

Q. Does this conclude your surrebuttal testimony?

A. Yes.

SHORT-TERM TELECOMMUNICATIONS PLANT UNDER CONSTRUCTION (TPUC)

Q. What is the purpose of this section of your rebuttal testimony?

A. The purpose of this section of my testimony is to rebut the testimonies filed by Messrs. Shriver (pages 34-39) and Flaherty (pages 63-71) on the issue of Short-Term TPUC.

Q. On page 35 of his rebuttal testimony, Mr. Shriver takes issue with your testimony (TR. 761) and states that "[t]he Commission explicitly found that capitalization of AFDC was inappropriate and they did much more than simply 'merely approved the stipulation.'" [original emphasis] Do you agree with that statement?

A. No. Mr. Shriver's testimony is particularly confusing as it takes a radically different position from that addressed by the Company in response to ACC Staff Data Request No. 18-20. Item B of that data request sought "...all reasons why the Off-Book capitalization of AFDC/IDC on Short-Term TPUC is inappropriate for ratemaking purposes." In response, the Company quoted from Commission Decision No. 53040 and concluded as follows:

> Thus, the ACC did not find the Off-Book Capitalization of Allowance for funds used during construction (AFUDC or, formerly, Interest During Construction or IDC) inappropriate for ratemaking purposes; it merely chose to adopt the FCC's required accounting for AFDC.

In reviewing this decision, nowhere does the Commission state that it finds the inclusion of Short-Term TPUC in rate base to be superior to the capitalization of AFDC.

Since the Commission approved a stipulation which adopted the FCC provisions to cease the capitalization of AFDC, it was appropriate and necessary for the Commission to similarly conclude that short-term plant under construction should be included in rate base. The failure to make such a provision would preclude the Company from earning any return on Short-Term TPUC either from current inclusion in rate base or capitalization of AFDC to be recovered in the future. It is clear that Staff's proposed accounting for Short-Term TPUC for Arizona Intrastate ratemaking purposes does not deny the Company a prospective return on these amounts.

In addition, the Company's attempt to characterize Decision No. 53040 as representing a specific finding of this Commission on the merits of the Short-Term TPUC issue is contrary to the terms of the Stipulation and Agreement:

> Furthermore, this stipulation, <u>any order of this Commission entered pursuant to this stipulation,</u> and the settlement offers leading thereto <u>shall not be used in any manner</u> by the parties hereto or any other party whatsoever, <u>in any litigation</u>, proceeding or docket pending, existing or to be tried in the future, it being expressly and clearly recognized that <u>this stipulation is considered a nonprejudicial compromise</u> of the parties' positions in this proceeding only. [Decision No. 53040, page 13; Emphasis Added]

Q. Also on page 35 of his rebuttal testimony, Mr. Shriver reviews your redirect testimony at TR.761. If the ACC did not adopt the 1979 FCC revision to the USOA to cease AFDC capitalization on Short-Term TPUC until 1982, how did the Company account for the continued capitalization of AFDC during the interim?

A. During this period, the AFDC on Short-Term TPUC was capitalized as part of the Off-Book accounting system and continues to be incorporated into the Company's operating results through a series of financial reporting adjustments. This AFDC will remain on the Company's books until the associated plant is retired from service. (See response to ACC Staff Data Request No. 35-12).

Q. On page 36, Mr. Shriver references two Commission rules [i.e., R14-2-510(G)(2) and R14-2-103(A)(3)(a)] and concludes that the Staff's recommended treatment for Short-Term TPUC is inappropriate and precludes the capitalization of interest on Short-Term TPUC. Do you have any comments on that testimony?

A. Yes. Mr. Shriver proposes essentially the same argument in his rebuttal testimony dealing with Part 32. In that section of my testimony, I address these allegations in detail and will not restate or reiterate them here. Nevertheless, Mr. Shriver's argument on this issue is without merit.

Q. Similarly, Mr. Flaherty (page 71) and Mr. Shriver (page 37) reference Commission Rules [i.e., R14-2-103(A)(3)(h)] as

requiring rate base to be valued at the end of the test year. Do you agree with that statement?

A. No, I do not. R14-2-103 is partially addressed in the Part 32 section of my testimony but is worthy of some additional comment herein. R14-2-103 represents the Commission Rules concerning the filing requirements of a public service corporation doing business in Arizona with respect to or in support of a proposed increase in rates or charges. While Messrs. Flaherty and Shriver are correct in that R14-2-103(A)(3)(h) references use of an "end of test year" level for original cost rate base, they fail to recognize that R14-2-103(A)(2) addresses the applicability of the rules which states, in part:

> These Rules are not intended to prohibit utilities from filing additional schedules, exhibits and other documents which may be material to the rate proceeding, <u>nor are they intended to prohibit the Commission from considering</u> such schedules, exhibits or <u>other documents in making its determination</u>. [Emphasis Added]

It is difficult to envision that Commission rules which apply soley to public service corporations and provide for the filing of additional evidence for the Commission's consideration can somehow be construed as limiting the types and nature of issues the Company and other parties can present to this Commission for consideration. Obviously, the Staff has not engaged in "cherry picking" or proposed "unilateral changes in the rules" as suggested by Mr. Shriver; rather, the

Staff has provided the Commission with a sound alternative to the rate base inclusion of Short-Term TPUC should the Commission elect to not continue the rate base treatment which was the subject of stipulation and compromise in Decision No. 53040. Furthermore, if the Commission determines that Short-Term TPUC should remain in rate base, Staff's proposed average balance eliminates the test year-end aberrational level proposed by Company which is addressed in my direct testimony (see pages 13-15).

Q. On page 39, Mr. Shriver states that "...current customers do receive a current benefit from TPUC." Are current customers receiving a current benefit from Short-Term TPUC?

A. Short-term TPUC represents plant that is under construction but not yet completed and ready for service. While today's customers (i.e., customers receiving service in 1989) are likely receiving the benefits of the 1987 test year Short-Term TPUC, the "current customers" associated with the 1987 test year in this proceeding were not receiving benefit of the Short-Term TPUC allowance the Company proposed be included in rate base. Since the 1987 test year does not reflect any 1988 customer growth or the efficiencies or other benefits attributable to the post-test year "in service" nature of this Short-Term TPUC, the inclusion of Short-Term TPUC in rate base would distort the balance of the test year revenue requirement elements. Further, the 1987 test year rate base already contains a year end valuation of plant in service thereby

Q. At page 52, Mr. Shriver agrees that the FCC has not pre-empted the states, notes this Commission's historical adoption of the FCC USOA and concludes that a change in some of the rules should not cause the imposition of additional record keeping on the industry solely because the distribution of costs between the capital and expense has changed. Do you have any comments on that portion of his testimony?

A. Yes. I believe that the fact this Commission has historically adopted the FCC USOA for ratemaking purposes is of limited value in the instant proceeding. It is a fact that certain of the changes to Part 32 create large additional revenue requirements. This fact makes it incumbent on the Commission to consider whether this revenue requirement adder should be implemented for Arizona Intrastate ratemaking purposes. It is this Commission which should decide whether general overheads should be capitalized or expensed, not the FCC or the Company.

Q. On page 44 of his rebuttal testimony, Mr. Shriver alleges that Staff's proposed capitalization of general overheads and pay-as-you-go ratemaking treatment for compensated absences violate the rules of this Commission. Do you agree with that allegation?

A. No. In support of his position, Mr. Shriver cites the following ACC rules: R14-2-510(G)(2), R14-2-510(I)(1), and R14-2-103(A)(3)(a).

Essentially, Mr. Shriver argues that since the Commission Rules require the Company to maintain its books and records in conformity with the FCC USOA and the filing requirements make reference to the accounting methods prescribed by the Commission, then the Commission cannot deviate from the accounting required under the FCC's USOA unless the Company files a verified application seeking a variance or exemption from the Commission Rules. While Staff does not believe that these rules, in any form, restrict or limit the evidence this Commission may consider or findings which may be held from such evidence, I will nevertheless address each alleged rule violation raised by Mr. Shriver and demonstrate how Staff's adjustments do not violate such rules.

Q. Does Mr. Flaherty also reference these Commission rules?

A. Yes. Mr. Flaherty specifically addresses Rule R14-2-510(G)(2) and generally references the Commission's rules regarding the USOA on pages 80 and 84, respectively.

Q. Would you please address each of these rules and explain why the Staff adjustments are not in violation?

A. First, R14-2-510(G)(2) reads as follows: "Each utility shall maintain its books and records in conformity with the Uniform Systems of Accounts for Class A....Telephone Utilities as adopted and amended by the Federal Communications Commission..."

While this Rule does cite the FCC USOA, Mr. Shriver proposes that this Commission blindly accept that language as limiting its ratemaking authority and fails to discuss specific conditions within FCC Part 32 which allow for the recording of jurisdictional differences between the FCC and the State jurisdictions (i.e., Section 32.1500 Other Jurisdictional Assets-Net; Section 32.4370, Other Jurisdictional Liabilities and Deferred Credits-Net; Section 32.7910, Income Effect of Jurisdictional Ratemaking Differences-Net). It is unbelievable that Mr. Shriver argues that this Commission's rules forbid it to vary, for ratemaking purposes, from the FCC USOA on this issue when the FCC USOA itself contains explicit accounting provisions for jurisdictional ratemaking differences.

The obvious question is, "How can the Commission violate its own rules by requiring the Company to capitalize general overheads contrary to Part 32 when Part 32 contains specific provisions to account for this type of jurisdictional difference?" Mr. Shriver has selectively ignored this fact in constructing a circular argument which is without merit.

Second, R14-2-510(I)(1) reads as follows: "Variations or exemptions from the terms and requirements of any of the Rules included herein (Title 14, Chapter 2, Article 5) shall be considered upon the verified application of an affected party to the Commission setting forth the circumstances whereby the

Public's interest requires such variation or exemption from the Commission Rules and Regulations. Such application shall be subject to the review of the Commission, and any variation or exemption granted shall require an order of the Commission. In case of conflict between these Rules and Regulations in an approved tariff or order of the Commission, the provision of the tariff or order shall apply." [Emphasis Added].

In his rebuttal testimony, Mr. Shriver states that "...USWC must file a verified application..." thereby implying that only the Company can request variations or exemptions from specific Commission Rules. While the Staff does not agree with the Company that this Rule somehow limits the Commission's discretionary authority in considering evidence during a rate proceeding, the Rule refers to "an affected party" not solely to regulated utility companies. Therefore, if one were to accept that a verified application is required, the Staff could file such a request addressing why a particular adjustment is necessary and should be granted (i.e., Staff direct testimony) and the Commission could grant the requested variance by issuing the required order (i.e., the final order resulting from this proceeding). This argument of the Company should similarly be dismissed.

Third, R14-2-103(A)(3)(a) defines accounting method in the context of the Commission's filing requirements as: "...the accounting method prescribed or recognized by the Commission."

The Company attempts to construe this section as requiring the Commission to establish utility rates on an accounting method based solely on the FCC USOA. This argument is not only fraught with the problems previously addressed, but the Company would also propose that this Section be considered totally out of context.

According to R14-2-103(A)(1) the purpose of this general order was to define the specific financial and statistical information to accompany a request of a public service corporation under Commission jurisdiction for increased rates or charges. R14-2-103(A)(2) also states that "...[t]hese rules are not intended to prohibit utilities from filing additional schedules, exhibits and other documents which may be material to the rate proceeding, nor are they intended to prohibit the Commission from considering such schedules, exhibits or other documents in making its determination..."

In addition to arguing that this Rule should be extended beyond the public service corporations to whom it is directed and incorporate the ACC Staff and, presumably, all other intervenors, the Company would further restrict the Staff from filing the "....other documents which may be material to the rate proceeding..." thereby not allowing the Commission to consider accounting methods or approaches at variance with those adopted by the FCC. Again, the Company's position is without merit and should be dismissed in its entirety.

Arizona
Docket No. T-1051B-99-105
UTI 13-021

INTERVENOR: Arizona Corporation Commission Staff (Utilitech)

REQUEST NO: 021

Please describe the Company's implementation of recently enacted accounting changes regarding the capitalization of computer software costs, indicating the following:

a. Anticipated income statement impacts in 1999 on USWC.

b. The Arizona intrastate share of item (a), with and without FCC nonregulated costs.

c. Test period pro-forma adjustment required to reflect the accounting change.

d. USWC's position regarding whether the change should be reflected inn revenue requirements and the reasons for same.

RESPONSE:

a. The capitalization of software costs is being reflected on USWC's financial books of accounts. It is anticipated that between $340M and $390M will be capitalized and $36M will be amortized in 1999. The capitalization of software will not be included on regulatory books of accounts unless the accounting rules are approved by regulatory commissions.

b. See the response to (a).

c. There is no pro-forma adjustment for this accounting change. See also the response to item (a).

d. The Company has not petitioned the Arizona Corporation Commission to adopt the software capitalization accounting. Since the life for the capitalized software is very short, the effect of this accounting on ratemaking is to produce a first year dip in revenue requirements followed by a near term turnaround of revenue requirements and over time, higher revenue requirements. Furthermore, the change from expensing of software to capitalization is not cash affecting, while the ratemaking effect would be cash affecting. Given both the short-term revenue requirement profile and the fact that software capitalization is not cash affecting the Company does not intend to petition the Arizona Corporation Commission to adopt this accounting.

George Redding
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Arizona
Docket No. T-1051B-99-105
UTI 15-020

INTERVENOR: Arizona Corporation Commission Staff (Utilitech)

REQUEST NO: 020

(Ref. USWC's response to UTI 13-21) Does USWC object to ACC adoption of the changes to GAAP associated with capitalization of software costs? If affirmative, please explain each and every basis for such objection and provide complete copies of all studies, analyses, workpapers and other documents (if any) associated with your response.

RESPONSE:

The Company's position is that the ACC should not adopt the change for ratemaking purposes for the reasons set forth in the response to UTI13-21, part d. Attachment A is an example of the total Company revenue requirement impact of the software capitalization showing the rapid change in that impact.

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**US WEST Communications**
An SOP 98-1Example - Assuming 5-year amortization
(dollars in millions)

**ASSUMPTIONS:**
**$360M ANNUAL SHIFT FROM EXPENSE TO CAPITAL BASED ON 1999 ESTIMATE**
**5-YEAR AMORTIZATION PERIOD**

| Ln | | YR 1 | YR 2 | YR 3 | YR 4 | YR 5 | YR 6 | YR 7 | YR 8 | YR 9 | YR 10 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | Current Software Expense to be Capitalized | 360 | 360 | 360 | 360 | 360 | 360 | 360 | 360 | 360 | 360 |
| 2 | **Intangible Asset (BOP)** | | | | | | | | | | |
| 3 | Adds | - | 360 | 720 | 1,080 | 1,440 | 1,440 | 1,440 | 1,440 | 1,440 | 1,440 |
| 4 | Retirements | 360 | 360 | 360 | 360 | 360 | 360 | 360 | 360 | 360 | 360 |
| 5 | Intangible Asset (EOP) | - | - | - | - | 360 | 360 | 360 | 360 | 360 | 360 |
| | | 360 | 720 | 1,080 | 1,440 | 1,440 | 1,440 | 1,440 | 1,440 | 1,440 | 1,440 |
| 6 | Accumulated Amortization (BOP) | - | 36 | 144 | 324 | 576 | 540 | 540 | 540 | 540 | 540 |
| 7 | **Amort of Asset Capitalized Yr** | | | | | | | | | | |
| 8 | 1 | 36 | 72 | 72 | 72 | 72 | 36 | | | | |
| 9 | 2 | | 36 | 72 | 72 | 72 | 72 | 36 | | | |
| 10 | 3 | | | 36 | 72 | 72 | 72 | 72 | 36 | | |
| 11 | 4 | | | | 36 | 72 | 72 | 72 | 72 | 36 | |
| 12 | 5 | | | | | 36 | 72 | 72 | 72 | 72 | 36 |
| 13 | 6 | | | | | | 36 | 72 | 72 | 72 | 72 |
| 14 | 7 | | | | | | | 36 | 72 | 72 | 72 |
| 15 | 8 | | | | | | | | 36 | 72 | 72 |
| 16 | 9 | | | | | | | | | 36 | 72 |
| 17 | 10 | | | | | | | | | | 36 |
| | Total Amort for the year (cum Ln 7-26) | 36 | 108 | 180 | 252 | 324 | 360 | 360 | 360 | 360 | 360 |
| 18 | Less Retirements (Ln 4) | - | - | - | - | 360 | 360 | 360 | 360 | 360 | 360 |
| 19 | Accumulated Amortization (EOP) | 36 | 144 | 324 | 576 | 540 | 540 | 540 | 540 | 540 | 540 |
| 20 | Deferred Taxes (BOP) | - | 126 | 223 | 293 | 335 | 349 | 349 | 349 | 349 | 349 |
| 21 | Adds (38.8% of Ln 3) | 140 | 140 | 140 | 140 | 140 | 140 | 140 | 140 | 140 | 140 |
| 22 | Turnaround (38.8% of Ln 17) | 14 | 42 | 70 | 98 | 126 | 140 | 140 | 140 | 140 | 140 |
| 23 | Deferred Taxes (EOP) (L20+21-22) | 126 | 223 | 293 | 335 | 349 | 349 | 349 | 349 | 349 | 349 |
| 24 | Rate Base (BOP) (Ln2 - Ln6 - Ln20) | - | 198 | 353 | 463 | 529 | 551 | 551 | 551 | 551 | 551 |
| 25 | Rate Base (EOP) (Ln5 - Ln19 - Ln23) | 198 | 353 | 463 | 529 | 551 | 551 | 551 | 551 | 551 | 551 |
| 26 | Average Rate Base (Ln24+Ln25)/2 | 99 | 275 | 408 | 496 | 540 | 551 | 551 | 551 | 551 | 551 |
| 27 | Average Rate Base (Ln26 above) | 99 | 275 | 408 | 496 | 540 | 551 | 551 | 551 | 551 | 551 |
| 28 | Average Authorized NOI Return at 10% | 10 | 28 | 41 | 50 | 54 | 55 | 55 | 55 | 55 | 55 |
| | NOI Effect of Income Statement Changes | | | | | | | | | | |
| 29 | (-(-Ln1+Ln17)*(1-38.8%)) | 198 | 154 | 110 | 66 | 22 | - | - | - | - | - |
| 30 | NOI Effect of SOP 98-1 (Ln28 - Ln29) | (188) | (127) | (69) | (17) | 32 | 55 | 55 | 55 | 55 | 55 |
| 31 | Estimated Revenue Effect (Ln30 * 1.65 gross-up) | (311) | (209) | (115) | (27) | 53 | 91 | 91 | 91 | 91 | 91 |
| 32 | Estimated Intrastate Revenue Effect (Ln31 * 75%) | (233) | (157) | (86) | (20) | 40 | 68 | 68 | 68 | 68 | 68 |

Arizona
Docket No. T-1051B-99-105
UTI 20-012

INTERVENOR: Arizona Corporation Commission Staff (Utilitech)

REQUEST NO: 012

Ref. USWC response to UTI 13-21 (Software Capitalization). The referenced response indicates, in part, that USWC has not petitioned the ACC to adopt the software capitalization accounting because "the life for the capitalized software is very short" and "the change from expensing of software to capitalization is not cash affecting". Please provide the following:

a. Please confirm that the phrase "not cash affecting" is intended to mean that the change in accounting method would not result in any change in the amount or timing of USWC's cash payments to fund software development and modification efforts, excluding the year-to-year revenue requirement effect of adoption of the capitalization method. If this can not be confirmed, please explain and define the intended use of this phrase.

b. Please identify and describe which of the following changes in accounting method are similarly "not cash affecting "to USWC, excluding the year-to-year revenue requirement effect of each change:

i. Capital to expense shifts resulting from the adoption of Part 32.

ii Adoption of the accrual accounting method for compensated absences.

iii. Adoption of the accrual accounting method for merit awards.

iv. Adoption of the accrual accounting method for medical and dental expenses.

v. Adoption of the increase in the capitalization rules for assets whose initial value was between $200 and $500.

vi. Adoption of the increase in the capitalization rules for assets whose initial value was between $500 and $2,000.

vii. Adoption of the accrual accounting method for pension costs (FAS87).

viii. Adoption of the accrual accounting method for OPEBs (FAS106).

ix. Adoption of revisions to depreciation accrual rates

x. Adoption of reserve deficiency amortizations.

c. For each change in accounting method that the response to item (b) above indicates is or was "cash affecting", please provide a detailed explanation supporting the Company's position.

RESPONSE:

a. The statement is confirmed.

b. Absent the revenue requirement impact, all of the items listed, except vii. and viii., are non-cash affecting. Item vii. (pensions) and viii (OPEB) are cash affecting to the extent regulators impose requirements to fund pensions and/or VEBA trusts as a condition of expense recognition. However, all of the items shown in this sub-part except viii (OPEB) are currently cash affecting in Arizona because they have previously been treated in the calculation of USWC's Arizona revenue requirement. Arizona has not adopted accrual accounting under SFAS 106 for OPEBs for USWC.

c. See response to b.

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Arizona
Docket No. T-1051B-99-105
UTI 20-013

INTERVENOR: Arizona Corporation Commission Staff (Utilitech)

REQUEST NO: 013

Ref. USWC CONFIDENTIAL response to UTI 13-21 (Software Capitalization). As a result of not petitioning the ACC to adopt the software capitalization accounting, does USWC intend to set up and maintain separate Offbook records to track the resulting differences between GAAP financial reporting and Arizona regulatory accounting methods? Please explain.

RESPONSE:

Yes. USWC would prepare Offbook adjustments to reverse the intrastate portion of the software capitalization and amortization entries.

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Arizona
Docket No. T-1051B-99-105
UTI 30-015

INTERVENOR: Arizona Corporation Commission Staff (Utilitech)

REQUEST NO: 015

Ref. USWC response to UTI 20-15 (Software Capitalization). Please provide a detailed discussion explaining why USWC "...did not take issue with the use of SOP 98-1 to satisfy external reporting requirements".

RESPONSE:

U S WEST did not take issue with the use of SOP 98-1 to satisfy external reporting requirements as U S WEST supported the primary goal of the SOP, namely to standardize external financial reporting. Prior to the SOP, there was divergence in how various companies treated internally developed software for financial reporting purposes.

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Arizona
Docket No. T-1051B-99-105
UTI 34-004

INTERVENOR: Arizona Corporation Commission Staff (Utilitech)

REQUEST NO: 004

Ref. USWC Confidential response to UTI 15-19 (Software Capitalization). Please provide the actual amount of software costs USWC has actually capitalized, pursuant to SOP 98-1, in Arizona by month thus far in 1999.

RESPONSE:

As stated in the response to UTI 13-21, USWC has not yet adopted SOP 98-1 on its regulatory books of account, therefore there have been no software costs capitalized in Arizona.

Bill Muir
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Seattle, WA

Arizona
Docket No. T-1051B-99-105
UTI 61-010

INTERVENOR: Arizona Corporation Commission Staff (Utilitech)

REQUEST NO: 010

Re: USWC confidential response to UTI 58-20 (Depreciation Expense). In reconciling the MR16-MR2A plant balance at 12/31/99 with the depreciable investment underlying the Company's proforma depreciation adjustment, Confidential Attachment B shows certain amounts being added in a column headed "Netwrk Software Write-Off." Please provide the following:

a. Please explain and describe what "Netwrk Software Write-Off" represents.

b. Please describe the book accounting for "Netwrk Software Write-Off."

c. Why does the Company believe that it was necessary for the "Netwrk Software Write-Off" to be added back in order to determine the appropriate level of year-end depreciable investment for intrastate regulatory purposes? Please explain.

d. Does the Company account for this "Netwrk Software Write-Off" through any off-book records? Please explain.

RESPONSE:

a. SOP 98-1 requires that "*the provisions of this SOP concerning amortization and impairment should be applied to any unamortized costs capitalized prior to initial application of this SOP that continue to be reported as assets after the effective date*". Because of this requirement, Qwest (formerly U S WEST) was required to write down the net book value of Network Operating System which had been capitalized prior to the adoption of SOP 98-1 to its realizable value.

b. The book accounting for the write off was a credit to Accumulated Depreciation (account 3122) and a debit to Depreciation Expense (account 6561). However, in addition, the software investment was also retired in error. This entry was a credit to Property, Plant and Equipment (accounts 2211, 2212, 2220, 2231 and 2232) and a debit to Accumulated Depreciation (account 3122). It was this retirement entry that was documented in UTI 58-020, Confidential Attachment B.

c. Since the retirement described in part (b) above was processed in error (and was subsequently reversed in June 2000 business), the book investment was understated in December and it was appropriate to add the amounts back in

to determine the appropriate end of year depreciable investment.

d. Yes. Since the Arizona Commission has not authorized the adoption of SOP 98-1, all entries associated with the SOP's adoption are reversed on an intrastate basis.

Bill Muir
Technical Accountant
1600 7th Avenue
Seattle, WA

**BEFORE THE ARIZONA CORPORATION COMMISSION**

| | | |
|---|---|---|
| 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 |

# SURREBUTTAL TESTIMONY

**OF**

**MICHAEL L. BROSCH**

**ON BEHALF OF THE STAFF OF THE ARIZONA CORPORATION COMMISSION**

**PUBLIC VERSION**

**JANUARY 12, 2005**

Q. Please state your name and business address.

A. My name is Michael L. Brosch. My business address is 740 North Blue Parkway, Suite 204, Lee's Summit, Missouri 64086.

Q. By whom are you employed?

A. I am a principal in the firm Utilitech, Inc., a consulting firm engaged primarily in utility rate and regulation work. The firm's business and my responsibilities are related to special services work for utility regulatory clients. These services include rate case reviews, cost of service analyses, jurisdictional and class cost allocations, financial studies, rate design analyses and focused investigations related to utility operations and ratemaking issues.

