

OPEN MEETING ITEM



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



ARIZONA CORPORATION COMMISSION

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DATE: DECEMBER 22, 2003 Arizona Corporation Commission

DOCKETED

DOCKET NO: T-01051B-03-0454

DEC 22 2003

TO ALL PARTIES:

DOCKETED BY *AK*

Enclosed please find the recommendation of Administrative Law Judge Jane Rodda. The recommendation has been filed in the form of an Opinion and Order on:

QWEST CORPORATION
(RENEWED PRICE REGULATION PLAN/MOTION)

Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Administrative Law Judge by filing an original and ten (10) copies of the exceptions with the Commission's Docket Control at the address listed below by **4:00** p.m. on or before:

JANUARY 8, 2004

The enclosed is NOT an order of the Commission, but a recommendation of the Administrative Law Judge to the Commissioners. Consideration of this matter has tentatively been scheduled for the Commission's Working Session and Open Meeting to be held on:

JANUARY 13, 2004 and JANUARY 14, 2004

For more information, you may contact Docket Control at (602) 542-3477 or the Hearing Division at (602)542-4250. For information about the Open Meeting, contact the Executive Secretary's Office at (602) 542-3931.

Brian C. McNeil
BRIAN C. McNEIL
EXECUTIVE SECRETARY

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 COMMISSIONERS

3 MARC SPITZER, Chairman
4 WILLIAM A. MUNDELL
5 JEFF HATCH-MILLER
6 MIKE GLEASON
7 KRISTIN K. MAYES

8 IN THE MATTER OF QWEST CORPORATION'S
9 FILING OF RENEWED PRICE REGULATION
10 PLAN.

DOCKET NO. T-01051B-03-0454

DECISION NO. _____

OPINION AND ORDER

11 **BY THE COMMISSION:**

12 On July 1, 2003, Qwest Corporation ("Qwest") filed the Qwest Renewed Price Regulation
13 Plan in accordance with the provisions of the Second Revised Settlement Agreement approved in
14 Decision No. 63487 on March 30, 2001. Qwest's Revised Price Regulation Plan proposed revisions
15 to the existing Price Cap Plan, including:

- 16 1. Elimination of the productivity/inflation adjustment mechanism;
- 17 2. Replacement of an indexed basket cap on the Basic/Essential Service Basket with a
18 newly determined revenue cap;
- 19 3. Introduction of a "Competitive Zone" test for moving services out of the
20 Basic/Essential Services Basket on a geographic basis;
- 21 4. Ability to move wholesale services to a competitive sub-basket within Basket 2;
- 22 5. Elimination of the revenue cap on the Competitive Services Basket; and
- 23 6. Greater flexibility for services in the Competitive Services Basket.

24 On October 2, 2003, Commission Utilities Division Staff ("Staff") filed a Request For
25 Procedural Conference.

26 Pursuant to our October 10, 2003, Procedural Order, the Commission convened a Procedural
27 Conference on October 20, 2003, for the purpose of discussing procedures to govern Commission
28 review of the Price Cap Plan.

On November 7, 2003, Qwest filed a Motion to Clarify, Or In the Alternative, To Terminate

1 Price Cap Plan. In its Motion, Qwest requested that the Commission clarify that after the expiration
2 of the initial term of the Price Cap Plan on March 30, 2004, the following conditions apply until the
3 Commission enters an order approving a revised plan or setting new rates for Qwest:

- 4 1. No further adjustment of the Price Cap Index for Basket 1 Services will be made
5 pursuant to 2(b) of the Price Cap Plan after March 30, 2004;
- 6 2. No further annual reduction in the level of access charges under the Settlement
7 Agreement and the Price Cap Plan will be made after April 1, 2004; and
- 8 3. The procedures for changes in Qwest's rates and charges, including the hard caps
9 imposed on the specific Basket 1 Services, continue to apply until superceded by a
10 revised plan approved by the Commission or a Commission order setting new rates
11 and charges for Qwest.

