IN THE MATTER OF QWEST CORPORATION’S FILING OF RENEWED PRICE REGULATION PLAN.

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

BRIEF OF COMMISSION STAFF

I. INTRODUCTION.

The proposed Settlement Agreement is the result of 28 weeks of negotiation between eight Parties. Every significant interest is represented except for RUCO, which withdrew from the meetings approximately eight weeks after they began and now challenges the proposed Agreement. The remaining eight Parties, representing Qwest, retail competitors of Qwest, wholesale customers of Qwest, an investor group, and Commission Staff continued their negotiations for an additional twenty weeks after the RUCO withdrawal, and the resulting settlement has been described as a “hard won agreement” in which participants were “tested to the edge.”

RUCO’s concerns with the Settlement Agreement are not well-founded and oftentimes contradict its own filed testimony in this Docket and others. RUCO’s primary objection to the Agreement is its belief that radical change, rather than compromise, is necessary. (Tr. at 24-25). Yet at the same time, RUCO criticizes the Settlement Agreement for going too far and giving Qwest too

1 “Settlement negotiations began on February 10, 2005 and culminated with the filing of the Settlement Agreement on August 26, 2005. RUCO withdrew from the settlement negotiations in April, but the Parties continued working until agreement was reached on every detail of the Settlement Agreement.” (Ex. DOD-4 at 2).

2 Participants: Staff, Qwest, the Department of Defense and all other Federal Executive Agencies, MCI, Inc., Time Warner Telecom of Arizona, Cox Arizona Telecom, the Arizona Utility Investors Association and XO Communications Services.

3 (Tr. at 225).
much pricing flexibility. RUO advocates rejection of the Settlement Agreement because it does not contain deaveraged pricing which would allow for higher rates in rural areas of the state and lower rates in urban areas of the state. Yet the evidence indicates that there was considerable disagreement among the parties in this proceeding over almost every facet of such a Plan. RUO criticizes the Agreement because it does not “promote competition” or “revamp” the Arizona Universal Service Fund. But, this proceeding was designed to review Qwest’s Price Cap Plan, and not to promote competition or “revamp” the Arizona Universal Fund. RUO is concerned that ratepayers are not receiving the full value associated with the $12 Million April 1, 2005 productivity offset. Yet, RUO advocated an approximate $160 Million revenue deficiency in this case which could have a much more severe impact upon consumers’ rates since it is over 13 times the amount of the productivity offset.

The Parties are confident that the record in this matter and the presentation to the Commission of 19 experts and witnesses and 111 exhibits, clearly supports each provision of the Settlement. Given the difficulty in reaching agreement, the complexity of the compromises, the length of the preceding litigation, the desire to keep further litigation to a minimum and the benefits to consumers, the Parties request that the Commission approve the Settlement Agreement.

II. THE SETTLEMENT AGREEMENT IS IN THE PUBLIC INTEREST.

A. The Process was Open and All Active Intervenors Participated.

Each provision of the Agreement was a compromise of the Parties’ litigation positions. Regarding compromises reached, one of the participants, Time Warner’s expert, Mr. Brian Thomas, “believes that the balance struck and the level of regulation agreed upon was an appropriate resolution.” Another competitor, XO’s expert, Rex Knowles, stated “[n]o interested party or stakeholder was excluded from the negotiation process and the Settlement Agreement represents a fair compromise of disputed issues.” XO’s counsel, Ms. Burke, attested “the process was very open, transparent and thorough.” Finally, Mr. Lee, the Department of Defense’s expert, offered an

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4 (Tr. at 23).
5 ACC Docket No. T-01051B-03-0454, T-00000D-00-0672.
6 (Ex. TWTA-3 at 5).
7 (Ex. XO-1 at 4).
8 (Tr. at 32).
observation, “the rejection of this intensely negotiated Settlement Agreement would place a chill over the prospects for the resolution of complex matters through good faith negotiation in the future.”

B. The Settlement Agreement’s Provisions Reflect a Balanced Outcome for Consumers, the Company and its Competitors.

1. The agreed upon revenue deficiency is less than 10% of Qwest’s original request and less than 20% percent of RUCO’s stated revenue deficiency.

Qwest entered these negotiations requesting $325 Million in additional revenue. RUCO countered with a recommendation for increased revenues of $159.5 Million, and Commission Staff proposed $3.5 Million. The parties ultimately agreed upon $31.8 Million. Since Qwest is entitled to raise their rates to compensate for any recognized revenue deficiency, the relatively small figure is a benefit to the consumer. This final revenue deficiency figure was less than 10% of Qwest’s request and less than 20% of RUCO’s recommendation.