Q. On whose behalf are you appearing in this proceeding?

A. I am appearing on behalf of the Arizona Corporation Commission Utilities Division Staff ("Staff").

Q. Are you the same Michael L. Brosch who previously submitted Direct Testimony in this Docket?

A. Yes.

Q. What is the purpose of your Surrebuttal testimony?

A. My Surrebuttal Testimony is responsive to the Rebuttal Testimony of Qwest witness Mr. Philip E. Grate on the broad topics of Qwest's Financial Performance, Ratemaking Methods, Disallowance Standards and future Regulatory Reporting Requirements. I also respond to Mr. Grate's specific arguments with respect to Staff's revenue annualization adjustments C-3, C-4 and C-5, Staff's Marketing and Advertising adjustment C-9 and the regulatory treatment of Fair Value Rate Base (Staff Schedule A and A-2). Messr's Carver and Dunkel will respond to other revenue requirement issues addressed in Mr. Grate's Rebuttal Testimony.

## QWEST'S FINANCIAL PERFORMANCE

Q. In your Direct Testimony, you explained your view that Qwest's financial performance in Arizona will continue to support the Company's access to capital markets on reasonable terms. How does Mr. Grate characterize Qwest's financial performance in Arizona?

A. Mr. Grate states that "Qwest's financial performance in Arizona is declining. Specifically Qwest's revenues are declining more rapidly than its expenses."[1] At pages 2 through 5 of his rebuttal, Mr. Grate displays graphs showing downward trends in Arizona retail access line counts and Arizona Intrastate Operating Revenues, in contrast to more volatile Arizona Intrastate Operating Expenses that are not trending downward significantly. From this data, Mr. Grate concludes that, "A decline in revenues does not produce a corresponding decline in expenses"[2]

Q. Has Mr. Grate provided a complete view of Qwest's financial performance in Arizona?

A. No. Revenue and expense trends are important indicators of financial health, but other factors also merit consideration. Mr. Grate has omitted any graph of the very favorable trends being experienced by the Company with respect to declining Arizona rate base investment. Moreover, the single largest expense line item within Mr. Grate's Total Operating Expense Graph is Depreciation and Amortization Expense, which is declining considerably on a pro-forma basis, but is shown as a constant in his graph of historical data.

As I noted in my Direct Testimony, another primary indicator of financial health in terms of access to capital markets is the consistent generation of cash flows sufficient to cover fixed charges. The Arizona Intrastate operations of Qwest Corporation produce sufficient cash flows to fully service the allocated interest expense reasonably attributed to Arizona and internally generated cash flow is also well in excess of annual new construction expenditures made by Qwest in Arizona.

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1 Grate Rebuttal, page 2, line 7.
2 Id, page 5, line 11.

Yet another indicator of financial performance under Price Cap Regulation is the revenue requirement that exists after several years experience under the existing Plan. Notably, Staff's calculated revenue requirement is not a large positive or negative amount, suggesting that the Company's adjusted earnings in Arizona are sufficient relative to its estimated cost of capital. A key driver of this result is the significant reduction in the rate at which capital assets are being consumed in Arizona, as evidenced by reduced depreciation accrual rates being advocated by both Qwest and Staff's witness.

Q. Please explain how Mr. Grate's Rebuttal graphs of access lines, revenues and expenses ignore another important trend that indicates improving financial performance?

A. Mr. Grate testifies at page 3 that, "Qwest has invested $6.8 billion in its Arizona network in order to be ready to provide high quality retail and wholesale telecommunications services on demand to whomever requests it." However, what Mr. Grate has neglected to disclose is the fact that Qwest has recently been experiencing declining net investment in Arizona because it is collecting depreciation more rapidly than it is investing in new plant. This trend is quite significant and can be observed in Qwest's Schedule E-5 within its R14-2-103 filing at line 44, which shows that Arizona Net Plant in Service on an Intrastate basis declined by $257 million in a single year 2003, which is a decline of more than 12 percent in the amount of Qwest telecommunications plant actually invested during that year.[3] As Qwest's net investment in Intrastate Plant (gross plant less accumulated depreciation) trends downward, the required return on rate base is reduced because the Company has less unrecovered capital investment in Arizona that must earn a return. Mr. Grate's graphs and conclusions are incomplete in showing high operating expense levels that include large depreciation accruals, while ignoring how those same high depreciation accruals are causing Arizona Intrastate rate base to decline significantly with each passing year.

3 Qwest Schedule E-5 indicates Intrastate Net Plant in Service of $2,097,73,000 at 12/31/2002,

Q. Is there also an omission in the "Arizona Retail Access Lines" graph appearing at page 3 of Mr. Grate's rebuttal?

A. The confidential graph appears to depict the shift from historically growing access line counts toward declining retail line counts starting in 2001. However, the scaling of the graph tends to visually amplify the apparent trend. Rather than an apparent massive loss of lines, the actual percentage decline is more accurately stated as the confidential figure set forth at Mr. Grate's page 2, line 12. More substantively, the complete omission of wholesale access line counts from the graph obscures the fact that Qwest is collecting considerable new and growing revenues by serving many of its departing retail customers on a wholesale basis. Qwest wholesale access lines have increased by more than [redacted] lines since early 2001, offsetting some of the retail access line declines recognized in Mr. Grate's graph. [4]

## DISALLOWANCE STANDARDS

Q. At page 63 of his Rebuttal, Mr. Grate notes that almost 20 pages of his Direct Testimony were directed toward what he calls the Commission's "Disallowance Standards", and then he states, "In my opinion, some of the standards that have been employed in prior Arizona rate cases provide inadequate protection to investors under current circumstances. The disallowances that are the subject of this portion of my testimony represent ratemaking standards that provide investors inadequate protection." Do you believe the Commission must predetermine any specific "disallowance standards" so as to better protect investor interests?

A. No. I am advised by Counsel that the Commission is required to consider and weigh all relevant evidence before determining whether any specific utility-incurred costs are properly included in ratemaking proceedings. In my experience, this process does not require and is not conducive to the application of any rigid, formulistic standards or criteria, but instead relies upon specific facts and circumstances associated with a

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declining to $1,840,369 by 12/31/2003.

4 Confidential Response to Data Request UTI 11-7, Attachment A, comparing January 2001 through August 2004 data.

particular type of cost. Whenever a party challenges a particular utility expenditure, the utility is typically called upon to explain and defend the expenditure. In this proceeding, Qwest has the opportunity in its Rebuttal and through participation in the hearings to fully respond to each cost disallowance that has been proposed.

Q. According to Mr. Grate, "Arizona's ratemaking rules provide that all investments shall be presumed to have been prudently made, and such presumption may be set aside only by clear and convincing evidence that such investments were imprudent, when viewed in the light of all relevant conditions known or which in the exercise of reasonable judgment should have been known, at the time such investments were made." What is the significance of this statement by Mr. Grate and his related footnote reference to Arizona Administrative Code R14-2-103 A. 3. l.?

A. Mr. Grate appears to be applying definitions within the Commission's Rules <u>that apply to Rate Base Investments</u> with issues in the pending Docket involving ratemaking recovery of <u>operating expenses</u>, such as disputed advertising and incentive compensation expenses. The only place within Commission Rules where one can find the regulatory criteria Mr. Grate relies upon relate solely to what can be included in "Original cost rate base". Specifically, the language he quotes and the citation he provides in his Rebuttal footnote 42 points into the "Definitions" associated with the minimum filing requirements set forth in R 14-2-103 that state the following:

> h. "Original cost rate base" -- An amount consisting of the depreciated original cost, prudently invested, of the property (exclusive of contributions and/or advances in aid of construction) at the end of the test year, used or useful, plus a proper allowance for working capital and including all applicable pro forma adjustments.
>
> l. "Prudently invested" -- Investments which under ordinary circumstances would be deemed reasonable and not dishonest or obviously wasteful. All investments shall be presumed to have been prudently made, and such presumptions may be set aside only by clear and convincing evidence that

> such investments were imprudent, when viewed in the light of all relevant conditions known or which in the exercise of reasonable judgment should have been known, at the time such investments were made.[5]

In contrast, operating expense items such as advertising, lobbying, corporate contributions and incentive compensation are not "investments" and such operating expenses have no presumption of reasonableness under Commission rules. No rate recovery criteria are set forth in Commission rules with respect to operating expenses.

Q. Is there any meaningful difference between the terms "investments" and "expenses" with regard to how one might reasonably interpret the Commission's Rules?

A. Yes. These accounting terms each have distinct meanings. "Investments" represent a specific type of expenditure that is capitalized as an asset on the books, for example as Plant in Service, that can then be included in rate base and depreciated over a defined useful life. If an expenditure is made (or a cost incurred) that does not produce a lasting benefit eligible for capitalization as part of Plant in Service or some other asset, that expenditure/cost is treated as an expense that is charged to income. The operating expense disallowance criteria Mr. Grate is trying to divine from Commission Rules simply does not exist, because the Rules pertain solely to how "investments" are to be evaluated for purposes of inclusion or exclusion in determining rate base.

Q. At page 64 of his Rebuttal, Mr. Grate complains that, "Staff's consultants, Utilitech, regularly advocate that discretionary expenditures be disallowed because they provide no direct tangible benefit to ratepayers. I find this disturbing because disallowances based on the tangible ratepayer benefit standard cannot yield just rates." Is "direct tangible benefit to ratepayers" the sole criteria used by Utilitech to determine which operating expenses should be allowed or disallowed?

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5 http://www.azsos.gov/public_services/Title_14/14-02.htm

A. No. Utilitech analyzes utility expenses for disallowance in many different ways, with attention given to whether the expense item in question is required to provide regulated services or can instead be viewed as discretionary, whether the Company can produce evidence of economic justification for the amounts expended, whether the expenses have been found objectionable by the regulator in previous proceedings and whether the expense produces any tangible benefits to the Company and its customers. In other words, I agree with Mr. Grate when he states that "whether a cost is reasonable must be viewed in light of the relevant facts and circumstances" (Grate Rebuttal at page 81, lines 8-9). Indeed, at pages 12 and 13 of my direct testimony, I list no fewer than six reasons why corporate image advertising should be disallowed in this Docket, in addition to the fact that the Commission has previously found such costs to be objectionable for ratemaking inclusion.

Q. At page 66 of his Rebuttal, Mr. Grate seeks to illustrate the problem that would arise from dependence upon a "tangible, direct benefit" criteria for ratemaking disallowances by stating, "A wide and abundant variety of prudent, reasonable and necessary costs incurred at the discretion of management in the operation of a regulated entity may provide no direct, tangible benefit to ratepayers. Some examples include employees' paid vacations and sick leave, employees' healthcare benefits and retirement savings plan benefits, employees' post employment benefits, and employee training expenses. Other expenses that may provide no direct tangible ratepayer benefit include the cost of compliance with immigration laws, environmental laws, safety laws, and workers' compensation laws and the costs of operating the Company's accounts receivable department, accounts payable department, customer billing department, customer credit department, legal department, tax department, human resources department, risk management department and real estate department." Has Staff sought to disallow any of these costs in this proceeding?

A. No. Staff's proposed disallowances are limited to areas where regulators often find problems with rate case recovery – such as corporate image advertising, legislative

affairs and incentive compensation. The employee benefits and various department costs listed by Mr. Grate are representative of costs that do provide tangible, direct benefits to the Company and its ratepayers and are not discretionary to the same extent as the corporate image advertising, legislative affairs and incentive compensation costs that are being challenged by Staff.

Q. At pages 65-66 of his Rebuttal, Mr. Grate states, "There is no administrative rule of this Commission and no published judicial opinion in Arizona that imposes a presumption that discretionary costs are to be disallowed unless a utility overcomes a burden of proof to show why they should not be. Instead, the Commission's rules articulate a ratemaking principle that presumes costs are reasonable and not dishonest or obviously wasteful. Except in very limited circumstances—such as fines and penalties—the burden must fall to those parties and their representatives who would disallow a cost to provide clear and convincing evidence in support of the disallowance." How do you respond?

A. It is true that Staff is not relying upon any administrative rule or judicial opinion in support of its proposed treatment of corporate image advertising or incentive compensation and a review of Staff testimony on these issues reveals no citation to any Rule or Opinion. On the other hand, there is no Commission rule as Mr. Grate suggests that would "presume costs are reasonable" or that would impose a "clear and convincing evidence" standard upon Staff in support of proposed disallowances. In the instant case, Staff has applied ACC precedent as well as the other criteria described in its Direct Testimony to certain costs and challenged Qwest to justify the rate case inclusion of such costs. Qwest then has the opportunity and responsibility to respond to this challenge in its Rebuttal, in hearings and in briefing to support the reasonableness of rate case recovery of such costs.

Q. At page 67 of his Rebuttal, Mr. Grate states, "Utilities, like commercial businesses in general, make substantial discretionary expenditures that provide their customers no direct tangible benefit. Consequently, Utilitech must select only a handful of these

kinds of expenditures and build a case against them based on policy arguments, not on a comparison to commercial business standards." Has Qwest, in its own revenue requirement filing, excluded certain discretionary costs based on policy rather than "commercial business standards"?

A. Yes. I find it remarkably inconsistent that Mr. Grate argues that any cost Qwest chooses to incur as a commercial business expense should be presumed reasonable for ratemaking purposes at the same time the Company has elected to not seek recovery of certain types of costs it must view as difficult to defend before regulators. For example, Qwest has elected to exclude discretionary test year corporate contributions and corporate sponsorship of athletic venues within its own ratemaking adjustments PFR-07 and PFN-16.[6]

To the extent Qwest sponsors a traditional revenue requirement case for consideration in this Docket, it is my opinion that the revenue requirement should be prepared using established Commission regulatory policies or that the Company bear a burden of proof to justify any proposed departure from such policies.[7]

## CORPORATE "IMAGE" ADVERTISING

Q. At page 79 of his Rebuttal, Mr. Grate states his disagreement with your assertion in Direct Testimony that Qwest's test year image advertising expenses have increased in an apparent effort to enhance Qwest's reputation, credibility and image after experiencing widely publicized financial difficulties, accounting investigations and senior management turnover. Did you draw this conclusion on your own, or did Qwest's own documents support this view?

A. This point about corporate image remediation was one of six reasons I cited in support of the Commission's policy to exclude corporate image advertising. On this point, I relied upon several of Qwest's own documents that were quoted in my Direct Testimony in passages on pages 16 and 17 that were classified by Qwest as "highly confidential" and "confidential". Copies of the Qwest marketing documents supporting this conclusion about customer perceptions of Qwest are included in

6 Rebuttal Exhibits of Philip Grate, Exhibit PEG-R5, page 4 of 6.
7 Confidential Response to Data Request UTI 11-7, Attachment A, comparing January 2001 through

Attachment MLB-4 and Attachment MLB-5 to my Direct Testimony. Instead of responding to the substance of this concern, Mr. Grate quarrels with the way I display Arizona Advertising Costs by Category in the table at page 11 of my testimony and he claims my conclusion about increased image advertising in the test year is "misleading".

Q. Is the comparative cost table on page 11 of your Direct Testimony "misleading", as claimed by Mr. Grate?

A. No. That table shows on the first two lines the amounts of recorded advertising in the two relevant FCC Accounts, while at lines 12 through 18 my testimony explains the accounting error that caused a mis-classification of advertising that is actually "Corporate Brand Advertising". Even after correction, Corporate Brand Advertising is much larger in the 2003 test year than in 2002, as Qwest's financial difficulties, accounting investigations and senior management turnover started to be widely publicized. Brand Advertising expenses are also slightly higher in 2003 than the average expense levels for 2000 through 2002. I noted at page 12 of my Direct Testimony that, "Qwest has indicated that corporate advertising allocated from Qwest Services Corporation to QC and recorded as corporate brand advertising is actually mis-classified on the books, because much of this activity and cost should actually be considered product advertising" and that, "Staff has accepted this management representation in quantifying the proposed adjustment, even though this result is inconsistent with recorded information."

Q. Is there an error in the Table set forth on page 11 of your Direct Testimony?

A. Yes. In reviewing the Table for this testimony, it became obvious that a formula error caused year 2001 and 2002 cost information to be overstated. A corrected Table is set forth below:

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August 2004 data.

Arizona Advertising Costs by Category ($000)

| | 2000 | 2001 | 2002 | 2003TY |
|---|---|---|---|---|
| Product Advertising | [redacted] | [redacted] | [redacted] | [redacted] |
| Corporate Brand Advertising | [redacted] | [redacted] | [redacted] | [redacted] |
| Total Advertising - AZ Share | [redacted] | [redacted] | [redacted] | [redacted] |
| Less: Disallowed Brand Advertising | [redacted] | [redacted] | [redacted] | [redacted] |
| Allowable Advertising | [redacted] | [redacted] | [redacted] | [redacted] |

However, after correction, it is still obvious that both recorded and adjusted Brand Advertising amounts were larger in 2003 relative to 2002 and that a reasonable overall level of "Allowable Advertising" results after implementation of Staff's proposed adjustment.

Q. At page 82 of his Rebuttal, Mr. Grate challenges your qualifications to evaluate advertising costs for ratemaking purposes and then states, "...it is well known in the advertising profession that image advertising promotes and improves overall product awareness within an enterprise's customer base." Is this new information that justifies rate case recovery of corporate brand or image advertising?

A. No. It has always been true that increased corporate brand awareness is considered supportive of product advertising, but that does not mean that costs incurred to promote a favorable public image, rather than promoting specific regulated telephone products and services, should be fully recoverable. As I noted in my Direct Testimony at page 8, the Company eliminated corporate image advertising in its filing in the 1993 rate case when it could also be said that image advertising promotes and improves overall product awareness – this is not new information that should change the Commission's regulatory policies.

Q. In the Company's 1999 rate case filing and again in this Docket, it is argued that increased competition now justifies modification of Commission policy regarding

corporate image advertising. In fact, Mr. Grate states at page 83, "Good service at reasonable prices is not enough in competitive markets. As, Ms. Nielander's affidavit explains, Qwest must maintain a visible brand/image presence to combat the competitive marketplace. This is accomplished through a combination of brand and image advertising." How do you respond?

A. As I explained in testimony, there has always been a degree of competition facing many of Qwest's regulated products and services and Staff has always been supportive of rate recovery for product specific advertising to promote regulated services. The declines in line counts and regulated revenues Mr. Grate emphasizes in his Rebuttal, at pages 2 through 6, suggest that Qwest's product and image advertising efforts and costs have been relatively ineffective at increasing or even sustaining sales of intrastate regulated products and services. Rate recovery of Qwest's product specific advertising costs under these circumstances is questionable, yet Staff has challenged only the corporate image advertising that cannot be directly related to regulated ILEC products and services.

Q. In your Direct Testimony, you state that Staff attempted to evaluate Qwest advertising in detail, to understand how costs were attributed among Qwest affiliates, but that useful information from Qwest was not readily available. Has the Company or Mr. Grate offered any studies of corporate image advertising effectiveness or analyses of costs by advertising campaign or ad message that represents economic justification for charging ratepayers for such costs?

A. No. Mr. Grate instead suggests that Staff has the burden of proof when applying long-standing Commission policies to disallow image advertising. He states at page 85, "Staff has not offered substantial evidence or expert opinion to show that Qwest's test year image advertising expenditures were commercially unreasonable or wasteful or imprudent." To my knowledge, these standards of review that Mr. Grate would apply have not been approved by the Commission in any proceeding or Rule that I am aware of. More importantly, Mr. Grate has offered no evidence or proof of cost-

effectiveness or reasonableness for the image advertising amounts he seeks to include in revenue requirements in opposition to established ratemaking policy in this State.

## FAIR VALUE RATE BASE

Q. At page 133 of his Rebuttal, Mr. Grate states, "The Arizona Constitution as interpreted by Arizona case law provides that utilities in Arizona are permitted to earn their cost of capital on fair value rate base instead of historical cost rate base." Is a utility's "cost of capital" the same for application to either original cost or fair value rate base?

A. No. I am not an attorney and will not respond to Mr. Grate's legal argument, leaving the legal issue to be addressed in Staff's Brief. However, as a matter of regulatory finance, the required cost of capital is lower under fair value regulation. The total dollars of return required to adequately service the debt and equity capital invested in the business is the same under either approach, but the overall percentage rate of return required to generate these return dollars is quite different. The cost of capital and corresponding overall rate of return applicable to fair value rate base is lower than the cost of capital applicable to original cost rate base because the fair value rate base has been restated and factored up to account for the impact of inflation upon historical investment values. Since the nominal cost of capital is reflective of the time value of money which is driven largely by inflation, a lower cost of capital is required if one seeks to remove the inflation element from the cost rates.

Q. Please explain why the cost of capital is lower if applied to fair value rate base.

A. Cost of capital is an "opportunity cost" that is demanded by investors in return for their surrender of the opportunity to use their capital for alternative investments. This opportunity cost is made up of two components, the required "real" return and the "inflation" element of the return. The "real" return is the economic rent required to compensate for the use of the capital, including compensation for risk of loss or non-return of amounts invested. The "inflation" element is simply the recognition by investors that the purchasing power of money returned in the future will be less than the current purchasing power of that money today because of investor expectations of

continuing inflation. The inflation element of the cost of capital explains why market interest rates tend to be higher in periods of rampant inflation and lower in periods of modest inflation.

When the cost of capital is applied to original cost rate base, which Mr. Grate refers to in his Rebuttal as "Prudently Invested Historical Cost Less Accelerated Depreciation" or ("PIHCLAD"), both the real return and the inflation element must be applied because the rate base is quantified on an historical or "original" cost basis, with no accounting for inflation that tends to cause the reproduction or replacement cost of historical assets to increase above historical cost. For this reason, Staff has applied the entire observed or nominal cost of capital to original cost rate base.

When the cost of capital is applied to Fair Value rate base, the historical original cost basis of plant investment is increased to account for inflation. Because inflation is being recognized in the investment base (rate base), double counting would result if the inflation element of the cost of capital were also recognized in determining the fair rate of return applicable to fair value rate base. To eliminate this double counting problem, Staff has adjusted the fair value rate of return downward proportionately, so as to revise the nominal cost of capital in direct relationship to the inflation levels being added to rate base.

Q. Mr. Grate also states, "Mr. Brosch and Ms. Diaz Cortez both back into a return for fair value rate base by first determining what Staff and RUCO believe the company should be allowed to earn on a PIHCLAD rate base and having established that amount of revenue requirement, calculate the rate of return on a fair value rate base necessary to achieve that same revenue requirement. This neutralizes the effect of using the fair value rate base and provides Qwest its cost of capital on its PIHCLAD rate base, not its fair value rate base." How do you respond?

A. First, I would note that Qwest has improperly assumed that its nominal weighted average cost of capital is applicable directly to either original cost or to fair value rate base without adjustment. This is simply wrong, in that Qwest investors do not require additional dollars of return on investment when the Company builds new

plant in Arizona, rather than some other state where fair value is not recognized. It is also wrong because investors would be compensated twice for the inflation element of the return under Mr. Grate's approach – once through the inflation adjustment of the rate base and again through application of the inflation element of the cost of capital to that rate base.

As to the claim that Staff has "neutralized" the effect of fair value rate base, I disagree with the notion that there should be any "effect" to start with. Either method of investment valuation should yield, as an end result, an opportunity to earn a reasonable return on invested capital – no more and no less. It is not a given that utility rates are intended to be systematically higher in each of the states where fair value regulation is practiced. It is also not reasonable to expect that capital markets demand higher returns upon investments made in regulated utility assets in each of the states that practice fair value regulation, relative to other states. However, that is precisely the result one would observe under Mr. Grate's theory that the same percentage cost of capital is applicable to original cost as well as inflation-adjusted fair value rate base.

Q. What is the purpose of Attachment MLB-R1 to your Surrebuttal Testimony?

A. This Attachment is a revision to Staff Accounting Schedule A-2, so as to reflect a change to Staff's "Condition Percent" values for three Plant accounts, as shown on page 2 at lines 26, 28 and 32 in column F. The effect of this revision carries forward to Page 1 of 2 at line 4 captioned, "Staff Witness Dunkel RCND Study Adjustments" and increases Staff's proposed Fair Value Rate Base. The basis of this change is described in Mr. Dunkel's Surrebuttal Testimony.

## YEAR END ANNUALIZATION ADJUSTMENTS

Q. At page 36 of his Rebuttal testimony, Mr. Grate states, "Qwest analyzed all significant USOA revenue and expense accounts and, using a consistently applied statistical method, annualized those accounts. Where a statistically significant factor could be identified that would be a statistically reliable indicator of year end levels

Qwest calculated an adjustment tied to that indicator." Does this mean that Qwest consistently annualized each element of the income statement to coincide with the use of year-end rate base?

A. No. In fact, Mr. Grate admits on the next page that, "Qwest applied its annualization analysis methodology to every significant account including every significant operating expense account. None of its expense accounts qualified for adjustment under the methodology Qwest employed." The reality is that Qwest annualized virtually every one of the significant intrastate revenue accounts, but the Company has not annualized any of its wage or non-labor expenses at year end. It would be unreasonable to characterize the Company's filing as representing an operating income annualization at year-end, when only revenues are annualized by Mr. Grate's regression approach.

Mr. Carver has addressed this problem in his Direct Testimony and will respond to Mr. Grate's Rebuttal regarding the omitted expense annualization adjustments. My testimony on this point is limited to the revenue annualization adjustments that were made by Qwest.

Q. Is it necessary to adopt and apply a single annualization calculation methodology rigidly to each and every revenue and expense account, as Mr. Grate seems to imply at page 40 in stating, "My disagreement with adjustment C-16 is that it is not based on a methodology used consistently and uniformly. Instead, it singles out just seven EXTCs and adjusts just those seven."?

