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BEFORE THE ARIZONA CORPORATION COMMISSION

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

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

NOTICE OF FILING TESTIMONY

Pursuant to the procedural order issued on August 26, 2005, the ARIZONA UTILITY INVESTORS ASSOCIATION (AUIA) hereby submits the initial testimony of Walter W. Meek in support of the proposed Settlement Agreement.

Respectfully submitted, this 6th day of September, 2005.

Walter W. Meek, President

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CERTIFICATE OF SERVICE

An original and 15 copies of the referenced testimony
filed this 6th day of September, 2005, with:

Docket Control
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Copies of the referenced testimony
hand delivered this 6th day of September, 2005, to:

Jeff Hatch-Miller, Chairman
Dean Miller, Executive Assistant
William A. Mundell, Commissioner
Adam Stafford, Executive Assistant
Mark Spitzer, Commissioner
Philip Dion, Executive Assistant
Mike Gleason, Commissioner
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Parties of Record

WALTER W. MEEK

DOCKET NO. T-01051B-03-0454

SETTLEMENT TESTIMONY OF WALTER W. MEEK

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SETTLEMENT TESTIMONY OF WALTER W. MEEK

I. INTRODUCTION, QUALIFICATIONS AND PURPOSE OF TESTIMONY

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

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

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

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

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

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

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

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

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

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

Q. ARE YOU TESTIFYING AS AN EXPERT WITNESS?

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

Q. HAVE YOU FILED TESTIMONY PREVIOUSLY IN THIS DOCKET?

A. Yes. AUIA filed my rebuttal testimony on December 20, 2004.

Q. ARE YOU WITHDRAWING THAT TESTIMONY?

A. No. I request that it remain a part of the record in this proceeding.

Q. WHAT IS THE OVERALL PURPOSE OF THIS TESTIMONY?

A. I am testifying in support of the settlement agreement that is proposed to define an amended and renewed price regulation plan for Qwest Corporation.

Q. IS AUIA A SIGNATORY TO THE SETTLEMENT AGREEMENT?

A. Yes. I have signed the agreement on behalf of AUIA.

Q. CAN YOU SUMMARIZE THE ELEMENTS OF YOUR TESTIMONY?

A. Yes. I will start by reviewing the reasons why AUIA supports the settlement agreement, including a brief discussion of how and whether it addresses certain concerns we raised in our rebuttal testimony. Next, I will comment on eight key elements of the settlement agreement and the price cap plan. Finally, I will discuss consumer benefits that flow from the agreement and indicate the various reasons why the Arizona Corporation Commission should support the settlement. Throughout my testimony, I will refer to the settlement agreement and the price cap plan interchangeably because a serious attempt was made by the parties to eliminate the possibility of any conflicting language and to make the two documents conform.

II. <u>THE SETTLEMENT BENEFITS QWEST AND ITS CUSTOMERS.</u>

Q. IN GENERAL, WHY DOES AUIA SUPPORT THE SETTLEMENT?

A. As I indicated in my rebuttal testimony, Qwest is in dire need of an infusion of new revenue to make up for some of the market share it has lost during the period of the current price cap plan. In addition, the company needs more flexibility in pricing and packaging its services in order to compete effectively with other telecom providers. The settlement agreement addresses both of these issues to some degree.

Q. DOES THE AGREEMENT PROVIDE A PERMANENT SOLUTION TO QWEST'S COMPETITIVE PROBLEMS?

A. I don't believe so. I would characterize the amended price cap plan that is proposed here as triage rather than major corrective surgery.

Q. WHAT IS NEEDED IN THE LONG TERM?

A. In its rebuttal testimony, AUIA supported Qwest's concept of designating competitive zones in which virtually all services would be free of price regulation. At some point, I believe the Commission must confront the realities of the competitive market as it has developed and modify its regulatory regime in a significant way. However, in shaping this agreement, the settling parties agreed that now is not the time to pursue that concept and the settlement prohibits Qwest from renewing that proposal during the period of the amended price cap plan.

Q. HOW DO CUSTOMERS FARE UNDER THE SETTLEMENT?

A. Apart from specific consumer benefits which I will discuss later, there are two broad areas of consumer interest that result from the settlement. First, the key elements of the agreement are designed to provide Qwest with more financial stability. That is an unrecognized but critical benefit to consumers who rely on Qwest to maintain the backbone of telecom service in Arizona and to act as the provider of last resort. Second, in spite of its potential benefits to Qwest, the settlement does not impose a general rate increase on Qwest's customers, which is the end result of most utility rate cases.