RUCO originally agreed with Staff that R14-2-103 information was necessary and required because Qwest was asking for changes to the Plan that would allow it to recoup significant additional revenues: Qwest’s assertions of a revenue deficiency of over $300 Million; and the Company’s request to eliminate the inflation/productivity offset. (January 29, 2004 OM Tr. at 80-81; May 4, 2004 OM Tr. at 36; See also, RUCO’s Response to Emergency Motion to Suspend the Inflation Minus Productivity Factor Adjustment, February 8, 2005). RUCO and Staff were both in agreement at the outset of this case that given the fair value requirement in Arizona law, for the Commission to approve a change in rates, there must be an examination of the company’s fair value rate base and a determination of a reasonable rate of return. Id.

RUCO argued at the hearing, however, that the revenue deficiency calculation is “hypothetical.” (Tr. at 446-50, 488-89). Staff does not agree. Given that such an examination is required under Arizona law when there is a change in rates, the calculation is anything but “hypothetical”. Given that the Company is allowed a fair rate of return on its investment and that it sought changes to the Plan that would have given it the potential to collect significant additional revenue, this calculation is required in Staff’s opinion. Given that RUCO and others advocated that

9 (Ex. DOD-4 at 4).
1. The Company be allowed to recoup any revenue deficiency through the Price Cap Plan, Staff believes that the calculation is necessary.

2. The Settlement Agreement resolves important accounting issues that have been in dispute for sometime relating to depreciation, OPEBs and Software in a manner that Staff believes is favorable to consumers.

   The Settlement Agreement resolves what have been contentious accounting issues between Staff and the Company. The Agreement provides that Qwest shall be treated as having adopted on April 1, 2001, Statement of Financial Accounting Standards ("SFAS") 106 to account for Other Post Employment Benefits ("OPEBs"), with a ten year amortization of Qwest's December 31, 2000 Accumulated Post-Retirement Benefit Obligation ("APBO") starting April 1, 2001.

   In addition, under the proposed Agreement, Qwest is treated as having adopted on January 1, 2001, the American Institute of Certified Public Accountants' Statement of Position 98-1 ("SOP 98-1") to account for the costs of internal use computer software, effective January 1, 2001. These resolutions are to be reflected in any operating rate base or revenue requirement calculations that Qwest submit to the Commission in the future.

   The parties also agreed to a revised set of depreciation rates and amortizations. These will result in approximately a $255 Million reduction in annual intrastate depreciation expense for each year of the first five years, and approximately a $224 Million annual reduction below the test year level in intrastate depreciation expense thereafter. The rates and amortizations and corresponding reductions in intrastate depreciation expense are to be used for all subsequent proceedings.

   Finally, Qwest agreed on a going forward basis, to charge Qwest Broadband Services, Inc. ("BSI") for the cost of installing pedestals and cabinets used by BSI in accordance with the FCC's affiliate billing rules and will continue to bill BSI for all other costs in accordance with these same rules. Further, in determining the revenue deficiency, Qwest's failure to bill BSI for pedestals and cabinets was taken into account.

3. The Price Cap Plan caps basic telephone rates for another 3 years or for the term of the Plan.

   The proposed Price Cap Plan again contains what Staff believes is a significant benefit to consumers; no increase to existing residential and business basic rates which are a hard capped for
the next 3 years. While Qwest can decrease the rates for basic residential and business telephone service, it cannot under the proposed Plan, increase the rates beyond levels existing at the time the Plan is approved. When viewed in combination with the existing Price Cap Plan, this means that residential and business consumers will have not seen an increase in their basic rates for approximately 7 years. Further, capping of basic rates at existing levels gives consumers a hedge against inflation.

In addition, the proposed Agreement contains a rate increase moratorium for the term of the Plan. This means that Qwest cannot request an increase to its rates for at least another 3 years.

4. **Price increases beyond existing levels under the Plan are limited to Baskets 2, 3 and 4.**

The proposed Agreement allocates all price increases beyond existing levels, due to the increase in revenue requirement, to Baskets 2 and 3. Moreover, a lesser amount is allocated to Basket 2, the Basket containing less competitive services. For Year 1, an amount not to exceed a $1.8 Million increase is to be allocated to Basket 2. The remainder of the aggregate $31.8 Million\(^\text{10}\) not used for Basket 2 may be allocated by the Company to Basket 3.