A. No. It would be impossible to analyze test year revenue and expense data and find a single mathematical algorithm that reasonably quantifies year-end operating income. Staff's approach in this case, as in all prior Arizona rate cases, is to analyze available data to seek a reasonable annualization approach that produces reasonable results, without constraining the analysis to a particular methodology or algorithm. The differences in proposed annualized revenues between Staff and Qwest regarding Access Charge Revenues (Grate Rebuttal pages 48-50), Toll Service Revenues (Grate Rebuttal page 50) and Directory Assistance Revenues (Grate Rebuttal page 51) all

have to do with Qwest's notion that one must rigidly apply the same calculation algorithm to every single account, or a reasonable annualization cannot be quantified.

Q. With respect to Access Charge Revenues, Mr. Grate is critical of your use of a "last quarter times four" methodology, stating, "There is no sound reason to prepare annualization adjustments that rely on different test period data periods based on subjective assessments. In particular, Mr. Brosch shows minutes of use for September through December in the table at Line 7 on Page 44 of his testimony and claims that the average for October through December (90,718 million) is more representative than December alone (88,196 million). He arbitrarily chooses to use October and November when minutes (and lines in service) were higher."[8] Why did you select October through December data to annualize access minutes of use ("MOU")?

A. As explained in my Direct Testimony, access MOU are variable from month to month and do not exhibit the stability needed to simply multiply the last month's MOU data and regression coefficient times 12, as Qwest has proposed. I display the effects of this month to month variability in a data table at page 45 of my Direct Testimony, to show how fluctuations can significantly impact the annualized result, depending upon which month is selected. To smooth out this fluctuation, I employed the same "last quarter times four" method that has been consistently used by Staff in prior rate cases. The result is a lower test year revenue level than Qwest has proposed, to the benefit of the Company and its shareholders.

Q. At page 49, Mr. Grate is critical of the Staff method, stating, "Aside from being arbitrary, it creates a mismatch between test period revenues and volumes. The table that Mr. Brosch uses shows on its face why this proposal is unreasonable. As shown, September minutes of 84,523 million are excluded from his "average." Had he added that month to his calculation, the average would have been 89,170 million or within

8 Grate rebuttal, page 49.

1% of the value of actual December volumes." Why didn't you use the September data as suggested by Mr. Grate?

A. September was not used for several reasons. First, Staff did not want to face criticism for deviating from the "last quarter times four" methodology it has used in prior cases, expecting that Qwest would characterize such methodological departure as "arbitrary". Second, it was not obvious that September data was any more representative than other months falling outside of the fourth quarter previously used by Staff. Finally, the further away from year-end one reaches for data, the less "matched" the resulting calculation is to year-end rate base.

In past Arizona rate cases, to annualize revenues Staff has relied primarily upon a "last month times 12" approach for the revenue accounts driven by recurring monthly charges that are inherently more stable from month to month or, alternatively, upon a "last quarter times 4" approach for revenue accounts that are driven by fluctuating monthly message volumes or minutes of use. While Qwest seems to advance a new and different methodology in each of its rate case filings[9], Utilitech has found merit in analyzing the data and applying consistent approaches to annualize at year end, while testing the results for reasonableness relative to overall trends. In this Docket, Staff evaluated Mr. Grate's new regression approach and results and accepted them in certain instances where the results were reasonable, while making further adjustments if the results of Mr. Grate's new approach were not reasonable.[10]

Q. Does Mr. Grate offer any substantive arguments in his Rebuttal to indicate why his Access, Toll or Directory Assistance Revenue annualization results are more reasonable than Staff's?

A. No. He is generally critical of Staff's selective rejection of Qwest's corrected regression calculations for certain revenue categories, stating at page 50, "Mixing this

9 See Brosch direct testimony at pages 37 and 38.

10 Staff initially rejected all of Qwest's regression calculations, until they were recalculated by Qwest to correct for the "constant price" problem, as explained at pages 39 through 41 of Brosch Direct Testimony.

annualization approach with a different annualization approach in order to satisfy the analyst's subjective criteria is manipulative and therefore leads to distortion of the overall results of Qwest's consistently applied annualization analysis." However, Mr. Grate has failed to explain why Qwest's results should be found reasonable, given the specific problems identified at pages 48 through 51 of my Direct Testimony. I reject that premise of Mr. Grate's Rebuttal that suggests one must rigidly apply the same mathematical regression algorithm to every account without regard to the reasonableness of the outcome.

Q. Were you able to convince Qwest that its regression results must be abandoned for any particular revenue account?

A. Yes. For Qwest's Other Revenue Account 5264.7 Miscellaneous Billings and Loadings, Mr. Grate's regression calculations produced an annualized revenue amount of negative $990,957 with an R-squared statistic of .533 which Qwest has concluded is acceptable (above .50). This result is clearly unreasonable in light of significant positive revenues recorded monthly in this account. In response to Staff Data Request No. 7-02S1, Qwest agreed that this adjustment was "made in error" and should be reversed after Utilitech notified the Company that this result appeared inconsistent with actual revenue data in this account.[11] I mention this situation to illustrate that it is impractical to suggest that a formulistic approach to revenue or expense annualization can be applied rigidly to all elements of the income statement and produce reasonable results. Some informed judgment and critical analysis of the results of each annualization calculation is required to ensure that known and measurable changes are properly reflected in a matched and balanced manner.

## FINANCIAL REPORTING

Q. In your Direct Testimony, you recommended that the Company be required to prepare and submit financial information indicating its achieved operating income,

11 Philip Grate e-mail transmission of Qwest's response to UTI 7-02S1 dated 10/26/2004, and UTI_7-02S1 Non-Confidential Attachment A Supplement 1 at row 21.

rate base and return on investment.[12] In his Rebuttal on this point, Mr. Grate claims that Staff "...fails to explain why Qwest should be obligated to make annual filings if no review or modification of the price cap plan is pending."[13] How do you respond?

A. I believe that Intrastate earnings and revenue requirement data will continue to be useful during the term of any renewed Price Cap Plan, so that the Commission and its Staff can be mindful of the Company's ongoing earnings and approximate revenue requirement position in each calendar year. At the present time, the Annual Reports submitted by Qwest are of limited use in this regard, because such reports do not provide separated intrastate financial data prepared on a basis of accounting consistent with ratemaking principles established by the Commission.

Q. Do you agree with Mr. Grate's statement in Rebuttal that "preparing a detailed revenue requirement is burdensome and expensive"?

A. No. Mr. Grate has mischaracterized my recommendation regarding financial reporting. I am not recommending a "revenue requirement" calculation each year. The recommendation is that Qwest simply augment its annual financial reporting with a few pre-defined ratemaking adjustments. This recommendation does not include any studies supporting fair value rate base, depreciation accrual rates or cost of capital. The recommendation does not include any obligation for Qwest to audit or examine the reported annual results for the many normalizing and annualization adjustments that are required in a rate case filing. Instead, only the seven key issues I identified in testimony need to be addressed by adjustment, so as to add perspective to reported actual data on an ACC basis of accounting.

Q. Do other Qwest state regulatory jurisdictions require such an annual report, even though no active proceedings are being processed?

A. Yes. According to the Company's response to Data Request UTI 21-24A, Qwest reports intrastate separated financial data at least annually in Colorado, Iowa, Montana, North Dakota, Oregon, South Dakota, Utah, Washington and Wyoming.

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12 Brosch Direct Testimony, page 6.

In Colorado, Iowa and Washington, the Company also provides ratemaking adjustments appended to their regulatory financial reports. Each of these reports in other states is more useful that the form of report presently filed in Arizona. At the present time, Arizona does not receive any intrastate separated earnings or achieved rate of return data, either on an actual or ratemaking-adjusted basis.

Q. Is most of the data required to prepare intrastate separated financial results existent within Qwest's automated financial reporting systems?

A. Yes. The raw data used by Qwest to assemble its R14-2-103 filing in this proceeding was compiled using automated procedures to extract separated financial information from existing automated information systems. Each of the adjustments Staff would have Qwest append to its annual report is either a fixed amount (directory imputation, cash working capital) or is readily assembled from records maintained to support jurisdictional accounting differences on the Company's books. Since Staff is not recommending any analysis work to identify other potential adjustments, procedures can be developed to routinely capture, format and submit such reports in a manner similar to that used by Qwest to prepare financial reports in Iowa and Washington.

Q. Mr. Grate asserts that, "Qwest should not be yoked with the burden of preparing a revenue requirement unless there is a compelling need for one. Annual informational reporting for the convenience and edification of Staff does not rise to that level of need." How do you respond?

A. Again, Staff is not recommending that Qwest "prepare a revenue requirement". The recommendation of Staff is for Qwest to simply append seven prescribed adjustments to the Company's unadjusted, separated intrastate financial reports. Mr. Grate has conceded in his Rebuttal that, "Qwest routinely provides its unadjusted separated results of operations to regulatory commission staffs. Staff can use Qwest's standard reports to make its own revenue requirement calculations if it so chooses."[14] Unfortunately, Qwest does not provide even this "routine" and quite relevant report

13 Grate Rebuttal, page 137.

of its "separated results of operations" in Arizona and this information is critical to any informed review of Qwest's financial performance under Price Cap regulation. For the Company to provide this data and a few additional prescribed adjustments conforming to ACC regulatory policies and the directory imputation Settlement is not an unreasonable "burden", given the importance of the resulting reports to Staff and the Commission.

Q. Do you agree with Mr. Grate that enhanced financial reporting in Arizona, "...runs directly counter to the direction regulatory reporting requirements are headed"[15] since other states have decided to reduce or eliminate certain financial reporting requirements?

A. No. Mr. Grate offers no details regarding how annual financial reports filed by Qwest in the other 13 Qwest state regulatory jurisdictions compare with what is proposed to be filed in Arizona. His selection of only two states where reporting has been reduced does not support a conclusion that Arizona's present or proposed reporting is excessive or burdensome in contrast to the other 13 states. As noted above, most state jurisdictions now require more reporting of intrastate earnings data than does Arizona. I do not believe that an annual report of separated intrastate financial results, with a small number of prescribed ratemaking adjustments, is in any way excessive or burdensome, given the importance of Qwest and its financial condition to the critical intrastate telecommunications infrastructure in the State of Arizona.

Q. Is modestly expanded financial reporting on an annual basis in Arizona likely to produce "...a competitive advantage by making Qwest bear the cost of new administrative burdens that its competitors are not also made to bear",[16] as suggested by Mr. Grate?

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14 Grate Rebuttal, page 138.
15 Id
16 Id, page 139.

A. No. Mr. Grate has provided no estimate of the incremental cost to perform the modestly expanded annual financial reporting being recommended by Staff. Since the vast majority of the data being requested resides within the Company's existing financial reporting systems, I do not expect such costs to be significant enough to yield any competitive impacts upon Qwest.

Q. Does this conclude your testimony at this time?

A. Yes.

Witness: M. Brosch

QWEST CORPORATION
DOCKET NO. T-01051B-03-0454
FAIR VALUE PERCENTAGE CONDITION ADJUSTMENT
TEST YEAR ENDING 12/31/2003
(000's)



| Line No. | Description | Reference | Qwest Pro Forma Test Year | ACC Adjustments | ACC Proposed |
|---|---|---|---|---|---|
| | (A) | (B) | (C) | (D) | (E) |
| 1 | Fair Value Rate Base | Qwest Sch. B-1 | $ 2,386,363 | | |
| 2 | Staff Rate Base Accounting Adjustments | Sch B. pg. 3 | | $ (83,052) | |
| 3 | Add Back: Short Term Plant Under Construction | Footnote (a) | | 21,448 | |
| 4 | Staff Witness Dunkel RCND Study Adjustments | Sch. A-2 pg. 2 | | (69,364) | |
| 5 | Total Staff Fair Value Adjustments | Line 2 + 3 + 4 | | (157,385) | |
| 6 | STAFF PROPOSED FAIR VALUE RATE BASE | Line 1 + 5 | | | $ 2,228,978 |

**FOOTNOTES:**

**(a)** Qwest Sch. B-1 Fair Value Rate Base failed to include Short Term Plant Under Construction while Sch. B-3 includes such amount.

Witness: M. Brosch

QWEST CORPORATION
DOCKET NO. T-01051B-03-0454
FAIR VALUE PERCENTAGE CONDITION ADJUSTMENT
TEST YEAR ENDING 12/31/2003
(000's)



Includes Embedded, FCC Deregulated & Other Plant

| Line No. | Description | Original Cost Incl Offbook | RCND Summary per Qwest Schedule B-4: Reproduction Cost New | Condition Percent | Reproduction Cost New Less Depreciation | Staff Condition Percent (Per WDA-17) | Staff Reproduction Cost Less Depreciation |
|---|---|---|---|---|---|---|---|
| | (A) | (B) | (C) | (D) | (E) | (F) | (G) |
| 1 | Land | 12,813 | 12,813 | 100.00% | 12,813 | 100.00% | $ 12,813 |
| 2 | Motor Vehicles | 71,269 | 74,251 | 46.88% | 34,811 | 40.36% | 29,968 |
| 3 | Special Purpose Vehicles | 26 | 33 | 26.38% | 9 | 27.06% | 9 |
| 4 | Garage Work Equipment | 1,519 | 1,821 | 64.47% | 1,174 | 64.93% | 1,182 |
| 5 | Other Work Equipment | 38,319 | 40,359 | 56.35% | 22,744 | 59.30% | 23,933 |
| 6 | Buildings | 238,452 | 432,300 | 65.44% | 282,893 | 59.83% | 258,645 |
| 7 | Furniture | 1,897 | 1,897 | 68.79% | 1,305 | 49.46% | 938 |
| 8 | Office Equipment | 5,913 | 6,123 | 37.83% | 2,316 | 19.88% | 1,217 |
| 9 | Company Communication Equipment | 2,429 | 2,566 | | | 43.80% | 1,124 |
| 10 | General Purpose Computers | 96,514 | 18,005 | 38.15% | 6,868 | 25.81% | 4,647 |
| 11 | Analog Switching | | | | | 0.00% | - |
| 12 | Digital Switching | 1,192,379 | 914,690 | 68.43% | 625,939 | 62.14% | 568,388 |
| 13 | Operator Systems | 2,534 | 2,902 | 36.53% | 1,060 | 30.99% | 899 |
| 14 | Radio Systems | 32,937 | 36,886 | 34.73% | 12,812 | 27.60% | 10,180 |
| 15 | Circuit DDS | 1,757,337 | 5,401 | 49.67% | 2,682 | 37.10% | 2,004 |
| 16 | Circuit Digital | | 1,690,094 | 76.36% | 1,290,497 | 55.05% | 930,397 |
| 17 | Circuit Analog | | 39,638 | 36.17% | 14,338 | 23.34% | 9,252 |
| 18 | Station Apparatus | 32,899 | 32,899 | 62.43% | 20,538 | 62.43% | 20,539 |
| 19 | Customer Premises Wiring | | | 0.00% | | 0.00% | - |
| 20 | Large PBX | | | | | | - |
| 21 | Public Telephone Terminal Equipment | 21,555 | 21,555 | 40.81% | 8,796 | 40.81% | 8,797 |
| 22 | Other Terminal Equipment | 61,166 | 59,208 | 92.47% | 54,749 | 58.10% | 34,400 |
| 23 | Poles | 52,723 | 199,908 | 57.95% | 115,855 | 63.94% | 127,821 |
| 24 | Aerial Cable - Metallic | 198,351 | 348,764 | 27.76% | 96,834 | 37.95% | 132,356 |
| 25 | Aerial Cable - Non-Metallic | 9,484 | 10,757 | 55.68% | 5,990 | 76.85% | 8,267 |
| 26 | Underground Cable - Metallic | 398,394 | 679,519 | 23.80% | 161,729 | 37.41% | 254,208 |
| 27 | Underground Cable - Non-Metallic | 183,141 | 199,445 | 50.74% | 101,205 | 75.32% | 150,222 |
| 28 | Buried Cable - Metallic | 1,645,740 | 2,178,731 | 43.13% | 939,667 | 50.03% | 1,090,019 |
| 29 | Buried Cable - Non-Metallic | 23,709 | 26,229 | 47.63% | 12,493 | 66.75% | 17,508 |
| 30 | Submarine Cable - Metallic | 3 | 5 | 0.00% | | 2.26% | 0 |
| 31 | Submarine Cable - Non-Metallic | | | | | | - |
| 32 | Intrabuilding Cable - Metallic | 46,456 | 80,436 | 38.22% | 30,741 | 35.11% | 28,241 |
| 33 | Intrabuilding Cable - Non-Metallic | 1,057 | 1,184 | 75.18% | 890 | 75.78% | 897 |
| 34 | Aerial Cable | 10,998 | 15,986 | 48.99% | 7,831 | 62.60% | 10,007 |
| 35 | Conduit | 451,409 | 878,335 | 56.31% | 494,618 | 56.33% | 494,766 |
| 36 | Capital Leases - Buildings | | | | | | - |
| 37 | Capital Leases - Vehicles | 16 | 16 | 100.00% | 16 | 100.00% | 16 |
| 38 | Capital Leases - Computers | | | | | | - |
| 39 | Capital Leases - Software | 4,432 | 4,432 | 100.00% | 4,432 | 100.00% | 4,432 |
| 40 | Capital Leases - Other | 685 | 685 | 100.00% | 685 | 100.00% | 685 |
| 41 | Leaseholds - Buildings | 32,889 | 32,741 | 100.00% | 32,741 | 100.00% | 32,741 |
| 42 | Leaseholds - Computers | | | | | | - |
| 43 | Intangibles - Software | 106,880 | 270,377 | 100.00% | 270,377 | 100.00% | 270,377 |
| 44 | Intangibles - Spectrum Rights | 29 | 29 | 100.00% | 29 | 100.00% | 29 |
| 45 | Total Plant in Service | 6,736,354 | 8,321,020 | 56.15% | 4,672,478 | | 4,541,925 |
| 46 | (L.1 thru 26)-L10 | | | | | | |
| 47 | | | | | | | |
| 48 | Reproduction Cost New Factor | 1.235 | | | | | |
| 49 | (Original Cost Plant / RCN Plant) | | | | | | |
| 50 | | | | | | | |
| 51 | Arizona Intrastate Operations | | | | | | |
| 52 | Intrastate Ratio | 72.20% | 72.20% | | 72.20% | Schedule F | 71.22% |
| 53 | Intrastate Plant in Service | 4,863,469 | 6,007,556 | | 3,373,405 | | 3,234,677 |
| 54 | RCND Adjustment Due to Percent Condition | | | | | | (138,728) |
| 55 | 50% Weighting Factor | | | | | | 50% |
| 56 | Fair Value Adjustment Due To Percent Condition | | | | | | (69,364) |

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

JEFF HATCH-MILLER, CHAIRMAN
WILLIAM A. MUNDELL
MARC SPITZER
MIKE GLEASON
KRISTIN K. MAYES

| | | |
|---|---|---|
| IN THE MATTER OF QWEST CORPORATION'S FILING OF 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 |

SURREBUTTAL TESTIMONY

OF

WILLIAM DUNKEL

AND

THOMAS REGAN

ON BEHALF OF

THE STAFF OF THE ARIZONA CORPORATION COMMISSION

JANUARY 12, 2005

NOTICE: CONFIDENTIAL INFORMATION HAS BEEN REDACTED FROM THIS TESTIMONY.

# DUNKEL

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

JEFF HATCH-MILLER, CHAIRMAN
WILLIAM A. MUNDELL
MARC SPITZER
MIKE GLEASON
KRISTIN K. MAYES

| | |
|---|---|
| IN THE MATTER OF QWEST CORPORATION'S ) FILING OF 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 |

# SURREBUTTAL TESTIMONY

OF

WILLIAM DUNKEL

ON BEHALF OF

THE STAFF OF THE ARIZONA CORPORATION COMMISSION

JANUARY 13, 2004

NOTICE: CONFIDENTIAL INFORMATION HAS BEEN REDACTED FROM THIS TESTIMONY.

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

JEFF HATCH-MILLER, CHAIRMAN
WILLIAM A. MUNDELL
MARC SPITZER
MIKE GLEASON
KRISTIN K. MAYES

| | |
|---|---|
| IN THE MATTER OF QWEST CORPORATION'S ) FILING OF 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 |

# SURREBUTTAL TESTIMONY

OF

WILLIAM DUNKEL

ON BEHALF OF

THE STAFF OF THE ARIZONA CORPORATION COMMISSION

JANUARY 13, 2004

NOTICE: CONFIDENTIAL INFORMATION HAS BEEN REDACTED FROM THIS TESTIMONY.

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## I. Introduction

**Q. Are you the same William Dunkel that prefiled direct testimony in this proceeding on behalf of the Arizona Corporation Commission staff?**

A. Yes, I am.

**Q. What is the purpose of this surrebuttal testimony?**

A. The purpose of this testimony is to respond to certain testimonies filed by other parties in this proceeding on or about December 20, 2004. The issues I address include depreciation, the charges that BSI paid for BSI's use of Qwest's remote terminals and associated cabling, the jurisdictional separations of the costs of the interstate DSL service, and the "condition percent" used in the RCNLD[1] calculation.

## II. Depreciation

**Q. What significant adjustment did Mr. Wu make in his Rebuttal Testimony?**

A. Mr. Wu stated that I had recommended using the end-of-year 2003 depreciation reserve levels instead of the beginning-of-year balances that he had used. As a result he revised his depreciation rates to use the end-of-year 2003 depreciation reserve levels. This reduced his claimed annual depreciation expense by approximately $50,000,000.[2] However, Mr. Wu has still not corrected the lives used in calculating his proposed

[1] Reconstruction cost new or less depreciation (RCNLD)
[2] Rebuttal Testimony of Mr. Wu, pages 15 and 16.

depreciation rates, so we must address the "lives" issues.[3]

**Q. On page 4, of his Rebuttal testimony, starting on line 7, Mr. Wu alleges:**

> **Based on this quote, Mr. Dunkel alleges that Part 32 requires "that depreciation be over the 'service life'" of the asset and that service life must be estimated based solely on historical mortality data.**

**Did you testify "that service life must be estimated based solely on historical mortality data"?**

A. No. I never testified "that service life must be estimated based solely on historical mortality data." This grossly misrepresents my testimony and the position of the Staff. Other than Mr. Wu, no witness or party to this case has stated "that service life must be estimated based solely on historical mortality data."

It is easy to demonstrate that the projection lives I proposed are not "estimated based solely on historical mortality data."

For example, for the five accounts with the largest investments, the observed life[4] and the projection life recommended in the Dunkel Direct Testimony are shown below:

| Account | | Recent Observed Life (years) | Staff Proposed Projection Life (years) | Diff. (years) |
|---|---|---|---|---|
| 2212 | Digital Switching Eq. | 29.0 | 15.0 | 14.0 |
| 2232 | Circuit Digital | 28.2 | 12.0 | 16.2 |
| 2422 | Underground Cable-Met. | 64.0 | 27.5 | 36.5 |
| 2423 | Buried Cable-Metallic | 58.8 | 23.0 | 35.8 |
| 2441 | Conduit Systems | 77.2 | 56.6 | 20.6 |

(Source: Schedule WDA-12, page 5, columns C and E)

[3] There is also a difference between myself and Mr. Wu on some "future net salvage" values, but the differences in the lives have a much larger financial impact that the differences in net salvage values, as discussed in my Direct Testimony.

[4] The life based on "historic mortality data".

The projection live Staff proposes clearly are not "estimated based solely on historical mortality data." The five account discussed above include 82% of the Qwest Arizona investment.[5]

**Q. Did your Direct Testimony clearly state that you were not recommending a life equal to the actual observed service life?**

A. Yes. This was clearly stated. For example the following started on page 32 of Mr. Dunkel's Direct Testimony:

> **Q. What is the actual observed average service life in the buried cable metallic account of Qwest in Arizona?**
>
> A. Based on the most recent data,[6] the observed average service life in the buried cable-metallic account of Qwest in Arizona is 58.8 years....
>
> **Q. Is Staff proposing a 58.8-year projection life for this account?**
>
> A. No. The FCC has established "ranges" in which the projection lives for various accounts are expected to fall. The FCC uses the ranges for determining the cost to be included in the High Cost Fund (HCF), for purposes of setting unbundled network element (UNE) and interconnection rates, and to determine the reasonableness of the price of new services.[7] To be conservative, Staff is not recommending a revised projection life for any account that is longer than the midpoint of the FCC range for that account.[8] This is a reasonable, but conservative, step at this time. For buried cable metallic the FCC range for projection lives is 20 to 26 years. As a result, the Staff recommendation is a 23-year projection life, although the actual current data shows that Qwest in Arizona keeps their investment in this account in service much longer than a 23 year average. Since the investment in this account is already 12.4 years old on average, the observed life indication is over 58 years,

[5] As can be calculated from column M of Schedule WDA-12, page 2, attached to the Dunkel Direct testimony.

[6] The data in the chart above was from activities in this account for Qwest in Arizona in the years 2001, 2002, and 2003.

[7] Paragraphs 34 and 39, FCC Order 99-397 CC Docket No. 98-137, released December 30, 1999.

[8] For some accounts the existing projection life was supported by the data and we have not changed those existing approved projection lives. Some of those existing projection lives were outside the FCC range. But any change in projection lives proposed by Staff are all with the FCC range.

and Qwest has no plans for massive retirements in this account, the expectation that these investments will retire an average of 23 years after they when into service is very conservative....

**Q. Does this recommendation assume the future will be identical to the past?**

A. No. This proposal does not assume that the future will be identical to the past. Using 23 years instead of the "observed" 58 years average life means Staff has included a generous allowance for the possibility that the investments may live a shorter average life in the future than they have in the past.