Q. WHAT IS THE IMPACT OF THE PROPOSED REVENUE INCREASE?

A. In the first place, the authorized increase in revenues ($31.8 million in the first year of the new price cap plan) is very nominal in comparison with Qwest's total annual revenues. In the second place, the settlement agreement only grants Qwest the *opportunity* to generate greater revenue through increased sales and/or selective price increases on some of its services. There is no guarantee that Qwest will realize any amount of increased revenue as a result of flexible pricing.

Q. IS THIS OUTCOME DIFFERENT FROM TYPICAL UTILITY RATEMAKING?

A. Yes. It is true that in Arizona, a regulated utility is never given more than an opportunity to earn an authorized return. But in a typical rate decision, an electric, gas or water utility would be granted a specific set of rates that are designed to produce that return under prudent management and normal operating conditions. In this case, Qwest will be on its own to determine how to price its services to produce the desired economic result while striving to remain competitive in the marketplace.

Q. HOW IS THE OUTCOME DIFFERENT FOR CONSUMERS?

A. There is no general rate increase that everyone has to pay. In practice, the only customers who will contribute to the higher revenue stream are those who purchase the specific services or packages of services that are subject to price increases. In most cases, if not all, that will be an individual decision. If the resulting prices are not acceptable to consumers, they can decline to buy the services or in many cases, they can turn to a competitive provider.

III. KEY ELEMENTS OF THE SETTLEMENT AGREEMENT

Q. ARE THERE SPECIFIC ELEMENTS OF THE SETTLEMENT AGREEMENT THAT YOU WOULD LIKE TO DISCUSS?

A. Yes. I will discuss eight elements of the agreement seriatim.

- **Basket Arrangement and Contents**

The settlement agreement proposes to rearrange the service baskets to give Qwest more room to maneuver in pricing and packaging its products. Basket 1 continues to house basic services, which are hard-capped at their current price levels. Under the agreement, Basket 2 would contain retail services that are given limited pricing flexibility. Price increases for these services cannot exceed 25 percent in any 12-month period. Basket 3 continues to hold competitive services that are flexibly priced, except that there is an overall cap on revenue increases from that basket. Wholesale services are moved from Basket 2 to a new Basket 4.

As a part of the move toward increased flexibility, the parties agreed to transfer some services from Basket 1 to Baskets 2 and 3. Examples include Additional Lines, PBX Trunks, DID Service and Custom Calling Features, which move to Basket 2, and Basic Service Packages, Market Expansion Line and Uniform Access Solution Service, which move to Basket 3.

These changes give Qwest additional revenue potential within the limits described below.

- **Inflation/Productivity Adjustment**

The settling parties agreed that the inflation/productivity adjustment applied to Basket 1 services in the current price cap plan should be eliminated. This device is anachronistic and because it is designed to suppress earnings, it has become punitive to the company. However, the settlement agreement provides that Qwest is responsible for the April 1, 2005 adjustment and accounts for that by reducing Qwest's revenue opportunity by $12 million in the first year of the amended price cap plan.

- **Switched Access Charges**

The settlement agreement provides for a permanent annual reduction in switched access charges of $12 million. However, the parties also agreed that this reduction should be revenue neutral to Qwest, with a resulting impact on Qwest's pricing opportunities described below. While there may not be a dollar-for-dollar impact, this reduction will result in lower costs for some consumers.

- **Authorized Revenue Increases**

The settlement agreement authorizes Qwest to increase its annual jurisdictional revenues by $31.8 million. As I noted earlier, this does not occur through a general rate increase, but through the opportunity for Qwest to price some of its services in ways that will produce greater revenues. Qwest's pricing opportunity is modified in the following ways:

The authorized revenue increase of $31.8 million is enlarged by $12 million as an offset to the switched access reduction, bringing the total of the increased revenue opportunity to $43.8 million. However, in the first year of the plan, Qwest's pricing opportunity is also reduced by $12 million to account for the April 1, 2005 inflation/productivity adjustment, bringing it down to $31.8 million.

The overall pricing opportunity of $43.8 million would be allocated between Baskets 2 and 3, as follows: a maximum of $13.8 million to Basket 2 and $30 million to Basket 3, plus any unused portion of the Basket 2 allocation.

However, in the first year, the Basket 2 allocation would be limited to $1.8 million as a consequence of the inflation/productivity adjustment for

April 1, 2005.