In Years 2 and beyond, the amount of the overall net revenue increase from price changes to be allocated to Basket 2 shall not exceed $13.8 Million. The remainder of the aggregate $43.8 Million\(^\text{11}\) not used for Basket 2 shall be allocated to Basket 3.

Basket 4 wholesale service prices are capped at the tariffed or contract price levels for the term of the Renewed Price Cap Plan, or until contracts are renegotiated, or the FCC, the Commission or the courts determine that other prices are appropriate.

5. **The Settlement Agreement contains many important consumer benefits.**

Besides the hard cap on existing local service basic rates for residential and business customers for another 3 years; the moratorium on future requests for rate increases for the next 3 years; the caps on increases to rates in Basket 2; specification of maximum rates for Baskets 2 and 3;
the reduced revenue requirement of $31.8 Million, the proposed Settlement Agreement contains other important consumer benefits.

The proposed Settlement Agreement contains a full $12 Million offset to Qwest's revenue requirement in Year 1 of the Plan to give consumers credit for the April 1, 2005 Productivity Adjustment.

Section 13 of the Settlement Agreement results in a reduction in Zone Charges by 50%. This change will result in projected savings to consumers of $2 million.\(^{12}\)

It also results in a $0.50 reduction to both Non-Published and Non-Listed Residential Telephone Number Service. Non-Published Listings and Non-Listed Numbers were also added to Basket 1 and their rates became hard capped. The reduction to these rates results in a savings to consumers of $2.5 million.\(^{13}\)

It calls for an increase to Qwest's contribution to the Telephone Assistance Plan for the Medically Needy ("TAP") of $1.0 Million. Thus, Qwest will be obligated under the proposed Agreement to contribute $2.0 Million annually to this Program in the future.

Combined, these changes alone produce over $5 Million per year of benefits to consumers.

Section 14 of the Settlement Agreement provides for Directory Assistance to be capped at its existing rate of $1.15 per call, which shall include: (a) the current one call allowance per month without charge, (b) two inquiries per usage, and (c) call completion.

Under Section 15 of the proposed Agreement, Qwest is subject to increased service quality standards.

Under Section 16 of the Agreement, Qwest is obligated to increase the line extension credit from $3,000 to $5,000 for underserved customers which will benefit consumers without telephone service.

\(^{12}\) (Ex. S-38 at 16).
\(^{13}\) (Ex. Q-35 at 5-6).
6. The Company obtains needed pricing flexibility to more effectively respond to competition.

The Settlement Agreement recognizes that local service competition has increased since adoption of the current Price Cap Plan in 2001. The Settlement Agreement allows Qwest pricing flexibility consistent with the level of competition it now faces.

The current price cap plan has three baskets: Basket 1 contains hard capped services and services with a 25% price cap limit for any one year; Basket 2 contains wholesale services; and Basket 3 contains competitive services with no price limit per service.

The proposed Settlement Agreement distributes the services currently in Basket 1 into two separate baskets, Baskets 1 and 2, and moves the wholesale services into Basket 4.

- **Basket 1** - hard capped retail services;
- **Basket 2** - retail services with 25% individual price increase limit; subject to overall cap on rate increases; subject to maximum rate filings;
- **Basket 3** - retail services with no price limit per service; but subject to overall cap on rate increases and subject to maximum rate filings;
- **Basket 4** - wholesale services. Capped at current contract or tariff levels until the contracts are renegotiated or the Commission, Courts or FCC determine that other prices are appropriate.

The Parties agreed that even though competition has increased substantially, this is a transitory period and constraints are still appropriate. Thus, Baskets 2 and 3 are subject to an overall cap on rate increases and individual maximum rates for each service. In addition, the services contained in Basket 2 are subject to a 25% individual price increase limit per year.

The Company obtained additional pricing flexibility for additional business and residential lines and PBX trunks by their placement in Basket 2. In addition, Local Service packages have been placed in Basket 3 but, they are subject to certain safeguards.

7. Rural consumers will benefit by the Plan's provisions.

Rural consumers will benefit in many ways by the Plan's provisions. First, like urban consumers, the basic rates of both residential and business rural consumers will be hard-capped at existing levels. Thus, the basic rates of rural customers cannot increase beyond existing levels for the term of the Plan.
Continuation of state-wide averaged rates will ensure that rural customers receive the benefits of competitive pressures in the urban markets. Price decreases in urban markets will translate into price decreases for rural customers as well. They also ensure that basic local rates will remain affordable in rural areas, and will not increase significantly due to the increased costs usually associated with serving rural customers.