It was also clear from my Direct Testimony that I included an analysis of Qwest's future plans in Arizona in my depreciation life analysis. This was explained in more detail starting on page 34 of the Dunkel Direct, which states as follows:

**Q. Is Qwest planning any widespread retirement of buried metallic cables?**

A. No. There are three different Qwest sources that indicated that Qwest is not planning a massive retirement of the existing buried cable metallic investments:

(1) A recent Wall Street Journal Article stated:

Qwest Communications International Inc., the local phone company in 14 Western states, has decided to roll fiber out only to new housing developments, and its chief executive officer, Richard C. Notebaert, has dismissed a blanket rollout of the technology as not economical.[9]

(2) In Schedule F-3 of R-14-2-103 standard filing requirements, Qwest's forecast for its construction budget through the year 2005 is the same construction level it had in 2003, so no massive accelerated replacements are forecast by Qwest.[10]

(3) In request WDA 04-11 we asked Qwest:

[9] November 8, 2004 Wall Street Journal article entitled "Showdown of the Giants", by Jesse Drucker, Dennis K. Berman and Peter Grant.

[10] Also, see the Confidential file provided by Qwest titled "Inputs-1203.xls" shows **
**

> WDA 04-011 (a.) Please provide a copy of any QWEST plans for the widespread retirement of Buried Cable-Metallic in the distribution portion of the network.
>
> In response they provided no copy of any such plans.

As the above excerpts from my Direct Testimony clearly demonstrate, Staff's recommended lives were not "estimated based solely on historical mortality data." Mr. Wu has misrepresented the Staff testimony and position.

In addition to my Direct Testimony, the Staff had already directly told Qwest in response to data requests that Staff's recommended depreciation lives did not rely solely on the observed life data.

Below is Qwest's request 9-4 to the Staff, and the Staff's responses. This Staff response was hand delivered to Qwest on December 6, 2004, which is 14 days prior to Qwest filing Mr. Wu's Rebuttal testimony.

> REQUEST NO.: Qwest 9-4
>
> Please identify all instances (of which you are aware) in which the asset lives approved by the Arizona Corporation Commission for Arizona utilities and used for purposes of setting Arizona intrastate depreciation rates relied solely on observed lives data. Please provide a copy of any documentation that supports your answer.
>
> STAFF RESPONSE 9-4[11]
>
> We object to this request in that it assumes that the Staff proposed lives were "based solely on the observed life data." We further object in that

[11] The response also said "Finally, we object to this request because it seeks to have Staff gather information for Qwest which is part of the public record and is as readily available to Qwest as to Staff. Qwest can obtain copies of prior ACC orders in the Commission's Docket Control during normal business hours. "

> this is not designed to produce relevant or admissible information (no party has proposed lives "based solely on the observed life data.")

**Q. Elsewhere in his Rebuttal, does Mr. Wu repeat this misrepresentation of the Staff testimony?**

A. Yes. On page 5-6 of my Direct Testimony I stated:

> **Failure to depreciate over the "service life"** violates the ACC and USOA (Uniform System of Accounts) depreciation requirements. (Emphasis added)

Starting on line 21 of page 1, Mr. Wu's Rebuttal Testimony, Mr. Wu drastically misstated this portion of my testimony. Referring to this sentence in my testimony, he claimed:

> "Staff's Mr. Dunkel testifies: (1) **utilizing depreciation lives less than implied by historical retirement rates** "violates the ACC [sic] and USOA (Uniform System of Accounts) depreciation requirements and (2) that end-of-year 2003 rather than beginning-of-year 2003 reserve balances should be used to develop depreciation rates used for test year 2003." (Emphasis added)
>
> [2] Direct Testimony and Schedules of William Dunkel on Behalf of Staff of the Arizona Corporation Commission, Docket No. T-01051B-03-0454 and No.T-00000D-00-0672, November 2004, pp 5-6.

I had actually said that "**Failure to depreciate over the 'service life"** violates these requirements. Mr. Wu misstates my testimony by falsely claiming that I testified that" **utilizing depreciation lives less than implied by historical retirement rates"** violates these requirements.

1 I determined the expected service life by considering many things other than just historic
2 retirement rates, as discussed elsewhere in this testimony. For example, as previously
3 discussed, on page 33 of my Direct Testimony I stated:

> 4 For buried cable metallic the FCC range for projection lives is 20 to 26
> 5 years. As a result, the Staff recommendation is a 23-year projection life,
> 6 although the actual current data shows that Qwest in Arizona keeps their
> 7 investment in this account in service much longer than a 23 year average.
> 8 Since the investment in this account is already 12.4 years old on average,
> 9 the observed life indication is over 58 years, and Qwest has no plans for
> 10 massive retirements in this account, the expectation that these investments
> 11 will retire an average of 23 years after they when into service is very
> 12 conservative...

13 I said that depreciation should be over the service life, but I did not saying the expected
14 service lives cannot be " less than implied by historical retirement rates." In fact, for the
15 major accounts the projected service lives I propose **are less than the historic lives**, as
16 previously discussed.
17
18 **Q. What did Mr. Wu do after he misstated your testimony?**
19 A. After he misstated my testimony, he then extensively rebutted the statement he had
20 created. He presented extensive arguments and evidence demonstrating why depreciation
21 lives should not be "estimated based solely on historical mortality data." In at least eight
22 different locations in that section[12] of his testimony, Mr. Wu makes it clear that he is
23 demonstrating why depreciation lives should not be estimated based solely on historical
24 mortality data.[13]

---

[12] This section of his testimony starts on page 3, line 16 of his Rebuttal and goes through page 11 (except for the question and answer which begins on page 8).

[13] On page 4, of Wu Rebuttal testimony, starting on line 7; page 5, of his Rebuttal testimony, starting on line 20; lines 26-27 of Wu Rebuttal testimony page 5; On page 6, of his Rebuttal testimony, starting on line 19; On page 7, of his Rebuttal testimony, starting on line 12; On page 10, of his Rebuttal testimony, starting on line 1; On page 10, of his Rebuttal testimony, starting on line 24; and on page 11, of his Rebuttal testimony, starting on line 15.

This section of his testimony is not applicable to the position presented by any opposing party or witness. No witness in this case, other than Mr. Wu, ever discussed depreciation lives "estimated based solely on historical mortality data." No witness in this case is proposing depreciation lives "estimated based solely on historical mortality data."

**Q. Are there other sections of Mr. Wu's Rebuttal Testimony that are not relevant?**

A. Yes. Mr. Wu makes several references to the determination of depreciation expense under the TELRIC requirements for purposes of determining Interconnection or UNE rates. Costs for Interconnection and UNE rates are determined under TELRIC requirements. The cost requirements for Interconnection and UNE rates are different from the rate of return regulation requirements.[14] In fact Section 252 (d) (1)(a) (i) of the Federal Telecommunication Act states that "Interconnection and network element charges"

> (A) shall be-
>
> (i) based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (which ever is applicable),

Determining depreciation expense under the TELRIC rules for purposes of determining UNE and Interconnection rates is not applicable to my depreciation testimony in this proceeding.

[14] There are some similarities, for example the FCC depreciation "ranges" were used in regulation of the price capped LECs and also used in TELRIC depreciation.

**Q. What portions of Mr. Wu's Rebuttal are addressing the requirements for determining TELRIC depreciation costs for purposes of determining Interconnection and/or UNE rates?**

A. Mr. Wu is addressing TELRIC costs for purposes of determining Interconnection and/or UNE rates in the following section of his testimony:

(1) The Illinois and Indiana Commission Orders discussed on page 8 of Wu's Rebuttal are Orders addressing TELRIC /UNE/Interconnection.[15]

(2) The term "safe harbor" that Mr. Wu uses repeatedly in his testimony[16] is a term he obtained from the above referenced Indiana proceeding on UNE rates and collocation[17]. I did not use the term "safe harbor" in my testimony and the FCC Orders which provided the FCC depreciation ranges do not use the term "safe harbor."

(3) The FCC NPRM that Mr. Wu refers to and quotes from starting on page 6, line 24 of his Rebuttal is a NPRM addressing Unbundled Network Elements (UNEs).

(4) The term "economic depreciation" on line 35 of page 6 of the Wu Rebuttal is a term from "Section 51-**Interconnection**" of the FCC rules.[18]

(5) The FCC NPRM that Mr. Wu refers to and quotes from on page 14 of his Rebuttal is a NPRM addressing Unbundled Network Elements (UNEs) and specifically addresses "TELRIC principles."

Mr. Wu's repeated discussions of the determination of TELRIC depreciation costs, which are used in setting Interconnection and UNE rates, are not relevant to the depreciation testimony which I presented. The TELRIC cost requirements are different than the rate of return regulation cost requirements.

[15] See page 8, line 14 and footnotes 10 and 11 in the Wu Rebuttal Testimony.
[16] For example on page 8 of the Wu Rebuttal.
[17] Qwest response to WDA 19-006
[18] Qwest response to WDA 19-005.

**Q. On page 4 and 5 of his Rebuttal Mr. Wu disagrees with the "straight- line method" of depreciation. What method did Mr. Wu use in the prior depreciation proceeding in Arizona?**

A. Mr. Wu used the "straight line" method in the prior proceeding in Arizona, as is shown by the following Qwest response:

> Request WDA 19-004 (part B)
>
> B. In calculating the depreciation rates shown on Exhibit 1 attached to Mr. Wu's Direct Testimony dated March 19, 1999 in Docket No. T-01051B-97-0689 did Mr. Wu use the straight-line method? Begin the answer with "yes" or "no". If not, what method did Mr. Wu use, and provide the documents with support any claim that Mr. Wu did not use the straight-line method.
>
> Qwest Response:
>
> B. Yes, the straight-line method was used.

**Q. On page 7, of his Rebuttal testimony Mr. Wu alleges that Mr. Dunkel advocated depreciation lives within the FCC 1995 life ranges. On pages 8 and 17 he alleges the FCC life ranges Mr. Dunkel used were established nearly 10 years ago. Does this statement accurately state the source of the FCC life ranges you used for the major accounts?**

A. No. Mr. Wu's claim that I used the 1995 FCC life ranges misrepresents the source of the FCC life ranges that I used for the major accounts. For most major accounts, the FCC life ranges I used were from the FCC's December 1999 Order.

1 The FCC first established depreciation life ranges in 1994 and 1995.[19] However the FCC
2 had a later proceeding in which the FCC considered proposed revisions to the
3 depreciation life ranges for the major accounts. As a result of that later proceeding, the
4 FCC in December, 1999 released Order FCC 99-397 (adopted December 17, 1999 and
5 released December 30, 1999) which changed the depreciation life range for account 2212,
6 Digital Switching, and, based "on recent carrier accounting data and trends"[20] rejected
7 proposals to reduce the prescribed projection life ranges in the other major accounts.
8
9 Schedule WDA-S3 attached hereto includes pages from that December 1999 FCC Order.
10 Appendix B of that FCC Order shows the "FCC Prescribed" life ranges which the FCC
11 adopted in that December, 1999 Order. In my analysis and testimony I used the FCC
12 prescribed life ranges from Appendix B of that December 1999 Order for all accounts
13 which appear on that Appendix B. The accounts that are on that Appendix B contain 81
14 percent of the Qwest Arizona investment.[21] Schedule WDA-12 in my Direct Testimony
15 clearly shows that "FCC 99-397, Released December 30, 1999, Appendix B"[22] was a
16 source I used for the FCC ranges.
17
18 It is clear that I used the life ranges the FCC prescribed in 1999. On Appendix B of the
19 December, 1999 Order the "FCC Prescribed" life range is 12 to 18 years for Digital
20 Switching equipment. Prior to that 1999 Order, the FCC prescribed depreciation life

[19] Order FCC 94-174 release June 28,1994 and Order FCC 95-181 released May 4, 1995.
[20] Paragraph 14, Order FCC 99-397 (adopted December 17, 1999 and released December 30, 1999).
[21] The accounts for which the FCC reviewed the life ranges in this 1999 proceeding were Underground Metallic Cable, Buried Cable -Metallic, Aerial Cable-Metallic, Circuit Equipments-Digital, and Switching –Digital, and all Fiber Cable, accounts (Appendix B, Order FCC 95-181). The accounts for which the FCC reviewed and /or modified the life range in the December, 1999 Order contain 81 percent of the Qwest Arizona investment (as can be calculated from Schedule WDA-12, page 3).
[22] "Sources" Footnote, Schedule WDA-12, page 5, attached to the Dunkel Direct.

range for this Digital Switching equipment was 16 to 18 years. Page 5 of 5 of Schedule WDA-12 attached to my Direct Testimony in this proceeding shows that for account 2212 Digital Switching, the FCC life range that I used was 12 to 18 years, which is the range from the 1999 Order, not the range from the FCC 1995 or 1994 Orders.

For the Digital Switching account, the 15.0 year Staff Recommended Life in Column E of Page 5 of 5 of Schedule WDA-12 attached to my Direct Testimony is the mid point of the 12 to 18 years life range that was first established by the FCC in December, 1999. It is not the midpoint of the 16 to 18 year life range that was established by the FCC in 1994/1995. Mr. Wu's claim that I advocates "the FCC's 1995" life ranges misrepresents my testimony.

**Q. On page i (Executive Overview) of Mr. Wu's Rebuttal Testimony, Mr. Wu claims:**

> **RUCO concurs in the use of Commission prescribed lives and parameters.**

**What did RUCO say their position was on these issues?**

A. Attached as Schedule WDA-S4 are RUCO's responses to three different Staff Data Requests.[23] In these requests Staff asked RUCO what depreciation lives or future net salvage parameters RUCO supported in this proceeding. To all three requests, the RUCO complete answer was:

> "RUCO has not performed a depreciation study and thus, has no position on this issue."

or:

> "RUCO has not performed a depreciation study and thus, has no opinion on this issue."

[23] Staff requests to RUCO, WDA 1.8, WDA 1.9, And WDA 1.10, and RUCO's responses.

**Q. On page 12 of his Rebuttal Mr. Wu discusses the fact that "Qwest's competitors" do not follow the utility regulatory depreciation rules. Is it clear from an MCI discovery response that MCI does not maintain records following the Uniform System of Accounting (USOA) requirements?**

A. Yes. MCI's response to question 4-1 in Qwest's fourth set of data requests is shown below:

> Qwest Request 4-1.
>
> At Pages 7-18 of the Brosch Testimony, Mr. Brosch proposes to disallow Qwest's image advertising costs in the calculation of Qwest's revenue requirement.
>
> a. Do you incur costs for product advertising in Arizona?
> b. Do you incur costs for image advertising costs (sic) in Arizona? If so, what portion (expressed as a percentage) of your advertising costs over the past three calendar years have been for image advertising?
>
> **MCI Response:**
>
> a. Yes.
> b. Because MCI maintains its financial records according to Generally Accepted Accounting Principles (GAAP) **rather than pursuant to the FCC's Part 32 Uniform System of Accounts,** MCI does not allocate image advertising on any jurisdictional basis, i.e., to separate states. For this reason, MCI is unable to provide a response to this question. (emphasis added)

It is clear from this response that MCI does not follow the FCC Part 32 Uniform System of Accounts (USOA) requirements. As discussed on pages 46-54 of my Direct Testimony, there are several reasons the CLEC/IXC "financial reporting" lives cannot be used as Qwest's regulated utility lives. These reasons are: (1) CLEC/IXC's depreciation rates are not calculated consistent with the USOA/ACC requirements; (2) the IXCs are

different than the ILECs, as the FCC has stated; (3) the "percent reserve" or other parameter used in calculating the depreciation rate for a specific Qwest account should be the Qwest values, not a CLEC's or IXC's values; (4) and there would be a mismatch of the way utility regulated depreciation rates are applied if depreciation rates are calculated on a different standard.

## III. BSI's Failure to Pay Construction Charges for the Qwest "Video Only" Remote Terminals

**Q. Does Mr. Grate acknowledge that BSI did not pay construction charges for the "video only" Qwest Remote Terminals?**

A. Yes. On page 110, lines 9-12 of his Rebuttal testimony Mr. Grate admits that BSI did not pay construction charges for the "video only" Qwest remote terminals. He also acknowledges that **

**[24]

**Q. On page 109 of his Rebuttal Testimony Mr. Grate states that**

> **Qwest, as the entity who would own the cabinets and cable, incurred the construction costs and placed the investment on its books. BSI, as the entity who would own in the shelves and cards needed to provide its cable services, incurred the cost for purchasing and placing the electronics and placed the investment on its books.**

[24] Page 112, line 1, Rebuttal Testimony of Philip E. Grate.

**

**

A. Yes. The remote terminal investments I used in my adjustment[25] were only the investments that were on the **Qwest** books. I did **not include** the investments that were on the **BSI books**. I was careful to distinguish the Qwest investment from the BSI investment. This is shown in the following discovery that produced the Qwest remote terminal investment figures which I used in my adjustment:

> Request WDA17-008
>
> (d) Separately for each of the 10 locations selected in part (a), provide the dollar amount of the Engineer, Furnish and Install (EF&I) investment for the cabinet, site preparations, connection to the electric utility and other items owned by Qwest "core" company at that location. **(Note, the "video" USAM electronics, and any other items owned by BSI, should not be included.)** (emphasis added)
>
> Qwest Supplemental Response Dated 11/03/04:
>
> (d) For each of the 10 sites selected, Confidential Attachment B shows the total labor associated with cabinet installation, including EF&I, the site preparations and connection to the electric utility. The material charges for the cabinet and other material costs associated with the cabinet are separately identified in the attachment. **The capital investment at each location shown on the attachment is owned by Qwest "core" company.** (emphasis added)

The investments figures used in my adjustment include only the investments on the Qwest books. The investments on the BSI books were not included. The term "EF&I"

[25] Schedule WDA-18, attached to the Dunkel Direct Testimony.

used in the above response means "Engineer, Furnish and Install", so this statement applies to installation and engineering, as well as the materials.[26]

**Q. On page 112 and 113 of his Rebuttal Testimony Mr. Grate alleges that allowing BSI to use the Qwest cabinets and cables without paying construction charges ****

**** is appropriate, because**

**

[27]** **(emphasis added)**

**Is this a valid reason?**

A. No. Under collocation, the CLEC is responsible for providing and installing the CLEC's equipment in the space that it rents from Qwest. Section 8.1.1.3 of Qwest's SGAT (Statement of Generally Available Terms and Conditions For Interconnection) states:

> CLEC is responsible for the procurement, installation and on-going maintenance of its equipment as well as the cross connections required within CLEC's leased Collocation space."[28]

The fact that BSI **

** does not help recover the Qwest cabinet investment.

The ** ** charges that BSI pays to Qwest for using the Qwest remote terminals are the **recurring** charges. The remote terminal **recurring** charges cover maintenance and

[26] "Furnish" means furnishing the materials.
[27] Page 112 of the Rebuttal Testimony of Mr. Grate
[28] Section 8.1.1.3 pertaining to Cageless Physical Collocation. Similarly Section 8.1.1.2 under Caged Physical Collocation states "CLEC is responsible for the procurement, installation and on-going maintenance of its equipment as well as the cross connections required within the cage." Section 8.2.7 "Terms and Conditions-Remote Collocation" points to these requirements as applying to Remote Collocation.

1 certain power costs,[29] but do not cover any of the Qwest investment in the cabinets, or
2 any of the depreciation expense on that Qwest cabinet investment, or allow for any return
3 on that Qwest cabinet investment.
4
5 The "Collocation: Remote Terminal" costs study which supports the remote terminal
6 collation rates which Qwest applied in 2003 states:
7 **
8
9
10
11
12
13
14 [30]
15
16 The page from the Qwest cost study that contains the above quoted statement is attached
17 hereto as Schedule WDA-S1.
18
19 The **
20
21 ** BSI has **not** paid the rate that includes recovery of
22 the Qwest investment in the cabinets.
23

---

[29] Along with some minor administrative and overhead costs.
[30] Executive Summary, page 1, Qwest "Collocation: Remote Terminal" cost study, provided by Qwest as Confidential Attachment A to Qwest's response to request WDA 21-001. It also says –

**

(emphasis added)

In addition BSI is not paying anything towards the depreciation expense of the Qwest cabinets, or any return (or cost of money) on the Qwest investment in the cabinets BSI uses. Referring to the remote terminal collocation rates that Qwest applied in 2003,[31] Staff request WDA 21-001 (b) and (c) asked:

> (b) Is it correct that the $1.35 recurring "Space per Standard Mounting Unit" rate and $0.82 recurring FDC Terminations per Binder Group rate do not include depreciation expense or cost of money for the Qwest investment in the cabinet or shelves? If this is not a correct statement, provide the corrected statement.
>
> (c) Is it correct that the $1.35 recurring "Space per Standard Mounting Unit" rate and $0.82 recurring FDC Terminations per Binder Group rate do not include depreciation expense or cost of money, other than perhaps depreciation expense and/or cost of money for overhead, support, or administrative investments? If this is not a correct statement, provide the corrected statement.

Qwest's complete response to these parts of WDA 21-001:

(b) Yes.
(c) Yes.

BSI has equipment inside many Qwest remote terminals. However, the fact that BSI has not paid construction charges ** ** means BSI has not paid anything towards the Qwest investment in those cabinets, has not paid anything towards the Qwest depreciation expense of those cabinets, and has not paid anything towards the cost of money (return requirement) on the Qwest investment in those cabinets. In addition, for many Qwest cabinets, BSI equipment is the only equipment using those Qwest cabinets.

**Q. On page 112 and 113 of his Rebuttal Testimony Mr. Grate states that:**

[31] In addition, in response to a different request (WDA 20-012 (d) and (e), Qwest also acknowledged that the Remote Terminal Collocation **recurring** rates in the current SGAT also do not include depreciation expense or cost of money.

There are also approximately ** ** other Qwest remote terminals which contain both Qwest voice cards and BSI video cards ("shared remotes").[33] My adjustment[34] addresses only the "video only" remote terminals. Since the "video only" remote terminals were constructed specifically to meet BSI's needs, construction charges should have applied, and these construction charges that BSI did not pay are what I am addressing in my adjustment.

Mr. Grate is correct when he points out that **

** at these "shared remote" locations, and therefore is not covering any of the Qwest cabinet investment at those locations, and is not supporting any of the Qwest depreciation expense or cost of money requirements on those Qwest cabinet investments. I made no dollar adjustment for the fact that BSI **

** charges for the "shared remotes", but the Commission should order that BSI (and any other Qwest affiliate) in the future pay the non-recurring remote terminal collocation charges (along with the recurring charges) when they utilize the Qwest remote terminals.

## IV. Qwest's Separation to the Intrastate Jurisdiction of the Majority of the Cost of Interstate DSL Service

[33] Qwest's response to WDA 12-003.
[34] The adjustment on Schedule WDA-18, attached to the Dunkel Direct testimony.

**Q. On page 95 of his Rebuttal Testimony Mr. Grate states "Qwest acknowledges that there is an inherent conflict between the FCC's language" in paragraph 23 of the FCC Freeze Order and what is Qwest's interpretation of that Order, but asks the Commission to adopt the Qwest interpretation. Should Qwest's interpretation be adopted over the FCC's language in the Freeze Order?**

A. No. The FCC in paragraph 23 of the Freeze Order says there is an exception to the freeze:

> 23. Similarly, we find that in order to relieve all carriers of performing traffic or relative-use studies for separations purposes, all allocation factors used to assign Part 36 categories, subcategories, or further subdivisions to the state or interstate jurisdictions shall be frozen utilizing the factors calculated for the calendar year 2000. Categories or portions of categories that have been directly assigned in the past, **however, will continue to be directly assigned to each jurisdiction. In other words, the frozen factors shall not have an effect on the direct assignment of costs for categories, or portions of categories, that are directly assigned.** Since those portions of facilities that are utilized exclusively for services within the state or interstate jurisdiction are readily identifiable, we believe that the continuation of direct assignment of costs will not be a burden on carriers, nor will it adversely impact the stability of separations results throughout the freeze.[60] (emphasis added)

> Footnote 60. Examples of facilities in which a portion can be directly assigned include, Central Office Equipment- Category 2, Tandem switching equipment and Cable and Wire Facilities-Category 2, Wideband and exchange trunk. *See* 47 C.F.R. §§ 36.124 and 36.155.

It is clear from the FCC language that there is an exception to the freeze. The FCC language above uses the word "however" to indicate the existence of an exception. The FCC language also recognizes that because of this exception the carriers will have to do some additional analysis but determined that additional analysis "will not be a burden on carriers".

As I will discuss below, the Part 36 rules adopted in the Freeze Order also repeatedly state there is an exception to the freeze, so the rules adopted by the FCC are consistent with what the FCC said in paragraph 23.

**Q. On pages 88 and 95 of his Rebuttal Testimony, Mr. Grate indicates that his recommendation regarding the treatment of the private line/directly assigned cost is based on paragraph 36.3(b). Is this a valid basis?**

A. No. The section of the FCC Part 36 separation rules that immediately precedes section 36.3(b) specifically says that "[d]irect assignment of private line service costs between jurisdictions shall be updated annually." (Part 36.3 (a))

The fact that this requirement is not **repeated** in section 36.3(b) does not mean this requirement does not exist in the FCC Part 36 separation rules. Mr. Grate wants to skip over the first step, and only consider the second step.

The general rules being discussed are as follows:

> **Subpart A – General**
>
> **§ 36.3 Freezing of jurisdictional separations category relationships and/or allocation factors**
>
> (a) Effective July 1, 2001, through June 30, 2006, all local exchange carriers subject to Part 36 rules shall apportion costs to the jurisdictions using their study area and/or exchange specific separations allocation factors calculated during the twelve month period ending December 31, 2000, for each of the categories/sub-categories as specified herein. **Direct assignment of private line service costs between jurisdictions shall be updated annually.**

> **Other direct assignment of investment, expenses, revenues or taxes between jurisdictions shall be updated annually.** Local exchange carriers that invest in telecommunications plant categories during the period July 1, 2001, through June 30, 2006, for which it had no separations allocation factors for the twelve month period ending December 31, 2000, shall apportion that investment among the jurisdictions in accordance with the separations procedures in effect as of December 31, 2000 for the duration of the freeze. (emphasis added)
>
> (b) Effective July 1, 2001, through June 30, 2006, local exchange carriers subject to price cap regulation, pursuant to § 61.41, shall assign costs from the Part 32 accounts to the separations categories/sub-categories, as specified herein, based on the percentage relationships of the categorized/sub-categorized costs to their associated Part 32 accounts for the twelve month period ending December 31, 2000. If a Part 32 account for separations purposes is categorized into more than one category, the percentage relationship among the categories shall be utilized as well. Local exchange carriers that invest in types of telecommunications plant during the period July 1, 2001, through June 30, 2006, for which it had no separations category investment for the twelve month period ending December 31, 2000, shall assign such investment to separations categories in accordance with the separations procedures in effect as of December 31, 2000.
>
> (1) Local exchange carriers not subject to price cap regulation, pursuant to § 61.41, may elect to be subject to the provisions of § 36.3(b). Such election must be made prior to July 1, 2001.....