12 Alternatively, Qwest requested that if the Commission does not clarify the Plan as it suggests,
13 the Commission should terminate the Plan. Qwest claims that the continuation of a Price Cap Plan
14 that results in inadequate or negative earnings, would amount to confiscation in violation of the Plan
15 as well as the Arizona constitution. Qwest's request would leave the current rates in effect.

16 On November 17, 2003, the Residential Utility Consumer Office ("RUCO") and AT&T
17 Communications of the Mountain States, Inc. and TCG Phoenix (collectively, "AT&T") filed
18 Responses to Qwest's Motion.

19 On November 21, 2003, WorldCom, Inc. ("WorldCom") and Staff filed Responses to the
20 Motion.

21 On December 1, 2003, Qwest filed a Reply.

22 Qwest argues that market conditions have changed dramatically since the Plan was adopted,
23 and Qwest must compete against companies that are not constrained in how they price, package and
24 choose to offer their services. Qwest notes that the parties to the Settlement Agreement intended it to
25 be in effect for three years and not continue automatically and indefinitely. Qwest claims it is clear
26 from the language of the Settlement Agreement and the testimony in the docket that the parties
27 contemplated that Qwest could be kept under price cap regulation past the expiration of the Plan's
28 initial term only if Qwest and the Commission both agreed.

1 The current Price Cap Plan contains a productivity/inflation adjustment factor for Basket 1
2 services, which requires an annual resetting of the Price Cap Index for Basket 1. Qwest argues that
3 the Price Cap Index Adjustment provision, by its express language, was limited to the three-year
4 term. Qwest states the Index was designed as an experiment that would be reviewed and adjusted at
5 the end of three years, and its application beyond the three year term was not contemplated. Qwest
6 requests that the Commission clarify that the provision of the Price Cap Plan providing for further
7 adjustments in the Basket 1 revenue cap based on the productivity/inflation mechanism terminates on
8 March 30, 2004.

9 Staff and RUCO argue that Qwest is obligated to continue making annual reductions in the
10 Basket 1 Revenue Cap under the Price Cap Plan until its renewal, modification, or termination. Staff
11 and RUCO rely on language in Section 4 of the Settlement Agreement that adopted the Plan and
12 which provides: “[r]enewal or modification of the Price Cap Plan at the end of the initial term is
13 subject to approval by the Commission. Until the Commission approves a renewal or modified Price
14 Cap Plan, or orders a termination of the Plan after its term, the Plan including the hard caps on Basket
15 One Services set forth in paragraph 2(c)(i) shall continue in effect.” Staff and RUCO argue this
16 provision requires that the plan as a whole, including all of its collective terms and conditions,
17 continue in effect until the Commission orders a renewal, modification or termination of the plan.

18 Qwest argues the language of Section 4 was intended to serve a limited purpose—to permit a
19 grace period after the initial term of the Plan expires and before Commission approval of a new price
20 cap plan, and was not intended to permit the Plan to be extended indefinitely simply by the
21 Commission taking no action on a proposed price cap plan or rate application. Qwest argues that any
22 continuation of the plan in its entirety, by inaction of the Commission or without Qwest’s consent,
23 including further automatic reductions in the revenue cap for Basket 1 could pose a constitutional
24 problem. Qwest asserts that “[t]he refusal of the Commission to process a rate application or
25 renewed price cap plan in the face of a confiscatory level of earnings by Qwest is contrary to the
26 provisions of the Arizona Constitution.” Qwest Motion fn 3, page 12.

27 In addition to the limit on the Price Cap Index, Qwest also argues that the Price Cap Plan did
28 not contemplate any further reductions in Qwest’s access charges upon the expiration of the three

1 year period. Staff, RUCO and AT&T agree with Qwest that under the terms of the Settlement
2 Agreement and the Price Cap Plan, the reduction in access charges was limited to three annual
3 reductions totaling \$15 million. WorldCom argued that further access reductions should occur on and
4 after April 1, 2004, if the Price Cap Plan is not renewed, modified, or terminated.