The settlement agreement requires Qwest to file a schedule of minimum-maximum rates for its services in Baskets 2 and 3 within 30 days of the entry of a Commission order in this proceeding. This requirement is in response to a recent appellate court decision regarding the Commission's responsibility for utility price-setting.

- **Rate of Return**

The settlement agreement calls for an overall rate of return of 9.5 percent. Staff's direct testimony dealing with capital costs recommended the same rate of return based on an actual capital structure of 75 percent debt and 25 percent equity, applied to a cost of debt of 7.8 percent and a recommended return on equity of 14.6 percent. Qwest's financial condition and the risk attendant to equity investment in the company might argue for a hypothetical capital structure and a higher return on equity, but overall, the weighted cost of capital adopted in the agreement is reasonable.

- **Special Offerings**

The settlement agreement provides that Qwest shall have the added flexibility of introducing promotional offerings with one day prior notice to the Commission and may include packaged offerings in Basket 3, provided that the individual services must be available on a ala carte basis in Basket 1, 2 or 3. The 1-day notice provision replaces a 30-day notice requirement in the current price cap plan, which puts Qwest at a serious disadvantage with its competitors.

- **Deregulated Services**

The parties agreed that the standard has been met the for deregulation of voice mail service and billing and collection services. The evidence is that there are sufficient competitive alternatives for these services to become unregulated. However, the agreement codifies the Commission's right to take appropriate action if it determines that these services are offered in a discriminatory or anti-competitive manner.

- **Dismissal of Court Appeals**

The settlement agreement provides that Qwest will dismiss its pending court appeals of commission Decision Nos. 66772 and 67047, when the

Commission's process in this case has been completed; that is, if no one has filed an application for rehearing within the time provided by statute or, if there has been an application, it has been denied by the Commission or by operation of law. Clearly the dismissal of these lawsuits removes a cloud over previous Commission actions and a palpable threat to consumers.

IV. CONSUMER BENEFITS

Q. WHAT CONSUMER BENEFITS ARE EMBODIED IN THE AMENDED PRICE CAP PLAN?

A. The settlement agreement and its amendments to the price cap plan provide some global benefits to consumers in addition to incremental adjustments to various services.

I must reiterate that the increased revenue opportunities, if they are implemented successfully, will contribute to Qwest's financial stability, which relates directly to the system reliability and quality of service that Qwest is able to deliver. Qwest continues to provide the backbone of the telecommunications system in Arizona and is the designated provider of last resort.

Moreover, the additional marketing and pricing flexibility provided by the amended price cap plan will make Qwest more nimble and responsive to conditions in the marketplace. In other words, Qwest will be able to compete more effectively, and robust competition benefits the consumer.

In addition to these broad benefits, there are other, specific changes in the price cap plan that will deliver benefits to consumers:

- The existing zone increment charges will be reduced by 50 percent.
- The rates for non-published and non-listed telephone numbers will also be reduced by half.
- Funding for the Telephone Assistance Plan (TAP) for the medically needy will be doubled, from $1 million to $2 million annually and there will be additional efforts devoted to increasing public awareness of the program.

Together with the fact that this case will not result in a general rate increase, there is much in the settlement agreement to benefit consumers.

V. CONCLUSION: THE COMMISSION SHOULD APPROVE THE SETTLEMENT AGREEMENT.

Q. DO YOU HAVE SOME CONCLUDING RECOMMENDATIONS FOR THE COMMISSION?

A. Yes. The evidence in this case is that Qwest has lost more than 577,000 residential wire lines since 2000. Excluding wireless connections, Qwest's competitors have acquired an estimated 22 percent of the combined business and residential wire-line market. When wireless penetration is included, Qwest's market share shrinks to a probable 40 percent. That is no longer a monopoly business.

As a result of shrinking market share, Qwest asserted in its direct case that it is suffering an annual revenue deficiency of $350 million. While Qwest's revenue deficiency was not fully vetted in settlement negotiations, there was no assertion by any party that Qwest was not entitled to an increase in jurisdictional revenues.

Clearly, the parties to this settlement agreement, which include some of Qwest's key competitors, believe that the changing market environment in Arizona justifies regulatory action to provide Qwest with increased marketing flexibility and greater earning opportunities.

In AUIA's view, the elements of the settlement agreement represent the minimum steps required to stave off a disaster for the state's leading provider of telecommunications services and its provider of last resort. We urge the Commission to adopt the settlement agreement without material alteration.

Q. DOES THAT CONCLUDE YOUR SETTLEMENT TESTIMONY?

A. Yes, it does.