Mr. Grate's effective interpretation of the above is that "[d]irect assignment of private line service costs between jurisdictions shall" **not** "be updated annually. Other direct assignment of investment, expenses, revenues or taxes between jurisdictions shall" **not** "be updated annually." Qwest's self-serving "interpretation" of the above Part 36 requirement is the exact opposite of what Part 36 actually says.

Mr. Grate argues that Qwest can ignore the statement in 36.3(a) because "the specific rule controls" over a general rule.[35] The rule that specifically states how the private line costs are to be treated is rule 36.3(a), which says **"[d]irect assignment of private line service costs between jurisdictions shall be updated annually. Other direct assignment of investment, expenses, revenues or taxes between jurisdictions shall be updated annually."** Paragraph 36.3(b) contains no specific mention of private line costs or direct assigned costs.

The above private line/direct assignment rule applies to the interstate DSL service at issue in this case. As discussed on page 5 of my Direct Testimony, the FCC has declared that DSL service used for Internet access is an interstate "Special Access" service (interstate "special access" is a form of interstate "private line" service),[36] and for separations purposes DSL is considered a "wideband" service.[37]

Section 36(a) and (b) discussed above are from the "General" section of Part 36. The specific Part 36 rule adopted in the Freeze Order for separating the circuit equipment investment includes the following requirement:

> Direct assignment of any subcategory of Category 4.1 Exchange Circuit Equipment to the jurisdictions **shall be updated annually**. (47 CFR § 36.126, (c) (4))[38] (emphasis added)

---

[35] Page 88 of Grate Rebuttal, lines 6-7.

[36] October 30, 1998 FCC "Memorandum Opinion and Order" in CC Docket No. 98-79 (FCC 98-292), paragraphs 1,2 and 25) Interstate "Special access" is a form of interstate "private line" service. The FCC later extended this ruling to carriers other than just GTE. See the November 30, 1998 "Memorandum Opinion and Order" in CC Docket Nos. 98-168, 98-161, 98-167, and 98-103 (FCC 98-317).

[37] See Qwest response to WDA 8-15. In jurisdictional separations (47 CFR FCC Part 36) the term "wideband" is used. The term "broadband" is not used.

[38] The above requirement applies to the "Wideband Exchange Line Circuit Equipment-Category 4.11," which is the category that contains the majority of the DSL circuit equipment direct investment.

The specific account rules say the direct assigned investments "**shall be updated annually".** The specific account rules adopted by the FCC in the Freeze Order are consistent with paragraph 23 of the Freeze Order and the "General" section of Part 36, which I previously discussed.

**Q. Can you summarize the above discussion?**

A. Yes. In summary (1) the FCC discussion in paragraph 23 of the Freeze Order, (2) the specific account rules in Part 36, and (3) the "general" instruction in Part 36 are all contrary to the Qwest interpretation, and are all consistent with each other and consistent with the Staff testimony on the separation of the costs of the interstate DSL service.

The section of the Rules that Mr. Grate relies on (36.3(b)) is a section that does not even mention private line or direct assigned investments.

**Q. On pages 93 and 98 of his Rebuttal, Mr. Grate claims a letter from the FCC "indicates that Qwest is interpreting the Freeze Order in the same manner as the FCC." Does that letter address the issue of the direct assignment of the DSL investment or otherwise address the area of dispute on this issue?**

A. No. That letter from the FCC Staff does not address the direct assignment of the DSL investment or otherwise address the area of dispute on this issue.

---

The wording that "direct assignment … to the jurisdictions shall be updated annually" is the same for all categories of circuit equipment (Categories 4.1, 4.2, and 4.2)[38] and major Cable and Wire Facilities (47 CFR §36.126, (c) (4), (e)(4) and (f)(4)).

According to Qwest data responses,[39] the FCC letter addressed two issues pertaining to the Qwest separations of investments.[40] Those issues were (1) Qwest had filed an original 2000 ARMIS report, but later filed a revised 2000 ARMIS report. In its 2003 filing, Qwest was using information from the original 2000 ARMIS report, instead of from the revised 2000 ARMIS report; and (2) In the original Qwest 2003 filing, Qwest froze the investment dollars in Cable and Wire Facilities categories 2, 3, and 4 at the year 2000 level, as a result all dollar amount changes were added or subtracted from Cable and Wire Facility Category 1 only.

In short, the FCC Staff letter did not mention or address the issue of the direct assignment of the interstate DSL costs.

**Q. On page 97 of his Rebuttal, Mr. Grate alleges that Mr. Dunkel's approach "would create a jurisdictional battle" Has the FCC ever rejected a separations cost study because the company had directly assigned the DSL investments to interstate?**

A. No. In request WDA 20-014 we asked Qwest:

> (a) Can Qwest provide any instances in which the FCC rejected any year 2001 Part 36 Cost Study because (when DSL was used for an Internet connection) DSL-related plant COE investment (i.e. DSLAM,) were directly assigned to interstate in Part 36?
>
> (c) Can Qwest provide any instances in which the FCC rejected any year 2002 or 2003 Part 36 Cost study because (when DSL was used for an Internet connection) DSL-related plant COE investment (i.e. DSLAM) was directly assigned to interstate in Part 36?

[39] Qwest responses to WDA 18-002 and WAS 20-004.
[40] The letter also addressed certain issues pertaining to Billing and Collection services.

(e) Can Qwest provide any instances in which the FCC rejected any year 2001, 2002 or 2003 Part 36 Cost Study because (when DSL was used for an Internet connection) DSL-related plant C&WF investment (i.e. DSLAM) was directly assigned to interstate in Part 36?

Qwest's responses were[41]:

(a) No

(c) No

(e) No

Qwest cannot provide any instance where the FCC has ever rejected a separations cost study because the company had directly assigned the DSL investments to interstate.

**Q. On pages 98 and 99 of his Rebuttal testimony Mr. Grate claims he also has correspondence from NECA "that indicate that Qwest is interpreting the Freeze Order in the same manner as the FCC." Did that letter audit and approve Qwest's separation of DSL costs?**

A. No. The NECA letter did not evaluate Qwest's treatment of DSL service. Instead it was a general letter NECA sent to its member companies in 2001.[42] NECA is an association of ILECs, and it must be remembered that the Part 36 Rules are what must be followed in separations.

**Q. What is NECA's current general recommendation pertaining the direct assignment of DSL investment to the interstate jurisdiction?**

[41] In parts (b), (c), and (f) we asked Qwest to provide supporting documents if they claimed there were any such cases, and Qwest responded "Not applicable".

[42] See footnote 81 in the Grate Rebuttal testimony. Also Qwest provided a copy of that NECA letter in response to Staff discovery WDA 20-002.

A. NECA's recommendation for DSL for the year 2003 Part 36 separations cost studies is:

> Digital Subscriber Line (DSL)
>
> **When used for an Internet connection, DSL service is a wholly interstate special access service tariffed at the federal level. In these instances, the DSL– related plant investments would be directly assigned to interstate in Part 36,** and assigned to the special access element in Part 69. Operating expenses related to the provision of the DSL service would be apportioned following normal part 36 and 69 cost allocation procedures, and are not directly assigned. See the DSL cost guideline paper on NECA's web site for more details. (emphasis added)

The NECA recommendation that contains the above statement is attached hereto as Schedule WDA-S2.[43]

The Qwest DSL services we are addressing in this case are "wholly interstate special access service tariffed at the federal level". (The reason that 100% of the Qwest DSL revenues are assigned to interstate is because it is an interstate tariffed service.)

**Q. On page 98 of his Rebuttal testimony Mr. Grate refers to "...the National Exchange Carrier Association that is responsible for administering the FCC's Access Charge Plans and related Part 36 costs allocations..." Are Qwest's Part 36 cost allocation studies subject to NECA audit or otherwise administered by NECA?**

A. Not since 1991. Prior to that time, Qwest's Part 36 separation studies were subject to NECA audits. However Qwest stopped participating in NECA "pools", and therefore after 1991 the Qwest Part 36 cost studies have no longer been subject to NECA audit or NECA administration.[44]

---

[43] Qwest provided this NECA document in response to request WDA 20-011.
[44] Qwest response to WDA 20-013.

1

2 **Q. On page 103 of his Rebuttal testimony Mr. Grate argues that studies have not been**

3 **done to separately identify the DSL investments. Is this a valid reason for not**

4 **making the adjustment you present?**

5 A. No. In fact Qwest has already identified the direct DSL investment, and provided those

6 figures, as shown on Schedule WDA –14 attached to my Direct Testimony. Those are the

7 investments used in my adjustment. We have the DSL investment figures we need for the

8 adjustment Staff proposes.

9

10 **Q. On page 105 of his Rebuttal testimony Mr. Grate argues the DSL cost adjustment is**

11 **"very one sided." Is it?**

12 A. No. What Qwest is proposing is very one-sided. Under Qwest's filing, the intrastate

13 jurisdiction is assigned the majority of the investments of interstate DSL service, but

14 receive none of the revenues.[45] That is very one-sided.

15

16 Under the Staff proposal the cost and revenues are treated consistently. Under the Staff

17 proposal, neither the revenues, nor the investments for interstate DSL service are in the

18 intrastate jurisdiction.

19 **Q. On page 96 of his Rebuttal testimony Mr. Grate argues that if the Commission**

20 **disagrees with the Qwest interpretation of the Part 36 rules, the Commission**

21 **"could file a petition for declaratory ruling with the FCC. The FCC is**
22 **in a position to ensure that the Separation rules are uniformly applied**

[45] Assigning none of the revenues to intrastate is appropriate, but the DSL investments also should not be allocated to intrastate.

**and that the sum of the interstate in intrastate percentages of the regulated rate base equals 100 percent."**

**Is this a valid argument?**

A. No. Qwest is not the one who decides what the rules are in separations. The Part 36 procedures must be followed. The Part 36 procedures were established in "Joint Board" proceedings in which both State and FCC Commissioners participated. This Commission, the FCC, and Qwest are required to abide by the Part 36 separations procedures. If Qwest is not following the Part 36 procedures in an intrastate proceeding, then the State Commission has the responsibility of enforcing the Part 36 requirements.

In response to discovery, Qwest admitted that in no past general intrastate rate case in Arizona has Qwest submitted its intrastate rate application to the FCC to receive verification from the FCC that the separation rules are uniformly applied and that the sum of the intrastate in intrastate percentages of the regulated rate base equals 100 percent.[46]

## V. "Condition Percent" Used in Reconstruction Cost New Less Depreciation (RCNLD)

**Q. In your Direct Testimony you calculated the "condition percents" to be used in RCNLD. As stated in your direct, these "condition percents" factors are used in the "fair value" rate base calculation, but are not used in the "original cost rate base"**

[46] Qwest response to WDA 20-009.

1 **calculations. In her rebuttal did Ms. Hughes agree that one of your corrections was**

2 **appropriate?**

3 A. Yes. On page 3, lines 4 and 5 she agreed with a major correction which I had presented.

4 As a result she reduced her RCNLD figure by over $912 million. The RCNLD figure in

5 the Hughes Direct Testimony was $4,667,243,928,[47] but the Qwest Rebuttal RCNLD is

6 $3,764,710,307.[48]

7

8 **Q. After that huge correction by Qwest, are there still some areas of disagreement**

9 **pertaining to the RCNLD calculation?**

10 A. Yes. Other than the difference in depreciation lives, Ms. Hughes has two remaining

11 disagreements with my "condition percent" calculation[49]. According to page 6 of the

12 Hughes Rebuttal, these two differences have a combined impact on the RCNLD of $3

13 million based on Staff's depreciation lives and survivor curves.[50]

14

15 **Q. To explain one of these two issues, on page 4 of her Rebuttal testimony Ms. Hughes**

16 **states that for the Buried Cable-Metallic account, you[51] show the remaining life for**

17 **the 1967 and prior vintages as zero but:**

18 **"By comparison, the remaining life in my analysis is held constant at**
19 **0.50 year for the older surviving plant vintages to reflect the fact that**

---

[47] Page 8, Direct Testimony of Nancy Heller Hughes.
[48] Page 6, Rebuttal Testimony of Nancy Heller Hughes. This difference was a result of the Qwest "Condition Percent" changing from 56% in the Qwest Direct Testimony to 45% in the Qwest Rebuttal Testimony, as a result of the correction presented the in Dunkel Direct Testimony.
[49] Starting on page 3 of her Rebuttal Ms. Hughes states that in her Rebuttal "For accounts and vintages that are depreciated using the ELG procedure, the remaining lives and average service lives were calculating using ELG depreciation. For the other vintages, remaining lives and average service lives were calculated using VG depreciation." This is the same as I did in my Direct Testimony, so this is not a difference.
[50] According to Attachment B to the Qwest response to Staff request WDA 21-006, the impact of these two issues on the RCNLD is $9,340,703, based on Qwest's depreciation lives and survivor curves.
[51] If the Qwest proposed life is used.

**although the plant is nearly fully depreciated it is still in service and has some value."**

**Is the above statement a correct description of Ms. Hughes' calculation as contained in her Direct Testimony?**

A. No. My treatment of this issue is exactly the same as Ms. Hughes' treatment in her Direct Testimony. In her Rebuttal Testimony, Ms. Hughes changes her treatment of this issue so that it is now different than what she had put forth in her Direct Testimony. This change by Ms. Hughes is shown below[52]:

Buried Cable-Metallic Account 2423

| | Remaining Life | | |
|---|---|---|---|
| Vintage Years | Hughes' Direct (Exhibit NHH-2, Page 46 of 65 Column (H)) | Dunkel Calculation **If Qwest's[53] Proposed** Life is Used (NHH-2R Page 2, Col. H) | Hughes' Rebuttal (Exhibit NHH-2, Page 46 of 65 Column (H)) |
| ... | | | |
| 1970 | 0.82 | 0.91 | 0.89 |
| 1969 | 0.60 | 0.74 | 0.75 |
| 1968 | 0.42 | 0.50 | 0.50 |
| 1967 | **0.00** | **0.00** | **0.50** |
| 1966 | **0.00** | **0.00** | **0.50** |
| 1965 | **0.00** | **0.00** | **0.50** |
| 1964 | **0.00** | **0.00** | **0.50** |
| 1963 | **0.00** | **0.00** | **0.50** |
| 1962 | **0.00** | **0.00** | **0.50** |
| ... | | | |

[52] For comparison purposes, all columns are calculated using the Qwest-proposed life. However, I do not support the Qwest-proposed life figures.

[53] As discussed elsewhere, I no not agree which the depreciation life Qwest uses for this account. Since the Hughes numbers used the life as proposed by Qwest, for comparison purposes in the above discussion, I used the life as proposed by Qwest, however this does not indicate I accept or approve of that life.

As the above shows, in her Direct Testimony, Ms. Hughes had a "0.00" remaining life for 1967 and earlier vintages. In her Rebuttal Testimony she changed this treatment to show 0.50 remaining life for 1967 and earlier vintages. She then complained that my calculations in this area were in "error", without acknowledging that my treatment of this issue was exactly the **same** as Ms. Hughes' treatment in her Direct Testimony.

There is no real rebuttal issue here. My treatment of this issue was the **same** as what Ms. Hughes had done in her Direct Testimony. The remaining lives I used in my "condition percent" calculation are correctly calculated.[54]

**Q. What is another issue raised by Ms. Hughes?**

A. For three specific accounts, she states that I should not have included the surviving balances for the year 1925 vintage.[55]

In the "condition percent" calculation I used the surviving balance for the 1925 as shown in the Qwest records, but to eliminate this issue I will a remove those 1925 amounts from the "condition percent" calculations of these three accounts. The revised "condition percents" are shown on Schedule WDA-S5. The only changes on that Schedule are the factors for these three accounts.

[54] The remaining lives are correctly calculated for the life and survivor curve used. As discussed elsewhere, I no not agree which the depreciation life Qwest uses for this account. Since the Hughes numbers used the life as proposed by Qwest, for comparison purposes in the above discussion, I used the life as proposed by Qwest, however this does not indicate I accept or approve of that life.

[55] Page 5, Rebuttal Testimony of Nancy Heller Hughes.

1 **Q. What changes have you made to the recommendation and calculation presented in**

2 **your Direct Testimony?**

3 A. I have revised the "percent condition" figure for three accounts. This impacts the "fair

4 value" rate base, but does not impact the "original cost" rate base. I made no other

5 revisions, and no other revisions are appropriate.

6

7 **Q. Does this conclude your Surrebuttal testimony?**

8 A. Yes.

**WDA S1**
Pages 1-3

REDACTED

ARIZONA
DOCKET NO. T-01051B-03-0454 &
T-00000D-00-0672
WDA 20-011
ATTACHMENT: C



NECA

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April 6, 2004

To: Cost Company Pool Participants

**Subject: Submitting 2003 Cost Studies**

Cost Study results for calendar year 2003 and supporting documentation are due to NECA by July 31, 2004. If you have a consultant prepare and submit your cost study, it is very important that they receive your data as early as possible so they can meet this time frame. Timely submission of your cost study is important for these reasons:

- NECA pool integrity is dependent on accurate cost study results reported to the pools on a timely basis.
- Monitoring rate performance and earnings for the test period.
- Recovery of Interstate Common Line Support (ICLS) and Local Switching Support (LSS) under current FCC rules requires submission of annual updates to USAC.
- To allow adequate time for analysis to ensure data accuracy and rules compliance.

When preparing your 2003 Cost Study for submission, please:

✓ Certify your cost study data – Attachment A.

✓ Read the attached guidelines – Attachment B.

✓ Refer to the Loop Count Guide – Attachment C.

Thank you for your cooperation. If you have questions, please contact your NECA Region Member Service Team.

Sincerely,

Carol A. Brennan  R.R. Snopkowski

Attachments
cc: Authorized Consultants

# NATIONAL EXCHANGE CARRIER ASSOCIATION

## COST STUDY CERTIFICATION FORM

I am _____. I hereby certify that I have overall responsibility for the (Title of Certifying Officer or Employee)

preparation of all data in the attached _____ data submission
(Title of Data Submission)

for _____ and that I am authorized to execute this certification.
(Name of Exchange Carrier)

Based on information known to me or provided to me by employees responsible for the preparation of the data in this submission, I hereby certify that the data have been examined and reviewed and are complete, accurate, and consistent with the rules of the Federal Communications Commission.

Date: _____

Certifying Signature: _____

Name: _____

Title: _____

Pursuant to FCC Rules, Section 69.601(c), Exchange Carriers are required to certify Cost Study Data submitted to NECA.

(FCC Rules state that persons making willful false statements in this data submission can be punished by fine or imprisonment under the provisions of the U.S. Code, Title 18, Section 1001.)

**Note: For certification of multiple study areas, complete the information on the reverse side of this page.**

| Study Area Name | Study Area Code | Title of Certifying Officer or Employee |
|---|---|---|
| | | |

Key Issues for Consideration in Preparing 2003 Cost Studies

- Averaging -
  - Major changes in investment resulting from acquisitions/mergers or other large plant additions that are recorded during the study period should be averaged using a method that more reasonably represents the annual investment such as:
    - average of monthly averages
    - average of averages
    - weighted average

    For further details on these methods, please reference Cost Issue 8.8 or contact your Region Member Service Manager.

- Digital Subscriber Line (DSL) - When used for an Internet connection, DSL service is a wholly interstate special access service tariffed at the federal level. In these instances, DSL-related plant investments would be directly assigned to interstate in Part 36, and assigned to the special access element in Part 69. Operating expenses related to the provision of DSL service would be apportioned following normal Part 36 and 69 cost allocations procedures, and are not directly assigned. See the DSL cost guidelines paper on NECA's Website for more details.

- Account 4340 –
  - Amounts reported in Account 4340 for rate base purposes only include deferred taxes associated with TPIS. While account 4340 is used to record operating deferred taxes for both plant related and non-plant related items, FCC rules generally limit amounts of account 4340 used for the interstate rate base calculation to those related to total plant in service.
  - Vintage account level detail should be used in calculating deferred taxes associated with depreciation in order to avoid an over depreciation of plant.
  - A negative balance in Interestate account 4340 is generally not allowed in the rate base under Part 65 rules and will require further review.
  - Non-operating deferred taxes are properly classified to account 4350, net non-current deferred non-operating income taxes. Examples of non-operating deferred taxes include the deferred taxes related to unrealized gains or losses on marketable securities or related to the amortization of goodwill. Companies should ensure that non-operating deferred taxes that should be reported in account 4350 are not improperly reported in account 4340.

- Wideband Cost Categorization –
  - Cost studies should properly identify wideband loops and the associated costs for categorization and allocation. CWF Cat. 2 Wideband investment does not have associated loop counts. For USF reporting, cost study and

settlements, plant re-categorized from CWF Cat. 1 wideband will result in a reduction in loop counts and Cat. 1 loop investment.

- NECA's Loop Count Guide is included in the Cost and Average Schedule Pooling Procedures and the USF Data Collection guidelines. Note that the counting of special access loops reflects that "high capacity" facilities (i.e., with 12 or more voice grade channels) are not counted as loops. (See Attachment C)

➢ General Support Facilities (GSF) – Effective July 1, 2002, companies that use general purpose computers to provide billing and collection services to IXCs will allocate a portion of their interstate GSF costs associated with general purpose computers to the billing and collection category using the Modified Big 3 Expense Factor described in Section 69.307(e). The Modified Big 3 Expense factor excludes any expense apportioned on the basis of allocators that include GSF investment. All remaining GSF investment will continue to be apportioned on the basis of Central Office Equipment, Information Origination/Termination Equipment, and Cable and Wire facilities, combined.

➢ Local Number Portability (LNP) –

- ILECs may recover ongoing costs of porting numbers to other carriers via a company–specific LNP End User Charge filed in the NECA tariff over the tariffed five-year recovery period. After the end user, five-year recovery period expires for an ILEC, any remaining LNP implementation costs will be considered normal network costs and recoverable through normal ratemaking in the state and interstate jurisdictions. ILECs cannot recover through the company–specific LNP End User Charge any costs already recovered as TBNP investment costs.

- ILECs who have not filed for a company specific rate must exclude their costs of providing LNP from their cost study. LNP costs are not recoverable through normal NECA access charges.

➢ Thousands Block Number Pooling (TBNP) - ILECs participating in NECA's traffic sensitive tariff may recover TBNP investment costs over a two-year period, directly assigned to the common line category. TBNP expenses should be directly assigned to the common line element in the year incurred. Examples of TBNP costs that may be recovered are: costs to identify, donate and receive blocks of pooled numbers, costs to create and populate regional and local databases, costs to adapt the number assignment procedures to accommodate number pooling, and shared costs of the TBNP Database Administrator (Neustar). After the recovery period expires for an ILEC, any remaining TBNP implementation costs will be considered normal network costs and will be recoverable through normal ratemaking in the state and interstate jurisdictions. ILECs cannot recover costs as TBNP that are already recovered through an LNP end user charge.

Attachment B

- Nonregulated Costs – Companies that combine nonregulated services with their existing regulated services are required by FCC rules to allocate the cost to these nonregulated services according to Part 64 regulations. Cost associated with nonregulated services are not permitted to be recovered through interstate cost studies. See Nonregulated Cost Guidelines paper on NECA's Members Only Website for more discussion on this issue, particularly as it related to the allocation of loop costs if DSL and video transmissions are provided on a nonregulated basis.