5 Staff and RUCO argue that pursuant to *Scates*¹, the Commission cannot terminate the Plan
6 without making a finding of the fair value of Qwest's property. Staff argues that the Plan, including
7 all of its terms and conditions, was designed to comply with *Scates* at the time it was adopted, and for
8 the time it was in effect, and that eliminating all the provisions of the Plan, except for the existing rate
9 levels, has not been determined to comply with *Scates*. RUCO argues that terminating certain terms
10 of the Plan, such as the annual Price Cap Index adjustment, amounts to setting new rates that must be
11 accompanied by a fair value finding.

12 AT&T notes that pursuant to *Scates*, the Commission may not increase rates without a
13 consideration of the impact on the return of the utility and a determination of its rate base. AT&T
14 asserts that in *US WEST v Ariz. Corp. Comm'n*, 201 Ariz. 242, 34 P.2d 351 (2001), the Arizona
15 Supreme Court held that while in all cases the Commission must perform a fair value determination,
16 in a competitive environment, the Commission has broad discretion to determine the weight to be
17 given, or the use to be made of, the fair value determination. Thus, AT&T argues that the
18 Commission must determine whether Qwest is a monopoly or not, and if not, the Commission may
19 develop and order a Price Cap Plan over Qwest's objections. AT&T believes that the Commission
20 arguably satisfied *Scates* under the current Plan based on the Commission's decision to adopt a fair
21 value, a rate of return, a revenue requirement and the conditions in the Plan that capped rates. AT&T
22 also believes that the Commission must do some kind of fair value analysis to renew the Plan and
23 must continue to do them periodically in the future if it orders a renewed price cap plan. AT&T
24 believes that if Qwest can show, based on restated financials that it has a negative return in Arizona,
25 it does not appear wise to reduce residential rates further before the rates for all services can be
26 reviewed and rates designed for the Company as a whole. AT&T asserts that reducing rates further
27

28 ¹ *Scates v. Arizona Corp. Comm'n*, 118 Ariz 531, 578 P.2d 612 (App. 1978).

1 will adversely effect the negative return on investment and make it more difficult to rebalance rates
2 and remove implicit subsidies, if any.

3 According to Qwest, *Scates* and its progeny only require a finding of fair value before a
4 utility's rates are raised or lowered. Qwest further argues that if the Plan is terminated, its current
5 rates would be in effect, and since they are not being changed, there is no need for a fair value
6 determination.

7 Staff argues that the information required under A.A.C. R14-2-103 is necessary to evaluate
8 either the rates in effect if the Plan is terminated, or the modifications that Qwest proposes to the
9 Current Plan. Thus, Staff recommends that the Commission order Qwest to immediately file the
10 information required by R14-2-103, as well as updated price cap information, since what it filed
11 originally is based on unreliable unaudited numbers.

12 Qwest asserts there is no need to require a R14-2-103 filing at this time as the Commission is
13 not obligated to determine fair value to terminate the Plan. Qwest states the Settlement Agreement
14 establishes the information that Qwest is required to file in connection with any proposed
15 modification or renewal and does not call for a full R14-2-103 filing.

16 Clarifying The Price Cap Plan

17 Section 6 of the Price Cap Plan provides "[t]he Price Cap Plan shall have an initial term of
18 three years". There is no ambiguity that the initial term of the Price Cap Plan is three years, which
19 expires on March 30, 2004. The language of Section 4 of the Settlement Agreement is unambiguous.
20 The current Price Cap Plan remains in effect until the Commission approves a renewal of a modified
21 Price Cap Plan or orders its termination after its term.

22 Section 2 (b) of the Price Cap Plan provides:

23 Given the uncertainty of recent interpretations of Arizona law regarding
24 rate increase mechanisms, for the initial three year term of the plan, the
25 weighted average price level (or "Price Index") of all services contained
26 in Basket 1 is capped, using an "inflation minus productivity" indexing
mechanism, subject to annual updates in the quantities of demand for
each service.