**Last year's Cost Study Letter attachment included additional issues for consideration that are still applicable. A copy of the April 18, 2003 letter and attachments are available on the NECA website in the "Resources" section under "Member Correspondence".**

**For additional cost guidance, see NECA's Cost Issues Manual and Cost Guidelines Papers available on the NECA website in the "Tools" section.**

LOOP COUNT GUIDE FOR USF, COST STUDY, AND COST C PANY POOL REPORTING

Attachment C

All outside study area boundary service (OSAB) lines should ... excluded from the access line count for each category.

| DESCRIPTION | 1.3 LOOPS USF LN 070 (end of period) | TOTAL LOOPS USF LN 060 (end of period) | *COST STUDY LOOPS (average) | COST COMPANY POOL ACCESS LINES (monthly count) | END USER COMMON LINE CHARGE (monthly) |
|---|---|---|---|---|---|
| 1-Party Subscriber Lines (Bus./Res.– includes Lifeline & toll restricted lines) – per line | 1 | 1 | 1 | 1 | 1 |
| Concession Service - per line | 1 | 1 | 1 | 1 | Note (a) |
| Temporary Suspension of Service (Vacation Rate) - per line | 1 | 1 | 1 | 1 | ½ |
| 2-Party Line Bridged in Field (2 lines) | 1 | 1 | 1 | 1 | 2 |
| 2-Party Line Bridged in Central Office (2 lines) | 2 | 2 | 2 | 2 | 2 |
| All Paystations (Customer owned, Telco owned) – per line | 1 | 1 | 1 | 1 | 1 |
| Basic Centrex CO - per station | 1 | 1 | 1 | 1 | 1 |
| Regulated wireless exchange access service provided by ILEC (e. g., BETRS) – per line | 1 | 1 | 1 | 1 | 1 |
| Mobile Telephone/Pager/Cellular Lines | 0 | 0 | 0 | 0 | 0 |
| Official Company Line – per line | 1 | 1 | 1 | 0 | 0 |
| Official Test Lines – per line | 0 | 0 | 0 | 0 | 0 |
| Direct Inward/Outward Dial (Non ISDN) – per line | 1 | 1 | 1 | 1 | 1 |
| 10 Trunks to PBX or Centrex CU with 50 Stations – per trunk | 10 | 10 | 10 | 10 | 10 |
| Off Premises Extension – per line | Note (b) | Note (b) | Note (b) | Note (b) | Note (b) |
| Special Access (e.g. WATS/800, Local Private Line) – per line | 0 | 1 | 1 | 0 | 0 |
| Foreign Exchange Service (FX) – per line | Note (c) | Note (c) | Note (c) | Note (c) | Note (c) |
| ADSL/SDSL Voice/ Data Service | 0 | 0 | 0 | 0 | 0 |
| Special Access SDSL Data Only (up to 768 kbps) – per line | 0 | 1 | 1 | 0 | 0 |
| ISDN Basic Rate Interface (BRI) Arrangement (Count 1 per arrangement) | 1 | 1 | 1 | 1 | 1 |
| ISDN Primary Rate Interface (PRI) Arrangement (Count 5 per arrangement) Note (d) | 5 | 5 | 5 | 5 | 5 |
| Exchange Access Lines to Internet Service Provider – per line | Note (e) | Note (e) | Note (e) | Note (e) | Note (e) |
| Unbundled Subscriber Lines (Count separately from ILEC customer loops) | 1 | 1 | Note (f) | 0 | 0 |
| Resold Lines | 1 | 1 | 1 | 1 | 1 |
| Special Access High Capacity Circuit (DS1,DS3, etc)- Wideband - Note (g) | 0 | 0 | 0 | 0 | 0 |
| Special Access 2 wire voice grade circuit | 0 | 1 | 1 | 0 | 0 |
| Special Access 4 wire voice grade circuit | 0 | 2 | 2 | 0 | 0 |
| SDSL Data Only (above 768 kbps) – Wideband – per line – Note (g) | 0 | 0 | 0 | 0 | 0 |

**NOTES:**

(a) If an EC chooses to bill EUCL, revenue must be reported to NECA pool.
(b) Count line and bill EUCL only if off premises extension is bridged in CO and is billed from EC's local service tariff at a residence or business line rate.
(c) If the closed end of an IntraLATA FX is billed under the local service tariff, count 1 line for all columns. If the closed end of an IntraLATA FX is billed from the special access tariff, count 1 TOTAL LOOP USF LN060, 1 COST STUDY LOOP, and 0 for all other columns.
(d) Includes PBX and Centrex facilities that are provided using ISDN.
(e) The local service line between the local switch and the ISP location is counted in all columns whenever the ISP lines terminate on the EC's switch. For lines provided using derived channel (or trunk-like) facilities, count each voice band equivalent channel carrying calls to the ISP in all columns.
(f) Count 1 if UNE revenue is netted in cost study otherwise count 0.
(g) A wideband channel is a communication channel of a bandwidth equivalent to twelve or more voice grade channels. Wideband facilities are Category 2 investment and are *therefore not counted in any column.*

* Cost study loop count applies to either message loop or private line loop in cost study, depending upon type of service.

4/18/03

**Before the**
**FEDERAL COMMUNICATIONS COMMISSION**
**Washington, D.C. 20554**

| | | |
|---|---|---|
| In the Matter of | ) | |
| | ) | |
| | ) | |
| 1998 Biennial Regulatory Review -- | ) | |
| Review of Depreciation Requirements | ) | CC Docket 98-137 |
| for Incumbent Local Exchange Carriers | ) | |
| | ) | |
| United States Telephone Association's | ) | |
| Petition for Forbearance from Depreciation | ) | ASD 98-91 |
| Regulation of Price Cap Local Exchange | ) | |
| Carriers | ) | |

**REPORT AND ORDER IN CC DOCKET NO. 98-137**
**MEMORANDUM OPINION AND ORDER IN ASD 98-91**

**Adopted: December 17, 1999** **Released: December 30, 1999**

By the Commission, Commissioner Furchtgott-Roth Dissenting and Issuing a Statement, Commissioner Powell Concurring:


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lives as short as eight years for digital switching, arguing that technological change, increased competition, and customer demand for new higher bandwidth services are shortening the lives of switches.[36] Based on our review of the record, we are persuaded that the lower limit of the life range for digital switching should be shortened from the current 16-year minimum to 12 years. We find that this reduction is justified by incumbent LEC accounting data that shows an upward trend in retirements of digital switching equipment in recent years.[37] The increasing retirements are due, in part, to the modular nature of modern digital switches, which allows the incumbent LECs to retire portions of a switch on an interim basis as technology improves.

14. Incumbent LECs also advocate shorter minimum lives for accounts other than digital switching. They contend that our currently prescribed lives are too long and prevent them from recovering adequate depreciation.[38] The incumbent LECs further contend that the Commission's ranges for projection lives are historical and backward-looking. Non-LEC commenters respond that the Commission-prescribed lives are appropriate and forward-looking. They note that the Commission has been reforming its depreciation prescription process since 1980, and that those reforms have resulted in an increase in the composite reserve level from 18.7 percent in 1980 to 48.8 percent in 1997.[39] MCI-WorldCom also notes that the incumbent LECs have been adding over $10 billion to their depreciation reserves each year since the Commission's 1993 depreciation simplification reforms took effect in 1994.[40] We agree with MCI-WorldCom, that, except for digital switching equipment, recent carrier accounting data and trends do not support reductions in the prescribed projection life ranges. Specifically, with the exception of digital switching equipment, incumbent LEC retirement rates have either dropped or remained relatively constant in recent years.[41] This certainly has contributed to the substantial increase in reserve levels that MCI-WorldCom cites.

15. Several incumbent LECs contend that we should adopt the projection lives recommended by Technology Futures, Inc. (TFI).[42] TFI develops its analysis by using the Fisher-Pry model to perform a "substitution analysis" to forecast the pattern by which new technology will replace old technology.[43] TFI's projections about replacement of digital switches, copper loop plant, and circuit equipment extend as far out as 2015.[44] The non-LEC commenters dispute

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at iii.

36 Ameritech Comments at 10; BellSouth Comments at 12.

37 ARMIS Report 43-02, Table B-1. This range is slightly wider than the 13 to 18 range we proposed in *Depreciation Notice* to reflect recent retirement rates and trends.

38 US West Comments at 11; BellSouth Comments at 12; SBC Comments at 22.

39 AT&T Reply at 3; MCI-WorldCom Reply at 7.

40 MCI-WorldCom Reply, Attachment 1 at p. 4.

41 ARMIS Report 43-02, Table B-6.

42 Ameritech Comments at 10; CBT Comments at 7-8; SBC Comments at 21; Sprint Comments at 6. TFI is an economic consulting firm that has analyzed depreciation issues on behalf of the incumbent LECs.

43 Transforming the Local Exchange Network: Analysis and Forecasts of Technology Change by Lawrence K. Vanston, Ray L. Hodges and Adrian J. Poitras at 29 (2d ed. 1997) (*Second TFI Study*).

44 TFI projects the following: fiber in the loop will replace copper feeder cable by 2015, *Id.* at 9; fiber will replace copper in 98 percent of all interoffice trunks by 2000, *Id.* at 8; SONET equipment will replace all non-SONET circuit equipment by 2005, *Id.* at 16; and fiber in the loop will replace copper distribution plant by between 2010 and 2015, *Id.* at 10.

## APPENDIX B

**Summary of Current Prescription Life Ranges and Proposals**
**(In Years)**

| | FCC Prescribed | SBC Proposal | TFI Proposal | BellSouth Proposal |
|---|---|---|---|---|
| Fiber Cable – All Categories | 25 –30 | 20 | 20 | |
| Underground Cable - Metallic | 25 – 30 | 12.5 - 15.5 | 14 - 20 | 10 - 14 |
| Buried Cable – Metallic | 20 – 26 | 18 -19 | 14 - 20 | 12 - 16 |
| Aerial Cable – Metallic | 20 –26 | 13.5 - 16 | 14 - 20 | 12 - 16 |
| Circuit Equipment – Digital | 11 – 13 | 7 - 13 | 6 - 9 | 8 - 10 |
| Switching – Digital | 12 –18 | 7 - 16 | 9 - 12 | 8 - 10 |

**RESPONSES TO STAFF'S FIRST SET OF DATA REQUESTS
TO THE RESIDENTIAL UTILITY CONSUMER OFFICE ("RUCO")
REGARDING QWEST CORPORATION'S PRICE REGULATION PLAN
DOCKET NOS. T-01051B-03-0454/T-00000D-00-0672**

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WDA 1.8 For the buried cable metallic account (Account Number 2423), does RUCO support using a 12 year Projection Life as proposed by Qwest, or the 23 year Projection Life as proposed by the Staff, or other (specify)?

Answer: RUCO has not performed a depreciation study and thus, has no position on this issue.

RESPONSES TO STAFF'S FIRST SET OF DATA REQUESTS
TO THE RESIDENTIAL UTILITY CONSUMER OFFICE ("RUCO")
REGARDING QWEST CORPORATION'S PRICE REGULATION PLAN
DOCKET NOS. T-01051B-03-0454/T-00000D-00-0672

---

WDA 1.9 After reading the Staff testimony, what Projection Lives does RUCO support?

Answer: RUCO has not performed a depreciation study and thus, has no opinion on this issue.

RESPONSES TO STAFF'S FIRST SET OF DATA REQUESTS
TO THE RESIDENTIAL UTILITY CONSUMER OFFICE ("RUCO")
REGARDING QWEST CORPORATION'S PRICE REGULATION PLAN
DOCKET NOS. T-01051B-03-0454/T-00000D-00-0672

WDA 1.10 After reading the Staff testimony, what future "Net Salvage" values does RUCO support?

Answer RUCO has not performed a depreciation study and thus, has no opinion on this issue.

## REPRODUCTION COST NEW LESS DEPRECIATION
### Staff Recommended Depreciation Parameters

| Account Number | Category | | Condition Percent (% of Life Remaining) |
|---|---|---|---|
| 2112 | Motor Vehicles | | 40.36% |
| 2114 | Special Pupose Vehicles | | 27.06% |
| 2115 | Garage Work Equipment | | 64.93% |
| 2116 | Other Work Equipment | | 59.30% |
| 2121 | Buildings | | 59.83% |
| 2122 | Furniture | | 49.46% |
| 2123.1 | Office Equipment | | 19.88% |
| 2123.2 | Company Communications Equipment | | 43.80% |
| 2124 | General Purpose Computer | | 25.81% |
| 2212 | Digital Switching Equipment | | 62.14% |
| 2220 | Operator Systems | | 30.99% |
| 2231 | Radio Systems | | 27.60% |
| 2232 | Circuit DDS | | 37.10% |
| 2232 | Circuit Digital | | 55.05% |
| 2232 | Circuit Analog | | 23.34% |
| 2362 | Other Terminal Equipment | | 58.10% |
| 2411 | Pole Lines | | 63.94% |
| 2421 | Aerial Cable - Metallic | | 37.95% |
| 2421 | Aerial Cable - Non Metallic | | 76.85% |
| 2422 | Underground Cable - Metallic | * | 37.41% |
| 2422 | Underground Cable - Non Metallic | | 75.32% |
| 2423 | Buried Cable - Metallic | * | 50.03% |
| 2423 | Buried Cable - Non Metallic | | 66.75% |
| 2424 | Submarine Cable - Metallic | | 2.26% |
| 2424 | Submarine Cable - Non Metallic | | 0.00% |
| 2426 | Intrabuilding Cable - Metallic | * | 35.11% |
| 2426 | Intrabuilding Cable - Non Metallic | | 75.78% |
| 2431 | Aerial Wire | | 62.60% |
| 2441 | Conduit Systems | | 56.33% |

Note:
* Changes made to remove 1925 vintages from calculation, see Hughes Rebuttal (Exhibit NHH-3R)

# REGAN

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

JEFF HATCH-MILLER, CHAIRMAN
WILLIAM A. MUNDELL
MARC SPITZER
MIKE GLEASON
KRISTIN K. MAYES

| | | |
|---|---|---|
| IN THE MATTER OF QWEST CORPORATION'S FILING OF 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 |

SURREBUTTAL TESTIMONY

OF

THOMAS REGAN

ON BEHALF OF

THE STAFF OF THE ARIZONA CORPORATION COMMISSION

JANUARY 12, 2004

NOTICE: CONFIDENTIAL INFORMATION HAS BEEN REDACTED FROM THIS TESTIMONY.

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

JEFF HATCH-MILLER, CHAIRMAN
WILLIAM A. MUNDELL
MARC SPITZER
MIKE GLEASON
KRISTIN K. MAYES

| | | |
|---|---|---|
| IN THE MATTER OF QWEST CORPORATION'S FILING OF 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 |

SURREBUTTAL TESTIMONY

OF

THOMAS REGAN

ON BEHALF OF

THE STAFF OF THE ARIZONA CORPORATION COMMISSION

JANUARY 12, 2004

NOTICE: CONFIDENTIAL INFORMATION HAS BEEN REDACTED FROM THIS TESTIMONY.

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## I. IDENTIFICATION OF WITNESS AND INTRODUCTION

Q. PLEASE STATE YOUR NAME, OCCUPATION, AND BUSINESS ADDRESS.

A. My name is Thomas M. Regan. I am employed as an economist with the firm of William Dunkel and Associates. My business address is 8625 Farmington Cemetery Road, Pleasant Plains, Illinois, 62677.

Q. ARE YOU THE SAME THOMAS M. REGAN WHO FILED DIRECT TESTIMONY IN THIS PROCEEDING?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. The purpose of my Surrebuttal testimony is to respond to the Testimony of Dr. Johnson filed on behalf of RUCO, to respond to the Direct testimony of Mr. Price filed on behalf of MCI, to respond to the Direct testimony of Mr. Lafferty filed on behalf of Cox, to respond to the Rebuttal testimony of Mr. Teitzel filed on behalf of Qwest, to respond to the Rebuttal testimony of Mr. McIntyre filed on behalf of Qwest and to respond to the Rebuttal testimony of Ms. Million filed on behalf of Qwest in this proceeding.

## II. THE PROPER CALCULATION OF TSLRIC

Q. ON PAGE 21 OF YOUR DIRECT TESTIMONY, YOU STATED THAT THE TSLRIC OF RESIDENTIAL BASIC LOCAL EXCHANGE SERVICE (1FR) IS ** **. DID RUCO'S WITNESS, DR. JOHNSON, ALSO REACH THIS CONCLUSION?

A. Yes. As shown on Dr. Johnson's Table 1 in his testimony, Dr. Johnson has calculated the TSLRIC of residential basic local exchange service to be ** **.

Q. IN YOUR DIRECT TESTIMONY, YOU DEMONSTRATED THAT THE PROPERLY CALCULATED TSLRIC OF BASIC LOCAL EXCHANGE SERVICE DOES NOT INCLUDE ANY OF THE SHARED LOOP OR PORT FACILITY COSTS. DOES RUCO'S ECONOMIST WITNESS ALSO ACKNOWLEDGE THIS PRINCIPLE?

A. Yes. On page 53, lines 5-9,

> Although loop and port costs are required for the provision of local exchange, custom calling, switched access, and toll service, there is no universally accepted method of allocating these costs. Differences in the allocation percentage or method can result in very significant differences in the cost study results. That is one reason why I prefer a "pure" **TSLRIC approach, which doesn't allocate shared costs to individual services**. (emphasis added)

Q. ON PAGE 2, LINE 13 OF HER REBUTTAL, MS. MILLION STATES:

> FIRST, WHILE IT MAY BE TRUE THAT THE OTHER MAJOR SERVICES LISTED BY MR. REGAN ARE PROVIDED OVER QWEST'S LOOP AND PORT FACILITIES, THEY ARE NOT THE REASON FOR QWEST'S DECISION TO INVEST IN THOSE

FACILITIES...QWEST'S DECISION TO INVEST IN ADDITIONAL LOOP AND PORT FACILITIES IS BASED ON THE PROVISIONING OF LOCAL DIAL TONE TO CONSUMERS. MR. REGAN'S SUGGESTION THAT THE APPROPRIATE WAY TO CALCULATE QWEST'S TSLRIC COST FOR BASIC LOCAL EXCHANGE SERVICE IS TO EXCLUDE THE COST OF THE LOOP AND PORT ENTIRELY IGNORES THIS REALITY.

SHOULD THIS COMMISSION ACCEPT MS. MILLION'S IMPLICATION THAT BASIC LOCAL SERVICE REVENUES ARE THE ONLY REVENUES THAT QWEST CONSIDERS WHEN MAKING THE DECISION TO INVEST IN LOOP AND PORT FACILITIES?

A. Absolutely not. Qwest responded **"No"** to my Data Request WDA 19-13(a and b), where I asked Qwest the following questions:

Data Request WDA 19-13:

A. Is it Ms. Million's testimony that Qwest's decision to invest in additional loop and port facilities is based on solely the revenue that Qwest expects to receive for basic local service?

B. Is it Ms. Million's testimony that when Qwest decides to invest in additional loop and port facilities, Qwest does not consider the revenues that it expects to receive from vertical services, switched access or toll services?

Qwest's Response:

A. No.

B. No.

Q. DO YOU HAVE ADDITIONAL EVIDENCE THAT CLEARLY DEMONSTRATES THE FACT THAT QWEST DOES RECOGNIZE THAT SERVICES OTHER THAN JUST BASIC LOCAL SERVICE CONTRIBUTE TO

THE RECOVERY OF QWEST'S TOTAL COSTS OF SERVING ITS CUSTOMERS?

A. Yes. For example, on page 66 of his Rebuttal testimony, Mr. Teitzel is responding to a statement made by RUCO's witness Dr. Johnson. In this response, Mr. Teitzel clearly admits that it is true that "Qwest doesn't rely exclusively on its basic monthly rate to recover its costs". Mr. Teitzel states:

> Dr. Johnson supports his Table 2 by saying 'Qwest doesn't rely exclusively on its basic monthly rate to recover its costs, nor do any of its competitors.' He is correct. Qwest does receive revenues from other services that contribute to the overall cost of serving a customer, just as Qwest's competitors do.

In addition, Qwest's Executive Vice President-Retail Markets for USWC, Inc., C.J. Bernard clearly indicated that Qwest considers the total revenues, not just the basic exchange service revenues:

> In the voice world today that $12 to $14 access line really represents anywhere from $60 to $80 a month as we add those vertical features. The same thing in the data world. That's how any of us in this business think about it.[1]

Ms. Million's implication that Qwest's decision to invest in loop and port facilities is based only on the revenues Qwest expects to receive from basic local exchange service is absolutely false, and should be disregarded.

[1] C.J. Bernard, Executive Vice President-Retail Markets for USWC, Inc. "Turning DSL Into Dough Is The Goal of US WEST", Telecommunications Reports, December 13, 1999, page 35.

## III. THE PROPER IDENTIFICATION OF A "SUBSIDY"

Q. IN ITS REBUTTAL TESTIMONY, QWEST MAKES NUMEROUS CLAIMS REGARDING "SUBSIDIES" THAT QWEST ALLEGES EXIST IN QWEST'S RATES.[2] WHAT MUST BE DEMONSTRATED IN ORDER FOR A SERVICE TO BE PROPERLY CONSIDERED TO BE RECEIVING A "SUBSIDY"?

A. As discussed below, in order for a service to be properly considered to be receiving a subsidy, it must be demonstrated that the rate charged for that service is below the service's properly calculated Total Service Long Run Incremental Cost (TSLRIC). If the rate charged for the service is equal to or above the TSLRIC of the service, the service is not receiving a subsidy.

Q. HAS QWEST ACKNOWLEDGED THE FACT THAT A SERVICE IS NOT RECEIVING A SUBSIDY IF IT IS PRICED EQUAL TO OR ABOVE ITS TSLRIC?

A. Yes. Qwest responded "Yes" to Data Request WDA 19-12(f), where I asked Qwest the following question:

Data Request WDA 19-12:

> F. Is it a correct statement that as long as a service is priced equal to or above its Total Service Long Run Incremental Cost (TSLRIC), that service is not properly considered to be receiving a subsidy?

[2] For example, see Teitzel Rebuttal testimony page ii, page iii, page 34 line 3, page 37 line 18, page 43 line 5, page 45 lines 9, 10 and 18, page 46 line 11, page 56 line 3, page 65 line 19, page 66 line 8, page 67 line 2, page 73 line 10 and Million Rebuttal testimony page 4 line 18, page 5 line 18 and line 21, page 6 lines 5, 15, 18 and 21, page 12 lines 5, 7 and 9, page 15 line 22, page 16 line 3.

Qwest's Response:

F. Yes.

As Qwest acknowledged, a service is not properly considered to be receiving a subsidy as long as the service is priced equal to or above its TSLRIC.

Q. YOU INDICATED THAT A SERVICE IS NOT RECEIVING A SUBSIDY AS LONG AS IT IS PRICED EQUAL TO OR ABOVE ITS TSLRIC. HOWEVER, ARE THE PRICES FOR SERVICES GENERALLY PRICED ABOVE TSLRIC?

A. Yes. Pricing at least equal to TSLRIC prevents a service from being subsidized, however prices for services are generally set above TSLRIC. The reason is that the TSLRIC only includes the costs that are caused directly by the individual service being addressed. Costs that are shared or are common to more than just the individual service being addressed are not included in the TSLRIC. Nevertheless, the shared and common costs must be recovered in the rates charged for services. Therefore, services are generally priced <u>above TSLRIC</u> to contribute toward the shared and common costs. If all services were priced just equal to TSLRIC, it would be correct that no service would be receiving a subsidy, however, the shared and common costs would not be recovered. The prices for services should be set in a manner such that the overall contribution from the whole family of services is sufficiently above TSLRIC to recover the shared and common costs.

Q. THE MAJORITY OF QWEST'S CLAIMS REGARDING "SUBSIDIES" AND "IMPLICIT SUBSIDIES" PERTAIN TO RESIDENTIAL BASIC LOCAL

EXCHANGE SERVICE. CAN YOU DEMONSTRATE THAT QWEST'S RESIDENTIAL BASIC LOCAL EXCHANGE SERVICE DOES NOT RECEIVE ANY "SUBSIDIES" OR "IMPLICIT SUBSIDIES"?

A. Yes. There is a specific economic test that is used to determine whether or not a service is receiving a subsidy. As long as a service is priced equal to or above its properly calculated TSLRIC, the service cannot properly be said to be receiving a subsidy. As I indicated in my direct testimony, the TSLRIC of residential basic local exchange service is ** ** per month[3], and the rate charged for residential basic local exchange service is $13.18 per month.[4] Qwest's residential basic local exchange service cannot properly be said to be receiving any subsidy. Therefore, every one of Qwest's numerous claims that residential basic local exchange service receives a "subsidy" or "implicit subsidy" are completely false, and should be disregarded.

## IV. THE ARIZONA UNIVERSAL SERVICE FUND (AUSF)

Q. ON PAGE 57, LINE 6 OF HIS TESTIMONY, DR. JOHNSON DISCUSSES DIRECTORY ADVERTISING REVENUES. HE STATES THAT THE DIRECTORY ADVERTISING REVENUES "CAN APPROPRIATELY BE CONSIDERED IN EVALUATING THE EXTENT TO WHICH QWEST CAN

[3] Regan Direct testimony, page 21, line 13.
[4] Regan Direct testimony, page 13, line 18.

1 PROFITABLY SERVE CUSTOMERS AT CURRENT RATES." DO YOU
2 AGREE WITH DR. JOHNSON?
3 A. Yes. I agree that directory advertising revenue is important to consider when
4 assessing the profitability of serving customers. However, the "overall analysis"
5 that I originally presented in my Direct testimony does not include imputed
6 directory advertising revenues. As discussed below, I have now incorporated
7 imputed directory advertising revenues into my "overall analysis" of Qwest's
8 intrastate revenues and intrastate costs by UNE Zone. My revised "overall
9 analysis" that incorporates the imputed directory advertising revenues is attached
10 hereto as Schedule TMR-S1. Schedule TMR-S1 replaces my original "overall
11 analysis" which was presented on my Direct testimony Schedule TMR-3.
12 Therefore, my Direct testimony Schedule TMR-3 is no longer a valid schedule.
13
14 Q. ON PAGE 66 OF HIS REBUTTAL TESTIMONY, MR. TEITZEL INDICATES
15 THAT QWEST SOLD ITS DIRECTORY ADVERTISING BUSINESS OVER
16 ONE YEAR AGO. SHOULD DIRECTORY ADVERTISING REVENUES
17 CONTINUE TO BE CONSIDERED WHEN ASSESSING THE PROFITABILITY
18 OF SERVING QWEST'S CUSTOMERS?
19 A. Yes. As Mr. Teitzel discusses beginning at page 66, line 4 of his Rebuttal
20 testimony, pursuant to a settlement agreement, Qwest imputes $72 million of
21 directory advertising revenue to its intrastate revenue requirement analysis. Under
22 the settlement agreement, Qwest agreed that the $72 million directory revenue

imputation would be included within all reporting to the Commission of Qwest's Arizona intrastate earnings.[5]

Q. HOW MUCH REVENUE DOES THE DIRECTORY ADVERTISING IMPUTATION ADD ON A PER LINE, PER MONTH BASIS?

A. The $72 million annual directory imputation represents about $2.53[6] per billable access line, per month in revenue.[7]

Q. HAVE YOU REVISED YOUR "OVERALL ANALYSIS" TO RECALCULATE THE LEVEL OF SURPLUS/SHORTFALL FOR EACH OF THE UNE ZONES WHEN THE IMPUTED DIRECTORY ADVERTISING REVENUE IS ADDED TO THE INTRASTATE REVENUES?