27 This provision states explicitly that "for the initial three year term of the plan" there shall be a Price
28 Index. Thus, we find that pursuant to the terms of the Plan, the annual Price Index adjustment does

1 not continue beyond the initial term of the Plan. The limitation on the term of the Price Index found
2 in Section 2(b) does not appear to apply to the Plan as a whole or to other specific terms. Thus, the
3 hard cap on basic services in Section 2(c)(i) is not similarly limited to the initial term.

4 Section 3(d) of the Plan provides:

5 Intrastate Switched Access Services which are to be reduced by \$5 million
6 per year for the duration of the initial term of the Plan, with further
7 reductions in Intrastate Switched Access Service rates taking place during
any subsequent term of the Price Cap Plan with the objection of obtaining
parity with interstate switched access rates.

8 This section of the Plan also specifically refers to reductions to be made during the initial term of the
9 Plan. Although Decision No. 63487 recognized that one goal of the Settlement Agreement was to
10 reach parity between Qwest's intrastate and interstate switched access charges, it also recognized that
11 goal was not met under the Agreement. It is clear from the language of the Price Cap Plan, and the
12 Order approving the Settlement Agreement, that the parties and the Commission only intended a \$15
13 million reduction in switched access revenue, and no further reduction in switched access is required
14 under the current Plan. It is also clear that the parties and the Commission intended at that time that
15 there should be further reductions in Intrastate Switched Access rates, but would consider that in
16 future plans or rate cases.

17 There is no stated limit on how long the Plan can remain in effect past its initial term.
18 Although this Price Cap Plan was not intended to continue indefinitely, the Commission and parties
19 must act to approve a modified plan or process a traditional rate application to replace the current
20 plan in a reasonable amount of time. What is reasonable depends on the circumstances. In this case,
21 almost six months after the deadline set in the Settlement Agreement, Qwest has yet to file accurate
22 Arizona financial statements that would allow the Commission to meaningfully review the Plan and
23 evaluate Qwest's proposed modifications. There is no indication that Staff or the Commission is not
24 acting reasonably in its review of Qwest's proposed revisions. Any delay is due entirely to Qwest's
25 failure to file accurate financial statements. At a minimum, the length of the delay in receiving
26 accurate financial statements should factor into any determination of what constitutes a reasonable
27 amount of time for Commission action.

28 ...

Required Financial Filings

The Settlement Agreement calls for Qwest to file nine months prior to the expiration of the Price Cap Plan, or by July 1, 2003, an application for extension or revision of the plan, which shall include the following information:

- a. A detailed statement of price and revenue changes effected during the initial term of the Price Cap Plan;
- b. A statement of the aggregate investment and retirements in plant, and associated depreciation for the preceding calendar year;
- c. A statement of the operating income and return on investment for the preceding calendar year;
- d. Service quality comparative data during the initial term of the Price Cap Plan as specified by Staff; and
- e. Updated analysis of productivity data applicable to the Price Cap Plan.

The Settlement Agreement also provides that "Staff may request and Qwest will provide, pursuant to A.R.S. § 40-204, such other additional information as Staff determines necessary for the analysis of Qwest's application."² Staff believes that a full R14-2-103 filing is required.

With its Notice of Filing Renewed Price Cap Plan, Qwest submitted financial information for Arizona for the year 2002, which Qwest stated was "preliminary and subject to change to reflect ongoing audit adjustments and any future restatement of Qwest's financial statements." Qwest's Notice of Filing at Page 2. Qwest has yet to file accurate Arizona financial statements as required under the Settlement Agreement. While arguably Qwest may have complied with the terms of the Settlement Agreement by filing the preliminary financial information, until Qwest files restated and accurate Arizona financial statements, the information before us does not allow Staff or other parties to proceed with an evaluation of Qwest's proposed modifications to the Plan.

The Commission cannot order termination of the Plan, or adopt a modified Plan without

² A.R.S. § 40-204 provides in relevant part: "Every public service corporation shall furnish to the commission, in the form and detail the commission prescribes, tabulations, computations, annual reports, monthly or periodical reports of earnings and expenses, and all other information required by it to carry into effect the provisions of this title and shall make specific answers to all questions submitted by the commission."