A. Yes. The results of my revised "overall analysis", including imputed directory advertising revenues, are shown on Schedule TMR-S1, attached hereto. Schedule TMR-S1 replaces the analysis that I filed with my Direct testimony as Schedule TMR-3. Schedule TMR-3 is no longer a valid schedule.

The results of my "overall analysis" are now as follows:

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[5] ACC Docket No. T-0105B-02-0666, *Decision No. 66230*, Exhibit A "Stipulation", starting at page 2, line 26.

[6] $72,000,000 divided by 12 months, divided by 2,367,173 total billable access lines (See FCC Armis Annual Summary Report 43-01, Row 2150, for the year 2003) = $2.53.

[7] The "overall analysis" does not include all billable access lines. For example, large business lines (e.g. Centrex lines) are not included in the "overall analysis". Therefore, the amount of imputed directory advertising revenues included in my "overall analysis" is actually less than $72 million.

[11] The added lines have the USOC codes ** ** on pages 2,3 and 4 of Schedule TMR-S1.

**Zone 1:** Qwest's annual intrastate revenues exceed Qwest's annual intrastate costs by a surplus of over ** **.

**Zone 2:** Qwest's annual intrastate revenues exceed Qwest's annual intrastate costs by a surplus of over ** **.

**Zone 3:** Qwest's annual intrastate revenues exceed Qwest's annual intrastate costs by a surplus of nearly ** **.

**Statewide:** Qwest's annual intrastate revenues exceed Qwest's annual intrastate costs by a surplus of over ** **.

Q. ABOVE, YOU INDICATED THAT YOU HAVE REVISED YOUR "OVERALL ANALYSIS" TO INCORPORATE IMPUTED DIRECTORY ADVERTISING REVENUES. HAVE YOU MADE OTHER MINOR REVISIONS TO YOUR "OVERALL ANALYSIS"?

A. Yes. I have made several other minor revisions to my "overall analysis". These revisions include the following:

1. Certain residential lines were inadvertently omitted in my original "overall analysis". My revised "overall analysis" incorporates the previously omitted lines.[11]

2. The residential revenue for intrastate toll and intrastate switched access were inadvertently applied to business package (e.g. packages that bundle 1FB service with vertical features) lines in UNE Zones 1 and 2. This revision does not impact my "overall analysis" for UNE Zone 3. My revised "overall analysis" applies the business revenues for intrastate toll and intrastate switched access to business package lines.[12]

3. Various minor formatting changes were made. For example, on page 3 of the original "overall analysis", various text inadvertently appears in the Column headed "UNE Zone". This Column is intended to specify the UNE Zone that is being analyzed. In the revised "overall analysis", the inadvertent text has been replaced by the appropriate UNE Zone indicators.

4. Page 1 of the original "overall analysis" summarized data contained elsewhere in the "overall analysis". This page has been omitted in the

[12] For example, one of the business packages that needed this revision has the USOC ** **, as shown on pages 2 and 3 of Schedule TMR-S1.

revised "overall analysis". The figures used on this page can be found on pages 3 and 4 of the revised analysis Schedule TMR-S1.

Q. WHAT DOLLAR IMPACT DO THE FOUR ADDITIONAL REVISIONS YOU DESCRIBED ABOVE HAVE ON YOUR "OVERALL ANALYSIS"?

A. Only revisions 1 and 2 described above impact the dollar amounts in the "overall analysis". These revisions have very little impact on the results of the "overall analysis". In total, these revisions described above result in an increase in the surplus of ** ** annually statewide.[13]

Q. ON PAGE 12 OF HER REBUTTAL, MS. MILLION DISCUSSES THE FACT THAT IN YOUR "OVERALL ANALYSIS" PRESENTED IN YOUR DIRECT TESTIMONY, YOU CALCULATED A $4.6 MILLION SHORTFALL FOR UNE ZONE 3. DOES THIS SHORTFALL STILL EXIST IN YOUR REVISED "OVERALL ANALYSIS"?

A. No. As shown on page 1 of Schedule TMR-S1 attached hereto, each of Qwest's three UNE Zones have annual intrastate revenues that exceed Qwest's annual intrastate costs. Schedule TMR-S1 is my revised "overall analysis", which replaces my previous "overall analysis presented on my Direct testimony Schedule TMR-3. Schedule TMR-3 is no longer a valid schedule.

[13] **

**

As shown on page 1 of Schedule TMR-S1, UNE Zone 3 now has a surplus of about ** **. The primary reason that UNE Zone 3 went from a shortfall of ** ** to a surplus of ** ** is the addition of the imputed directory advertising revenues.[14]

Q. ON PAGE 65, LINES 12-15 OF HIS REBUTTAL TESTIMONY, MR. TEITZEL STATES:

> INTERESTINGLY, EVEN STAFF WITNESS MR. REGAN IDENTIFIED A REVENUE SHORTFALL OF OVER $4.6 MILLION IN THE ZONE 3 WIRE CENTERS, AND MR. REGAN'S CALCULATIONS ARE BASED ON AN EXTREMELY CONSERVATIVE SET OF ASSUMPTIONS REGARDING HOW TSLRIC COSTS SHOULD BE CALCULATED IN HIS ANALYSIS.

PLEASE COMMENT.

A. First of all, the $4.6 million shortfall that Mr. Teitzel is referring to is the result of the "overall analysis" that I presented in my Direct testimony. In this Surrebuttal testimony, I have revised my "overall analysis" to include imputed directory advertising revenues.[15] The results of the revised analysis show that there is no revenue shortfall in any of Qwest's three UNE Zones, as shown on Schedule TMR-S1.

[14] Of the approximate ** ** increase, nearly ** ** of the increase is from the addition of the imputed directory advertising revenues.

[15] I made several other minor revisions, but these other changes have a very small impact on UNE Zone 3 (i.e. an increase in surplus of about ** **).

Secondly, Mr. Teitzel's comments regarding a "conservative set of assumptions regarding how TSLRIC costs should be calculated" appears to be referring to the "Code Analysis" I presented in my Direct testimony, not the "overall analysis" that I presented. The "Code Analysis" compares the TSLRIC of basic local exchange service to the "benchmark rates" defined by the Code (i.e. the sum of the rates for basic local exchange service and the interstate EUCL charge).[16]

The "overall analysis" does not limit costs to just the TSLRIC costs. The "overall analysis" includes all of Qwest's intrastate costs of providing the whole family of services that are provided using Qwest's loop and port facilities. The "Overall Analysis" does include the intrastate loop and port costs. Therefore, Mr. Teitzel's comments are simply misplaced, and irrelevant with respect to my "overall analysis".

Q. BEGINNING ON PAGE 9, LINE 12 OF HER REBUTTAL TESTIMONY, MS. MILLION IS DISCUSSING YOUR "OVERALL ANALYSIS", AND THEN ON PAGE 10, LINE 3 OF HER REBUTTAL, MRS. MILLION STATES:

> IF THE PURPOSE OF MR. REGAN'S ANALYSIS IS TO COMPARE THE RETAIL REVENUES FOR A 1FR SERVICE TO THE TSLRIC COSTS FOR THAT SERVICE, THEN IT SHOULD USE THE TSLRIC COSTS BASED ON RETAIL FACTORS, NOT UNE RATES THAT WERE DEVELOPED USING WHOLESALE FACTORS.

DO YOU HAVE A RESPONSE?

[16] Qwest would not receive any AUSF support following the analysis required by the Code, as discussed on page 13, line 24 of my Direct testimony.

A. Yes. First of all, it is **not** the purpose of my **"overall analysis"** to "compare the retail revenues for a 1FR service to the TSLRIC costs for that service". Ms. Million has failed to recognize the distinction between the two separate analyses I have presented in this proceeding. The **"Code Analysis"** that I have presented in my direct testimony compares the TSLRIC of basic local service to the "benchmark rates" for basic local service (i.e. the sum of the monthly rate for basic local service and the End User Common Line Charge), not the **"overall analysis"**.[17] The cost of shared facilities **are not** properly included in the TSLRIC of a service, and are therefore not included in the "Code Analysis" I have presented.[18]

However, the **"overall analysis"** that I have presented is completely separate from, and totally unrelated to, the "Code Analysis". The "overall analysis" I have presented compares all intrastate revenues to all of the intrastate costs of serving customers.[19] The intrastate costs used in the "overall analysis" are not limited to just TSLRIC costs. The costs used in the "overall analysis" are the total intrastate costs, which includes the intrastate costs of the loop and port facilities, and also includes other shared and/or common costs.

Q. IN THE ABOVE QUOTE, MS. MILLION CRITICIZES YOUR USE OF THE COMMISSION'S APPROVED UNE LOOP AND PORT RATES IN YOUR "OVERALL ANALYSIS", BECAUSE SHE SAYS THAT THOSE RATES WERE

[17] See Regan Direct testimony, page 14, lines 1-11.
[18] As I pointed out on page 23, lines 18-26 of my Direct testimony, Qwest has specifically acknowledged the fact that the TSLRIC does not include shared costs.
[19] My presentation of the "overall analysis" begins on page 26 of my Direct testimony.

CALCULATED USING "WHOLESALE FACTORS" INSTEAD OF "RETAIL FACTORS". IS THIS A VALID CRITICISM?

A. No. The loop and port facilities are not retail services. The loop and port are facilities that are *used to provide* retail services, but they are not, in themselves, services. In docket FCC 96-325, CC Docket No. 96-98, et. al., Released August 8, 1996 (Local Competition Order), the FCC specifically addressed the issue of whether UNEs are properly identified as facilities, or "services". The FCC specifically found that UNEs are <u>not</u> services. This is clear from the FCC's Local Competition Order[20], which states that:

> Moreover, we agree with those commenters that argue that network elements are defined by facilities or their functionalities or capabilities, and thus, **cannot be defined as specific services.** A single network element could be used to provide many different services. **For example, a local loop can be used to provision inter- and intrastate exchange access services, as well as local exchange services.** (citations omitted, emphasis added) (Paragraph 264)
>
> We premised the latter view on **the definition of the term "network element," as a facility and not a service,...** (citations omitted, emphasis added) (Paragraph 343)
>
> **The incumbent LEC offerings to be priced using this methodology generally will be "network elements," rather than "telecommunications services," as defined by the 1996 Act.** ...The **costs of local loops** and their associated line cards in local switches, for example, **are common with respect to interstate access service and local exchange service**, because once these facilities are installed to provide one service they are able to provide the other at no additional cost. **By contrast, the network elements, as we have defined them, largely correspond to distinct network facilities.** (citations omitted, emphasis added) (Paragraph 178)

[20] *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; Interconnection between Local Exchange Carriers and Commercial Mobile Radio Service Providers*, CC Docket No. 96-98; CC Docket No. 95-185, 11 FCC Rcd 15499; 1996 FCC LEXIS 4312; 4 Comm. Reg. (P & F) 1, August 8, 1996 Released; Adopted August 1, 1996 ("Local Competition Order").

1 The UNE loop and port costs that I used in the "overall analysis" were calculated
2 by starting with the Commission's approved UNE loop and UNE port rates.[21] I
3 then determined the intrastate portions of the UNE loop and port using
4 jurisdictional separations.[22] However, for the costs of the retail services that I
5 included in my "overall analysis" (e.g. basic local exchange service, toll, switched
6 access, vertical features, etc.), I used the "Fully Allocated TSLRIC" costs that were
7 filed by Qwest in this proceeding.[23] According to Ms. Million, the "Fully Allocated
8 TSLRIC" costs that Qwest has filed in this proceeding are calculated using Qwest's
9 proposed "retail factors".[24] Therefore, I have used "retail factors" for the costs of
10 retail services, and I have used the Commission's approved UNE loop and UNE
11 port rates for the costs of the loop and port facilities.
12
13 Q. DOES THE FEDERAL UNIVERSAL SERVICE FUND ADDRESS THE ISSUE
14 OF PROVIDING SUPPORT FOR HIGH COST LOOPS?
15 A. Yes. The Federal Universal Service Fund provides "High Cost Loop Support" to
16 those carriers that have high loop costs.[25] Therefore, the issue of high cost loops is
17 already being addressed at the Federal level.[26] In fact, the Commission's rules
18 require that AUSF funding is to be provided "net of any universal service support

[21] Ms. Million's proposed "retail factors" have not been approved by the Commission.
[22] Regan Direct testimony, page 27, line 21 through page 28, line 9.
[23] Regan Direct testimony, page 28, lines 14-17.
[24] Million Rebuttal testimony, page 10, lines 1-6.
[25] See the FCC's "High-Cost Support" discussion in Section 3 of the FCC's Universal Service Monitoring Report, October 2004.
[26] Despite the fact that Qwest's loop costs are already being addressed under the current Federal Universal Service Fund system, as discussed beginning on page 26 of my Direct testimony, I have performed an "overall analysis" that considers Qwest's total intrastate costs of serving its customers, including the intrastate costs of Qwest's loop and port facilities. The results of the "overall analysis" demonstrate that Qwest's total intrastate revenues exceed Qwest's total intrastate costs in each of Qwest's three UNE Zones. Therefore, the conclusion to be drawn is the Qwest does not need any additional support to recover its intrastate costs in any of its three UNE Zones..

from federal sources."[27] The Arizona Commission has found that federal funding should be pursued as "the primary source of high cost support." The Commission specifically found:

> In addition, the Commission's rules require that AUSF funding is to be provided "net of any universal service support from federal sources". This rule clearly intends AUSF to supplement FUSF and, implicitly, that **federal funding should be pursued as the primary source of high cost support rather than AUSF** being provided as a precursor to FUSF funding. (emphasis added, citations omitted)[28]

As I pointed out on page 33 of my Direct testimony, Qwest does not receive any Federal high cost loop support in Arizona under the current Federal high cost loop system. It would make little sense to conclude that the "supplement" to federal support should provide $64 million per year in high cost support, while "the primary source of high cost support" concludes that Qwest does not need high cost loop support.

Q. BEGINNING AT PAGE 7, LINE 7 OF HER REBUTTAL TESTIMONY, MS. MILLION STATES THAT YOUR "CONCLUSION THAT THE LOOP AND PORT COSTS SHOULD BE EXCLUDED FROM THE AUSF CALCULATION CANNOT BE CORRECT BECAUSE IT DOESN'T MAKE SENSE...." WHY DOES IT MAKE SENSE TO EXCLUDE THE COSTS OF THE LOOP AND PORT IN THE AUSF ANALYSIS THAT YOU HAVE PERFORMED IN

[27] A.A.C. Rule 14-2-1202.A.

[28] Arizona Corporation Commission Decision No. 64011 in Docket No. T-02532A-00-0512, September 5, 2001, page 19, lines 18-21.

COMPLIANCE WITH THE ARIZONA ADMINISTRATIVE CODE (I.E. THE "CODE ANALYSIS")?

A. It makes sense to exclude the costs of the loop and port in the "Code Analysis" I have performed, because: (1) the Code requires that the TSLRIC be used in the AUSF analysis, as discussed on page 23, line 33 of my Direct testimony. The TSLRIC excludes the costs of shared facilities. Since the loop and port are facilities that are shared by the whole family of services that are provided using the loop and port facilities, they are properly excluded from the TSLRIC of basic local exchange service. (2) the "Code Analysis" includes only the revenues from basic local exchange service and the interstate EUCL.[29] There are many other services that share the loop and port facilities with basic local exchange service, and the revenues from those other services contribute toward the recovery of the shared costs of the loop and port facilities. If the costs of the shared loop and port facilities were to be included in the analysis, but all of the revenues that contribute toward the recovery of the shared costs of the loop and port facilities are not also included, the result would be a misleading mismatch of costs and revenues. (3) As I discussed above, The Federal Universal Service Fund provides high cost loop support to those carriers that have high loop costs. Therefore, the issue of high cost loops is <u>already being addressed</u> at the Federal level. In fact, the Arizona Commission has found that federal funding should be pursued as "the primary source of high cost support." and that the AUSF is intended to be a "supplement" to the Federal USF.

[29] Regan Direct testimony, page 13.

Q. DID ANOTHER WITNESS IN THIS PROCEEDING ALSO STRESS THE IMPORTANCE OF PROPERLY MATCHING COSTS AND REVENUES WHEN THE COSTS OF SHARED FACILITIES ARE INCLUDED IN AN ANALYSIS?

A. Yes. RUCO's economist witness Dr. Johnson stresses the importance of matching costs and revenues when shared costs[30] are included in an analysis. For example, on page 70 of his Direct testimony, Dr. Johnson states:

> Despite using the TSLRIC label, Qwest includes joint costs in its analysis. Furthermore, it mismatches all of its joint costs with only a portion of the revenues it receives that provide support for those costs.

On page 71, lines 17-21 of his Direct testimony, Dr. Johnson states:

> I strongly dispute the notion that total costs should be compared to just a subset of the revenues that result from the decision to serve these customers. An appropriate matching of revenues and costs is crucial for meaningful results. If total costs (including joint costs) are to be considered in the analysis, then total revenues should also be considered, including revenues from toll, access, and features.

On page 42 of his Direct testimony, Dr. Johnson states:

The LECs have many revenue sources which help cover these joint costs, including toll, switched access, and custom calling. Carriers have long relied upon all of these different revenue sources in order to pay their loop costs. The loop facilities used in providing local exchange service are also required for (and used by) other services that local carriers provide, including interstate switched access, intrastate switched access, intrastate toll, custom calling, and Caller ID service. The poles, cable, drop wire, line card, and channel connection are equally required for the

[30] Dr. Johnson refers to the loop facilities as being a "joint cost".

provision of these other services, and there is no logical reason to impose the entirety of these costs onto just one of the services benefiting from them.

Q. ON PAGE 10 OF HER REBUTTAL, MS. MILLION CRITICIZES THE FACT THAT YOU INCLUDED ONLY THE INTRASTATE PORTIONS OF THE LOOP AND PORT COSTS IN YOUR "OVERALL ANALYSIS". MS. MILLION ARGUES THAT YOU SHOULD HAVE ALSO INCLUDED THE INTERSTATE LOOP AND PORT COSTS AND THE INTERSTATE REVENUES IN THE "OVERALL ANALYSIS". DO YOU AGREE?

A. No. As I discussed beginning on page 24, line 18 of my Direct testimony, the USF being addressed in this proceeding is an intrastate USF. A comparison of Qwest's intrastate revenues and intrastate costs should logically provide the Commission with an accurate depiction of Qwest's intrastate USF needs.

Q. IN YOUR DIRECT TESTIMONY, YOU POINTED OUT THAT MS. MILLION'S USE OF WHAT SHE CALLS THE "FULLY-ALLOCATED COSTS" IN HER CALCULATION OF AUSF SUPPORT VIOLATES THE ARIZONA ADMINISTRATIVE CODE'S REQUIREMENT THAT AUSF SUPPORT BE CALCULATED USING TSLRIC.[34] DID COX'S WITNESS MR. LAFFERTY ALSO POINT OUT THIS FLAW IN THE QWEST ANALYSIS?

A. Yes. On page 47, line 9 of his Direct testimony, Cox witness Mr. Lafferty states:

[34] Regan Direct testimony, page 23, line 29.

Qwest witness Million's choice of fully-allocated costs violates the specific requirement that Qwest use TSLRIC to calculate its costs.

On page 48, line 3 of his Direct testimony, Mr. Lafferty states that using Qwest's claimed TSLRIC instead of Qwest's claimed fully-allocated costs in the AUSF analysis reduces Qwest's AUSF draw from $64.04 million to "no more than $24.5 million.

Q. DOES MS. MILLION'S CALCULATION OF AUSF SUPPORT SUFFER FROM ANOTHER CRITICAL FLAW THAT MR. LAFFERTY DID NOT ADDRESS?

A. Yes. Mr. Lafferty recognized the fact that in its AUSF analysis, Qwest is using what Qwest calls the "fully allocated costs" instead of what Qwest calculates as the "TSLRIC" of basic local exchange service. However, Mr. Lafferty failed to recognize that even the TSLRIC that Ms. Million uses in her AUSF analysis is seriously flawed. Qwest's seriously flawed calculation of the "TSLRIC" of basic local exchange service is the key reason that Qwest calculates its enormous $64 million claimed support funding need from the AUSF

As discussed beginning on page 16 of my Direct testimony, Ms. Million's claimed TSLRIC of basic local service includes 100% of the loop facility costs, and includes 100% of the port facilities costs. The loop and port facilities are examples of facilities whose costs are shared among the whole family of Qwest's major services. Qwest requires the loop and port facilities to deliver vertical features to end users, to provide IXCs with switched access services, and to provide end-users

with toll services. In this proceeding, Qwest has acknowledged the concept that the properly calculated TSLRIC of a service excludes the costs of shared facilities.[35] However, when Qwest calculates its claimed TSLRIC of basic local exchange service, Qwest refuses to acknowledge the fact that the loop and port facilities are shared by a number of Qwest's major telecommunications services.

The costs of the loop and port facilities are not included in a proper calculation of the TSLRIC of any of these major services, as discussed more fully beginning on page 16 of my Direct testimony.

Q. ON PAGE 66, LINE 15 OF HIS REBUTTAL TESTIMONY, MR. TEITZEL IS RESPONDING TO RUCO WITNESS DR. JOHNSON'S DIRECT TESTIMONY WHEN HE STATES:

> DR. JOHNSON SUPPORTS HIS TABLE 2 BY SAYING: 'QWEST DOESN'T RELY EXCLUSIVELY ON ITS BASIC MONTHLY RATE TO RECOVER ITS COSTS, NOR DO ANY OF ITS COMPETITORS.' HE IS CORRECT. QWEST DOES RECEIVE REVENUES FROM OTHER SERVICES THAT CONTRIBUTE TO THE OVERALL COST OF SERVING A CUSTOMER, JUST AS QWEST'S COMPETITORS DO. HOWEVER, THE REVENUE GENERATED BY CUSTOMERS IN THE HIGHEST COST WIRE CENTERS IS NOT SUFFICIENT TO COVER QWEST'S COSTS OF PROVIDING SERVICE TO THOSE CUSTOMERS. THIS FACT IS THE DRIVER OF QWEST'S AUSF PROPOSAL.

PLEASE RESPOND.

A. In the above referenced quote from Mr. Teitzel's Rebuttal testimony, Mr. Teitzel implies that Qwest's AUSF proposal is driven by an analysis that includes

[35] See Regan Direct testimony, page 23, lines 23-26 and Million Direct, beginning at page 19, line 16.

"revenues from other services that contribute to the overall cost of serving a customer". Mr. Teitzel's statement is misleading. Mr. Teitzel's statement implies that Qwest did an "overall analysis" that included all Qwest revenues, but Qwest did not. Qwest's AUSF analysis that resulted in a $64 million AUSF support request[36] includes all of the shared costs of the loop and port facilities, but does not include all of the revenues from the services that share and contribute to the cost of the loop and port facilities.[37]

Qwest's AUSF analysis only includes the revenues from basic local exchange service and the interstate EUCL charge, as does my "Code Analysis". However, unlike Qwest's proposed AUSF analysis, my "Code Analysis" compares these limited revenues to the properly calculated TSLRIC of basic local exchange service, as required by the Arizona Administrative Code. The properly calculated TSLRIC of basic local exchange service does not include the costs of shared facilities (e.g. the loop and port facilities).

Since Qwest's AUSF analysis includes the costs of the shared loop and port facilities, but excludes the considerable revenues that Qwest receives from other services that contribute toward the overall cost of serving a customer[38], what Qwest has proposed is a misleading mismatch of revenues and costs.

[36] Teitzel Rebuttal testimony, page 65, line 9.
[37] Regan Direct testimony, page 26, line 2.
[38] The other services include switched access services, toll services and vertical services.

In addition to the "Code Analysis", I have presented a separate and unrelated additional AUSF analysis, which I call the "overall analysis". My proposed "overall analysis" includes all of the intrastate costs of the loop and port facilities, and includes the revenues from all of the intrastate services that share the loop and port facilities.[39] Therefore, my "overall analysis" properly matches total intrastate revenues to total intrastate costs. The results of my "overall analysis" are presented on my Surrebuttal Schedule TMR-S1, attached hereto.

Q. ON PAGE 39, LINE 13 OF HIS REBUTTAL TESTIMONY, MR. TEITZEL STATES:

> REGARDLESS OF WHETHER THE COST OF THE LOOP IS CONSIDERED JOINT, COMMON OR A DIRECT COST, QWEST NEEDS TO HAVE A REASONABLE OPPORTUNITY TO RECOVER THIS COST.

DOES QWEST HAVE A "REASONABLE OPPORTUNITY" TO RECOVER ITS LOOP COSTS?

A. Yes. As shown on page 1 of Schedule TMR-S1 attached hereto, Qwest's total intrastate revenues exceed Qwest's total intrastate costs[40] by over ** **. In Zone 1, Qwest's total intrastate revenues exceed Qwest's total intrastate costs by over ** **. In Zone 2, Qwest's total intrastate revenues exceed Qwest's total intrastate costs by over ** **. In Zone 3, Qwest's total intrastate revenues exceed Qwest's total intrastate costs by nearly ** **.

[39] Regan Direct testimony beginning at page 27, line 12.
[40] The total intrastate costs include the intrastate portions of the shared loop and port facilities costs.