1 making a finding of fair value and a determination that the rates adopted therein are just and
2 reasonable. Whether the Commission and Qwest ultimately continue under some sort of Price Cap
3 Plan, or whether we return to traditional rate of return regulation, the Commission must make a
4 finding of fair value and Qwest must provide whatever information is necessary to make such a
5 determination. Qwest must file the restated Arizona numbers as required under the Settlement
6 Agreement as soon as possible. As long as Qwest is requesting a modified Price Cap Plan instead of
7 a traditional rate case, however, it is not clear that all the information required under R14-2-103 is
8 necessary. For example, R14-2-103 refers to the "test year," and this concept may not be relevant to
9 review of the Price Cap Plan. There is information required under R14-2-103, however, that appears
10 not to be required under the Settlement Agreement, but will be necessary for Commission action on
11 the Renewed Plan.

12 Under the terms of the Settlement Agreement, Staff is entitled to request whatever
13 information it believes is necessary for its analysis. Thus, Qwest has agreed to provide Staff with the
14 information that would be required under R14-2-103, if Staff believes such information is necessary
15 for its analysis. Because at this point, Qwest is seeking to continue some sort of Price Cap
16 Regulation, Staff should review the information required under R14-2-103 to determine if the form of
17 the information that must be provided pursuant to that rule is best suited to Staff's task of reviewing
18 the experience under the current Price Cap Plan and for evaluating a modified plan. After Staff's
19 evaluation and determination of what information is required (which may or may not mirror the
20 requirements of R14-2-103), Qwest shall promptly file such information.

21 * * * * *

22 Having considered the entire record herein and being fully advised in the premises, the
23 Commission finds, concludes, and orders that:

24 **FINDINGS OF FACT**

- 25 1. In Decision No. 63487 (March 30, 2001), the Commission approved a Settlement
26 Agreement in Qwest's then pending rate case which adopted a Price Cap Plan for Qwest.
27 2. On July 1, 2003, Qwest filed its Renewed Price Regulation Plan in accordance with
28 the provisions of the Second Revised Settlement Agreement approved in Decision No. 63487.

1 3. On October 2, 2003, Staff filed a Request For Procedural Conference.

2 4. Pursuant to our October 10, 2003 Procedural Order, the Commission convened a
3 Procedural Conference on October 20, 2003, for the purpose of discussing procedures to govern
4 Commission review of the Price Cap Plan.

5 5. On November 7, 2003, Qwest filed a Motion to Clarify, Or In the Alternative, To
6 Terminate Price Cap Plan. In its Motion, Qwest requested that the Commission clarify that after the
7 expiration of the initial term of the Price Cap Plan on March 30, 2003, the following conditions apply
8 until the Commission enters an order approving a revised plan or setting new rates for Qwest:

9 (a) No further adjustment of the Price Cap Index for Basket 1 Services will be
10 made pursuant to 2(b) of the Price Cap Plan after March 30, 2004;

11 (b) No further annual reduction in the level of access charges under the Settlement
12 Agreement and the Price Cap Plan will be made after April 1, 2004; and

13 (c) The procedures for changes in Qwest's rates and charges, including the hard
14 caps imposed on the specific Basket 1 Services, continue to apply until superceded by
15 a revised plan approved by the Commission or a Commission order setting new rates
16 and charges for Qwest.

17 5. On November 17, 2003, RUCO and AT&T filed Responses to Qwest's Motion.

18 6. On November 21, 2003, WorldCom and Staff filed Responses to the Motion.

19 7. On December 1, 2003, Qwest filed a Reply.

20 8. The Price Cap Plan has an initial term of three years from the effective date as
21 specified in the Commission's Order approving the Settlement Agreement and Plan.

22 9. Renewal or modification of the Price Cap Plan at the end of the initial term is subject
23 to approval by the Commission. Until the Commission approves a renewal or modified Price Cap
24 Plan, or orders a termination of the Plan after its term, the Plan, including the hard caps on Basket
25 One Services set forth in paragraph 2(c)(1) shall continue in effect.

26 10. The language of the Price Cap Plan expressly limits the applicability of the Price
27 Index to the Initial Term of the Plan.

28 11. Under the Price Cap Plan, the \$5 million annual reduction in Qwest's intrastate
switched access revenue is limited to the initial term of the plan.

1 IT IS FURTHERED ORDERED that the Hearing Division shall schedule a Procedural
2 Conference for the purpose of setting a procedural schedule, including discovery timeframes,
3 testimony deadlines and hearing dates for Commission consideration of the Qwest's Renewed Price
4 Cap Plan, once Qwest has filed its restated and accurate Arizona financial statements.

5 IT IS FURTHER ORDERED that this Decision shall become effective immediately.

6 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

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8
9 CHAIRMAN COMMISSIONER COMMISSIONER

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11 CHAIRMAN COMMISSIONER

12 IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive
13 Secretary of the Arizona Corporation Commission, have
14 hereunto set my hand and caused the official seal of the
15 Commission to be affixed at the Capitol, in the City of Phoenix,
16 this ____ day of _____, 2003.

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18 _____
19 BRIAN C. McNEIL
20 EXECUTIVE SECRETARY

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18 DISSENT _____

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20 DISSENT _____

1 SERVICE LIST FOR:

QWEST CORPORATION

2 DOCKET NO.:

T-01051B-03-0454

3 Timothy Berg
4 Teresa Dwyer
5 Darcy Renfro
6 FENNEMORE CRAIG, P.C.
7 3003 North Central Ave., Suite 2600
8 Phoenix, Arizona 85012-2913
9 Attorneys for Qwest Corporation

10 Todd Lundy
11 Qwest Law Department
12 1801 California Street
13 Denver, Colorado 80202

14 Scott S. Wakefield, Chief Counsel
15 RUCO
16 1110 Qwest Washington, Suite 220
17 Phoenix, Arizona 85007

18 Richard S. Wolters
19 AT&T Law Department
20 1875 Lawrence Street, Suite 1503
21 Denver, CO 80202

22 Joan S. Burke
23 OSBORN MALEDON, P.A.
24 2929 North Central Avenue, Suite 2100
25 Phoenix, Arizona 85012-2794
26 Attorneys for AT&T

27 Thomas F. Dixon
28 WorldCom, Inc.
29 606 17th Street, 39th Floor
30 Denver, Colorado 80202

31 Thomas H. Campbell
32 Michael T. Hallam
33 LEWIS AND ROCA
34 40 N. Central Avenue
35 Phoenix, Arizona 85004
36 Attorneys for WorldCom, Inc.

37 Michael W. Patten
38 ROSKA HEYMAN & DEWULF PLC
39 400 East Van Buren Street, Suite 800
40 Phoenix, Arizona 85004

- 1 Mark A. DiNunzio
- 2 Cox Arizona Telcom, LLC
- 3 20401 North 29th Avenue
- 4 Phoenix, Arizona 85027

- 5 Peter Q. Nyce Jr.
- 6 Regulatory Law Office
- 7 U.S. Army Litigation Center
- 8 901 N. Stuart Street, Suite 713
- 9 Arlington, VA 22203-1644

- 10 Richard Lee
- 11 Snavely King Majors O'Connor & Lee, Inc.
- 12 1220 L Street N.W., Suite 410
- 13 Washington, DC 20005

- 14 Christopher Kempley, Chief Counsel
- 15 ARIZONA CORPORATION COMMISSION
- 16 1200 West Washington Street
- 17 Phoenix, Arizona 85007

- 18 Ernest Johnson, Director
- 19 ARIZONA CORPORATION COMMISSION
- 20 1200 West Washington Street
- 21 Phoenix, Arizona 85007

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- 23
- 24
- 25
- 26
- 27
- 28