1 Qwest's allegation that it does not have a reasonable opportunity to recover its
2 shared loop facility costs is the result of failing to look at the overall picture of
3 Qwest's costs and revenues. Qwest's analysis looks at all of Qwest's shared loop
4 and port costs and just a portion of Qwest's revenues that contribute toward the
5 recovery of Qwest's shared loop and port costs. A proper comparison of Qwest's
6 intrastate revenues and intrastate costs clearly demonstrates that Qwest is
7 recovering all of its intrastate costs.
8
9 Q. ON PAGE 31, LINES 12-14 OF HIS REBUTTAL TESTIMONY, MR. TEITZEL
10 CRITICIZES YOUR ANALYSIS OF QWEST'S AUSF PROPOSAL, BECAUSE
11 YOU HAVE FOCUSED ON QWEST'S COST STRUCTURE AND
12 "VIRTUALLY IGNORE" COSTS FACED BY QWEST'S COMPETITORS.
13 PLEASE COMMENT.
14 A. First of all, one of the purposes of this proceeding is to determine whether or not
15 Qwest needs support funding from the AUSF. It seems logical that Qwest's need
16 for support should be based on a comparison of Qwest's costs to serve customers
17 and Qwest's revenues that Qwest uses to recover those costs. Therefore, it is not
18 clear how or why Qwest's competitor's costs would be used to calculate AUSF
19 support needs for Qwest.
20
21 Q. ON PAGE 33 OF HIS REBUTTAL TESTIMONY, MR. TEITZEL COMPARES
22 QWEST'S AUSF PROPOSAL WITH AN APPLICATION FOR A

DISBURSEMENT FROM THE AUSF MADE BY MIDVALE TELEPHONE EXCHANGE, INC. DO YOU BELIEVE THAT A COMPARISON OF QWEST AND MIDVALE IS RELEVANT WITH RESPECT TO THE ISSUE OF AUSF DISBURSEMENTS?

A. No. Midvale Telephone Exchange, Inc. ("Midvale") is a very small telephone company. Under the Arizona Administrative Code, AUSF disbursements for small telephone companies like Midvale are calculated using a completely different formula than they are for a large telephone company like Qwest.

At the time of the application that Mr. Teitzel is referring to, Midvale had fewer than 700 lines in service.[42] Under the Arizona Administrative Code, Midvale is considered a "small local exchange carrier".[43] Under the Arizona Administrative Code, the calculation of AUSF support for a "small local exchange carrier" like Midvale is performed using the formula and process described in Section R14-2-1202(B) of the Code.

Under the Arizona Administrative Code, the calculation of AUSF support for a "large local exchange carrier" like Qwest is performed using the formula and process described in Section R14-2-1202(A) of the Code.[44] The "Code Analysis" that I have presented in my Direct testimony for Qwest, is the AUSF calculation

[42] FCC's Universal Service Monitoring Report, October 12, 2004, Table 3.33 "Number of Loops by Study Area"), for the year 2000.
[43] Section R14-2-1201(13) indicates that a "Small Local Exchange Carrier" is an incumbent provider of basic local exchange telephone service serving 20,000 or fewer lines in Arizona.
[44] Section R14-2-1201. "Definitions", defines "Large Local Exchange Carriers" as incumbent providers of basic local exchange telephone service serving 200,000 or more access lines in Arizona.

that specifically applies to a "Large Local Exchange Carrier" under the Arizona Administrative Code. There is no other ILEC in Arizona that is a "Large Local Exchange Carrier". Qwest is the only incumbent provider of basic local exchange service serving 200,000 or more access lines in Arizona.[45]

Q. ON PAGE 33 OF HIS REBUTTAL TESTIMONY, MR. TEITZEL ARGUES THAT MIDVALE RECEIVED A "WAIVER" OF THE COMMISSION'S AUSF RULES IN ORDER TO RECEIVE ITS AUSF DISBURSEMENT. HOW DOES MIDVALE'S AUSF DISBURSEMENT COMPARE TO QWEST'S REQUESTED DISBURSEMENT FROM THE AUSF?

A. As indicated on page 33, line 21 of his Rebuttal testimony, Midvale's annual draw from the AUSF is $71,651. This is a far cry from the $64 million in annual AUSF funding that Qwest is requesting in this proceeding. Quite simply, Qwest's request for a "waiver" from following the Commission's AUSF rules to receive AUSF funding would place a much larger burden on the AUSF than the Midvale annual draw to which Mr. Teitzel refers.

In addition, as Mr. Teitzel indicates on page 33, lines 4-7 of his Rebuttal, Midvale applied for AUSF funding so that Midvale could begin serving two communities that were unserved areas at that time. Midvale was asking for AUSF support until federal USF funding became available for those areas. Midvale indicated that it expected that it would eventually receive federal USF support for these new areas,

[45] For example, see the FCC's Universal Service Monitoring Report, October 12, 2004, Table 3.33 "Number of Loops by Study Area".

but that the federal support would not be available to Midvale until several years after Midvale began providing service to these new areas.[46]

On page 33, lines 12-15 of his Rebuttal, Mr. Teitzel states that the Commission found that a waiver of the AUSF rules for Midvale was in the public interest. However, it is important to understand that Midvale wanted AUSF funding so that it could begin serving two communities that were unserved areas at that time. It is clear that the Commission found it in the public interest to do what it could to encourage carriers like Midvale to make the investments necessary to begin serving unserved areas.

Qwest has expressed no intent to use AUSF funds to provide new services to unserved areas. Therefore, from a public interest perspective, Qwest's AUSF proposal in this proceeding is much different than Midvale's request for AUSF funding.

## V. INTRASTATE SWITCHED ACCESS SERVICE

Q. ON PAGE 7 OF HIS REBUTTAL, MR. MCINTYRE STATES THAT THE COMMISSION HAS INDICATED THAT HAVING QWEST'S INTRASTATE SWITCHED ACCESS RATES REACH PARITY WITH THE INTERSTATE RATES IS A "LAUDABLE GOAL". ON PAGE 8, MR. MCINTYRE STATES THAT THE COMMISSION SHOULD BALANCE THIS GOAL WITH "THE

[46]ACC Decision No. 64011 in Docket No. T-02532A-00-0512, September 5, 2001, page 20, lines 9-15.

CURRENT SITUATION IN ARIZONA AND DETERMINE THE CURRENT STATE OF PROGRESS TOWARD THIS GOAL." IS YOUR INTRASTATE SWITCHED ACCESS PROPOSAL A REASONABLE BALANCE OF REACHING PARITY WITH THE INTERSTATE RATES WHILE ALSO CONSIDERING PUBLIC POLICY CONCERNS?

A. Yes. As I discussed in my Direct testimony, my switched access proposal will effectively bring Qwest to "parity" with the Qwest interstate switched access rates (when the interstate EUCL charges are factored into the calculation of the interstate switched access rates).[47] The interstate switched access charges are priced so much lower because those rates are supported by end-user charges called End User Common Line (EUCL) charges.[48] The Commission has specifically expressed concern about imposing a EUCL charge in the intrastate jurisdiction. The Commission stated:

> While we agree that achieving parity between intrastate and interstate switched access rates is a laudable goal, there are many other public policy issues that impact our ability to reach that goal, such as the desirability of imposing an End User Common Line charge.[49]

By factoring in the interstate EUCL charges into the interstate rates, my proposed rates balance the goal of achieving parity with the interstate rates, while also addressing the Commission's public policy concern regarding imposing an EUCL charge on end users.

[47] Regan Direct testimony, page 39.
[48] Regan Direct testimony, page 35.
[49] Commission Opinion and Order in Docket No. T-01051B-99-0105 et. al, page 12, October 20, 2000.

1 Q. ON PAGE 6, LINE 3 OF HIS REBUTTAL TESTIMONY, MR. MCINTYRE
2 ADDRESSES YOUR COMPARISON OF INTRASTATE SWITCHED ACCESS
3 CHARGES ACROSS QWEST'S 14-STATE SERVICE REGION.[50] MR.
4 MCINTYRE CLAIMS THAT YOUR COMPARISON OF RATES IS FLAWED
5 BECAUSE IT DOES NOT ADDRESS THE DIFFERENCES IN REGULATORS'
6 PUBLIC POLICIES REGARDING THE "SUBSIDIES" THAT INTRASTATE
7 SWITCHED ACCESS SERVICE PROVIDES TO BASIC LOCAL SERVICE. IS
8 THIS A VALID CRITICISM OF YOUR ANALYSIS?
9 A. No. The foundation of Mr. McIntyre's argument (i.e. that intrastate switched access
10 rates "subsidize" basic local exchange service) is factually incorrect. As I have
11 already discussed, the proper test for a subsidy is to compare the rate for the service
12 to the properly calculated TSLRIC of that service. If the rate for the service is
13 equal to or above the TSLRIC, the service is not receiving a subsidy. Both
14 RUCO's economist witness and myself have concluded that the TSLRIC of
15 residential basic local exchange service is ** **. The rate for
16 residential basic local exchange service is $13.18. Therefore, residential basic local
17 exchange service is not subsidized by any service. Qwest's residential basic local
18 exchange rate covers its TSLRIC and makes a contribution above TSLRIC toward
19 the shared and common costs of providing the whole family of services to
20 customers. Quite simply, the basis for Mr. McIntyre's claim is factually incorrect.
21 Therefore, Mr. McIntyre's criticism is not valid.
22

[50] This analysis is shown on page 2 of my Direct testimony Schedule TMR-5.

1 Q. ON PAGE 3 OF HIS DIRECT TESTIMONY, MCI'S WITNESS MR. PRICE
2 ARGUES THAT QWEST'S INTRASTATE SWITCHED ACCESS RATES ARE
3 ABOVE "COST". IS THERE ANYTHING WRONG WITH RATES BEING
4 ABOVE THE "COST" THAT MR. PRICE IS REFERRING TO?
5 A. No. A service must be priced equal to or above its TSLRIC in order to prevent the
6 service from being subsidized. The "cost" that Mr. Price is referring to is the Total
7 Service Long Run Incremental Cost (TSLRIC).[51] Prices for services are generally
8 priced above their TSLRIC. The reason that services are generally priced above
9 TSLRIC is because the TSLRIC does not include any shared or common costs. In
10 discovery, MCI admitted that if Qwest's intrastate switched access rates were set
11 equal to TSLRIC, the intrastate switched access rates would not make any
12 contribution toward Qwest's shared, joint or common overhead costs.[52] Quite
13 simply, the appropriate price for a service is generally above the TSLRIC to provide
14 a contribution to shared and common costs.
15
16 In discovery, Mr. Price indicated that it is not his position that all of Qwest's
17 services should be priced equal to TSLRIC.[53] Apparently, Mr. Price believes that
18 just the rates that his client pays should be priced at a level that would no make any
19 contribution toward Qwest's shared, joint or common overhead costs. Mr. Price's
20 position is unreasonable and unfair. All of Qwest's services (including basic local
21 exchange service, toll services, switched access services, vertical services, etc.)

[51] MCI's response to WDA Data Request 1-3(a).
[52] MCI's response to WDA Data Request 1-3(c),
[53] MCI's response to WDA Data Request 1-3(d).

should be priced above TSLRIC in order to provide some contribution toward Qwest's shared, joint or common overhead costs.

Q. ON PAGE 9 OF HIS REBUTTAL, MR. MCINTYRE CLAIMS THAT QWEST'S PROPOSED $5 MILLION INTRASTATE SWITCHED ACCESS REDUCTION IS MORE VALID THAT THE STAFF'S PROPOSED $8.9 MILLION REDUCTION BECAUSE THE $5 MILLION "HAS ALREADY BEEN PLANNED FOR IN TERMS OF THE RATE ADJUSTMENTS NECESSARY TO DEVELOP THIS REVENUE REDUCTION." MR. MCINTYRE THEN STATES THAT ANY ADDITIONAL REVENUE REDUCTION IN SWITCHED ACCESS BEYOND THIS $5 MILLION "WOULD REQUIRE ADDITIONAL ANALYSIS AND RATE CALCULATIONS." HAS THE STAFF DETERMINED THE RATE ADJUSTMENTS NECESSARY TO ACHIEVE ITS PROPOSED $8.9 MILLION REDUCTION?

A. Yes. The Staff's proposed rates for intrastate switched access are shown on my Direct testimony Schedule TMR-5. The $8.9 million reduction is the result of applying an across the board reduction of ** ** to each of the switched access rate elements shown on Schedule TMR-5. Mr. McIntyre failed to specify what "additional analysis and rate calculations" he believes should be performed, or why he believes they would be necessary.

Q. ON PAGE 9, LINE 9 OF HIS REBUTTAL, MR. MCINTYRE CLAIMS THAT ANY INTRASTATE SWITCHED ACCESS REDUCTIONS BEYOND QWEST'S

1 $5 MILLION REDUCTION "MUST BE OFFSET WITH AN INCREASE IN
2 OTHER RATES." DOES THE STAFF'S PROPOSAL IN THIS PROCEEDING
3 ADDRESS THIS CONCERN?
4 A. Yes. As discussed on page 13, beginning on line 1 of Mr. Rowell's Direct
5 testimony, Staff has proposed to increase the revenue cap on Basket 3 to account
6 for Staff's proposed switched access reduction.
7
8 Q. ON PAGE 14 OF HIS DIRECT TESTIMONY, MCI'S WITNESS MR. PRICE
9 STATES:
10 ...THERE IS NO NON-ARBITRARY WAY TO ALLOCATE
11 "RESPONSIBILITY" FOR THE COST OF THE LOOP PLANT
12 BETWEEN QWEST'S TRADITIONALLY REGULATED SERVICE
13 AND THE OTHER SERVICES PROVIDED OVER THE LOOP...IN
14 TODAY'S ENVIRONMENT WHERE BOTH REGULATED AND
15 UNREGULATED SERVICES CAN BE PROVIDED BY QWEST OVER
16 THESE LOOP FACILITIES, HOWEVER, THE ONLY RATIONAL WAY
17 TO SOLVE SUCH DISPUTES IS FOR THE END USER TO BEAR ALL
18 COSTS ASSOCIATED WITH THE LOOP.
19
20 IS MR. PRICE'S PROPOSED LOOP ALLOCATION REASONABLE?
21 A. No. Mr. Price is proposing an "arbitrary" allocation that is unreasonable and unfair
22 to end-users. Mr. Price's position is that determining how much each user or each
23 service that uses the loop facilities should contribute to the costs of the loop
24 facilities is not simple and is often controversial, so therefore the easiest solution is
25 to place the full burden on end users. Basically, Mr. Price is arguing that his client,
26 MCI, should be allowed to use the loop facilities for free, and have end users foot
27 the entire bill for the loop facilities costs. Mr. Price's proposed allocation is

arbitrary, egregious, unreasonable and unfair to end users. Mr. Price's position should be rejected.

Q. IN FOOTNOTE 20 OF HIS DIRECT TESTIMONY, MR. PRICE DISCUSSES A PLAN PROPOSED BY A GROUP COMPRISED OF INCUMBENT LECS, RURAL CARRIERS, COMPETITIVE LECS, NEXT GENERATION NETWORK PROVIDERS AND WIRELESS CARRIERS, WHERE THE LOOP COSTS WOULD BE RECOVERED DIRECTLY FROM END USERS. MR. PRICE CLAIMS THAT SINCE THESE "DISPARATE" COMPANIES CAN AGREE ON THIS ISSUE, THIS DEMONSTRATES THAT THERE IS A "CONSENSUS" REGARDING HOW THE COSTS OF THE LOOP FACILITIES SHOULD BE RECOVERED. DO YOU AGREE?

A. No. Noticeably missing from Mr. Price's "consensus" is any representation on behalf of the end users who would be left holding the bill for the loop facilities under the "plan" he describes. It is not difficult to obtain a "consensus" that someone else should pay for something that you would like to rent. For example, assume that three men decide to share a cab. Further assume that two of the men talk amongst themselves and reach a "consensus" that the third man should pay for the entire cab ride. The third man, who would be stuck paying the full bill for the cab would not likely be happy about this "consensus". This is exactly the type of "consensus" that Mr. Price is describing.

Q. BEGINNING ON PAGE 30, LINE 25 OF HIS DIRECT TESTIMONY, MR. PRICE DISCUSSES THE CARRIER COMMON LINE CHARGE (CCLC) FOR SWITCHED ACCESS SERVICE. MR. PRICE CLAIMS THAT THE CCLC "REPRESENTS A REAL COST OF SERVICE TO MCI, BUT NOT TO QWEST". DO YOU AGREE?

A. No. The CCLC is Qwest's charge for providing IXCs with Carrier Common Line Access Service. Qwest's tariff describes Carrier Common Line Access Service as follows:

> Carrier Common Line Access Service provides for the use of Company common lines by customers for access to end users to furnish intrastate telecommunications service.[54]

The "common lines" are the loop facilities owned by Qwest. Qwest's investment in loop facilities is one of Qwest's most significant investments in Arizona. Qwest has many expenses associated with constructing and maintaining its loop facilities. The IXCs want to share the loop facilities with other services so that the IXCs can provide toll services to their end users. The IXCs should pay for renting the loop facilities. I agree with the National Association of Regulatory Utility Commissioners (NARUC), when they stated:

> Interexchange carriers should pay a portion of the NTS loop cost because they use the LECs loop to provide their services.[55]

In the real world, there is no such thing as a "free ride" or "free rent". In the real world, if you want to rent a facility, you must pay rent for that facility, or work out some

[54] Qwest Arizona Access Service Price Cap Tariff, Section 3.1.
[55] Page 13, Initial Comments of the National Association of Regulatory Utility Commissioners, CC Docket No. 96-262, January 29, 1997.

arrangement with the owner of the facility where something of value can be provided to the owner of that facility in exchange for renting that facility.

Q. ON PAGE 36, LINE 26 OF HIS DIRECT TESTIMONY, MR. PRICE STATES THAT QWEST'S INTRASTATE SWITCHED ACCESS RATES DO NOT APPLY TO WIRELESS CARRIERS. DO WIRELESS CARRIERS PAY ACCESS CHARGES?

A. Yes. If a wireless customer calls a landline telephone, the wireless carrier does pay terminating access charges to the LEC for wireless calls that originate outside of the wireless carrier's local calling area (Major Trading Area ("MTA")).[58] Therefore, for wireless calls that originate outside of the wireless carrier's local calling area, the wireless carriers do pay switched access charges just as the IXCs do.

The wireless carriers do not pay access charges for calls <u>within</u> the MTA, because calls within the MTA are effectively considered local calls.

Q. ARE THERE ANY VALID DIFFERENCES BETWEEN WIRELESS CARRIERS AND INTEREXCHANGE CARRIERS THAT JUSTIFY HAVING INTEREXCHANGE CARRIERS PAY QWEST FOR INTRASTATE SWITCHED ACCESS, WHILE WIRELESS CARRIERS DO NOT PAY QWEST INTRASTATE SWITCHED ACCESS CHARGES FOR CALLS WITHIN THE MTA?

[58] FCC 96-325, First Report and Order, CC Docket No. 96-98, Released August 8, 1996, paragraph 1043.

A. Yes. In a nutshell, Qwest and wireless carriers both own valuable loop facilities that they can trade access to rather than charging each other for it. The IXCs do not own loop facilities, so they cannot make a similar trade of access with Qwest. Instead, the IXCs make a payment of access charges to Qwest in exchange for renting the Qwest loop facilities.

The wireless carriers own and maintain "loop" facilities. Radio equipment is required, expensive frequency licenses must be purchased, etc. There is still a "loop" cost, even if that loop is provided using radio facilities. The wireless carriers own and maintain the cellular towers used to originate and terminate wireless-to-landline and landline-to-wireless calls. When a Qwest customer terminates a call to a wireless customer, the wireless carrier is providing Qwest with access to the wireless carrier's loop facility. In this scenario, Qwest owns the loop facility on the originating end of the call and the wireless carrier owns the loop facility on the terminating end of the call.

When a wireless customer terminates a call to a Qwest customer, Qwest is providing the wireless carrier with access to Qwest's loop facility. In this scenario, the wireless carrier owns the loop facility on the originating end of the call and Qwest owns the loop facility on the terminating end of the call.
Therefore, Qwest and wireless carriers own valuable loop facilities that they can trade access to rather than charging each other for it. This is why it is common for wireless carriers and LECs to have arrangements where the wireless carriers and

LECs exchange terminating access services between each other's networks rather than making an actual monetary payment to each other.[59]

In contrast, IXCs do not own their own loop facilities. When an IXC provides a toll call, the IXC is using someone else's loop facilities (either a wireless carrier's loop facilities or an LEC's loop facilities, or a combination of both) on **both the originating and terminating ends** of the call. Quite simply the IXCs have little or no loop facilities of their own to provide to Qwest in exchange for allowing the IXCs to rent Qwest's loop facilities. Therefore, it is appropriate for the IXCs to make a payment to Qwest for using the Qwest loop facilities.

## VI. ZONE INCREMENT CHARGES

Q. ON PAGE 44, LINE 12 OF HIS DIRECT TESTIMONY, MR. TEITZEL STATES THAT THE ACC SHOULD RETAIN THE CURRENT ZONE INCREMENT STRUCTURE IF THE ACC DENIES QWEST'S AUSF PROPOSAL. DO YOU AGREE WITH THIS PROPOSAL?

A. Yes. As I discussed on page 35 of my Direct testimony, the current Zone increment charges are properly serving the purpose of defraying at least part of the costs in high cost areas. Therefore, I agree with Mr. Teitzel's proposal to maintain the current Zone Increment Charge structure if the ACC does indeed reject Qwest's request for AUSF support. My recommendation is that the ACC should reject Qwest's request for AUSF support.

[59] Or it will be a lower payment than the intrastate switched access rates are.
[61] Million Direct testimony Exhibit TKM-01, page 2.

## VII. DIRECTORY ASSISTANCE

Q. ON PAGE 45, LINE 1 OF HIS REBUTTAL, MR. TEITZEL STATES

> STAFF'S CONSULTANT, MR. REGAN, SUGGESTS THAT QWEST SHOULD CONTINUE TO PROVIDE FREE DIRECTORY ASSISTANCE CALLS BASED ON HIS VIEW THAT THE QWEST DIRECTORY ASSISTANCE ("DA") PRODUCT IS MARGINALLY PROFITABLE.

DID YOU EVER SAY THAT QWEST'S DA SERVICE IS "MARGINALLY PROFITABLE"?

A. No. On page 42 of my Direct testimony, I stated that Qwest's current DA rates (including free call allowance calls) provide contribution of over ** ** above Qwest's proposed "Fully Allocated TSLRIC" cost. Qwest's proposed TSLRIC for Qwest's DA service is even lower than Qwest's proposed "Fully Allocated TSLRIC" cost.[61] Qwest's Local DA service provides contribution of over ** ** above Qwest's proposed "TSLRIC".[62]

In addition, it is important to understand that both Qwest's TSLRIC and "Fully Allocated TSLRIC" include cost of money (i.e. a return on investment). In response to Data Request WDA 20-15(a and b), Qwest acknowledged the fact that Qwest's "Fully Allocated TSLRIC" includes a 9.61% cost of money. Therefore, the contribution of over ** ** above "Fully Allocated TSLRIC" is over and above the cost that already includes return on investment.

---

[62] (**

**

1 In addition, on pages 42-44 of my Direct testimony, I explained that Qwest has
2 provided no valid support for eliminating the one free call allowance for DA.
3
4 Q. ON PAGE 45, LINE 7, MR, TEITZEL STATES "QWEST RECEIVES NO
5 REVENUE FOR DA CALLS PROVIDED WITHIN THE EXISTING FREE
6 CALL ALLOWANCE, AND THE COST OF THOSE CALLS MUST BE
7 SUBSIDIZED BY DA CALLS FOR WHICH A FEE IS CHARGED." IS IT
8 ACCURATE TO DESCRIBE THE FREE CALL ALLOWANCE AS A
9 "SUBSIDY"?
10 A. No. Qwest's claimed TSLRIC of Local Directory Assistance "Local DA"
11 is ** ** per call.[63] The average revenue per Local DA call (including the
12 current free call allowance calls) is ** ** per call.[64] Therefore, Qwest's Local
13 DA service provides contribution of over ** ** above Qwest's proposed
14 "TSLRIC", even after considering the free call allowance calls.[65] The current
15 Qwest Local DA rates are well above the TSLRIC. Therefore, DA service does not
16 require a subsidy from any other service.
17
18 Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?
19 A. Yes.

[63] Million Direct testimony Exhibit TKM-01, page 2.
[64] Regan Direct testimony, page 42, line 14.
[65] As discussed on page 42, line 15 of Regan Direct testimony, the current Local DA rates (including free call allowance calls) provide a contribution of over ** ** above Qwest's proposed "Fully Allocated TSLRIC" cost. Qwest's proposed TSLRIC is ** ** Qwest's proposed "Fully Allocated TSLRIC" cost.

REDACTED

Arizona
T-01051B-03-0454 and T-00000D-00-0672
NDA 19-003

INTERVENOR: William W. Dunkel and Associates

REQUEST NO: 003

With reference to page 3, lines 3-5 of her Rebuttal testimony, Ms. Million states:

For example, whether calculating price floors for retail services or UNE rates for unbundled elements Qwest's cost studies include the entire cost of the loop and the port in the cost of the service or element.

A. Is it Ms. Million's testimony that Qwest includes the entire cost of the loop and the port in the cost of switched access when calculating price floors for switched access services?

B. Is it Ms. Million's testimony that Qwest includes the entire cost of the loop and the port in the cost of Caller ID service when calculating price floors for Caller ID service?

C. Is it Ms. Million's testimony that Qwest includes the entire cost of the loop and the port in the cost of any vertical features services when calculating price floors for those vertical features service? If yes, please specify for which vertical features services Qwest includes the entire cost of the loop and the port in the cost of those features when calculating price floors for those services.

D. Is it correct that Qwest includes the entire cost of the loop and the port in the cost of residential basic local exchange service when calculating price floors for residential basic local exchange service?

E. Is it correct that residential basic local exchange service is the only residential service for which Qwest includes the entire cost of the loop and the port in the in the cost of a residential service when calculating price floors? If the response is no, please provide a complete list of each residential service for which Qwest includes the entire cost of the loop and the port in the in the cost of that residential service when calculating price floors for that service.

RESPONSE:

A. No.

B. No.

C. No.

D. Yes.

E. Yes. However, in addition to the basic primary and additional access line service, residential basic local exchange service may be included in packages that contain additional products or services.

Respondent: Richard Buckley, Jr.