Rural customers benefit by the reduction in Zone Charges. Under Section 13 of the Agreement, Zone Charges are reduced by half. The current Zone 1 Charge of $1.00 will be reduced to $0.50. The current Zone 2 charge of $3.00 will be reduced to $1.50.

Many rural customers are also likely to benefit by the increase in the Line Extension credit from $3,000 to $5,000.

RUCO's proposal for geographic deaveraging coupled with 3 price cap baskets would set the stage for rate increases in basic rates in rural areas up to 25% per year. (Ex. RURO-12 at 26).

8. The Settlement Agreement will result in the dismissal of litigation now pending in the Arizona Superior Court and Court of Appeals on the Productivity Adjustment.

The Settlement Agreement will result in the dismissal by Qwest of two pending court appeals of Commission Decision Nos. 66772 and 67047, which are collectively referred to as the "Consolidated Appeals." Under Section 28 of the Agreement, Qwest will dismiss the Consolidated Appeals following the issuance of a Commission Order approving the Settlement Agreement, provided that (i) the period of time set forth in A.R.S. Section 40-253 for the filing of an application for rehearing has expired and no individual or entity has filed any such application, or (ii) if there has been an application for rehearing, it has been fully denied by the Commission or by operation of law.

These appeals challenge determinations by the Commission that required Qwest to make productivity adjustments for years 2004 and 2005. While Staff believes that the Commission correctly interpreted the existing Price Cap Plan's provisions in this regard, there is always a risk with any litigation that a Court may not agree. The Settlement Agreement resolves these outstanding issues and removes the risk associated with an adverse Court decision.
9. The Settlement Agreement is beneficial to competitors.

One of Qwest's competitors' objectives was to reduce access rates which they considered "uneconomic, anticompetitive and discriminatory."\(^{14}\) They contended that they could not effectively compete if Qwest is allowed total pricing control over this component of their business.\(^{15}\) The $12 million switched access rate reduction, according to MCI's expert, is "an appropriate compromise."\(^{16}\)

The Department of Defense and all other Federal Executive Agencies supports reduced switched access rates because "the biggest component of long distance rates is the access."\(^{17}\)

The sole objecting intervenor to this provision is again RUCO, which opposes the access rate reduction on the grounds that it discourages competition in the rural areas. RUCO contends that by reducing the amount of cost support provided by switched access charges, this rate reduction makes it less profitable for competitive local exchange carriers ("CLECs") to serve high cost rural areas.\(^{18}\) A facilities based CLEC, however, would actually have its own terminating access charges in place. In addition, Staff is not aware that the level of switched access charges in an exchange has prevented any CLEC from entering a market. Moreover, those advocating most strongly in favor of the reduction provide services both as a CLEC and an interexchange carrier ("IXC"). Staff believes that this access rate reduction is the right step to take in the industry and is consistent with the objectives set forth in the existing Plan and with trends at the federal level.

Qwest also agreed to make available to other carriers DS1 private line services on a contract basis. This contract will provide for reductions on DS1 channel terminations and transport mileage charges, subject to certain volumes of purchases, in Tucson and Phoenix.\(^{19}\) This will allow competitors to access many office buildings through the leased circuits provided by Qwest and will allow enhanced competitive choices for consumers.\(^{20}\)

\(^{14}\) (MCI Settlement Test. Summary)
\(^{15}\) The last Price Cap Plan contained an objective to ultimately bring the level of intrastate Switched Access Charges in parity with interstate Switched Access Charges.
\(^{16}\) (Ex. MCI-3 at 4-5).
\(^{17}\) (Tr. at 218).
\(^{18}\) (Ex. RUCO-14 at 23).
\(^{19}\) (Ex. TWTA-3 at 4).
\(^{20}\) Id. at 5.
10. Qwest withdraws its request for $64 Million in AUSF under the Settlement Agreement.

In addition, under Section 19 of the proposed Agreement, Qwest agrees to withdraw its request for $64 Million of Arizona Universal Service Fund ("AUSF") support. Had Qwest's request been granted, it would have been borne by all consumers in the state through an increased surcharge on their bills. The Settlement Agreement ensures that this will not happen.

III. RUCO'S CONCERNS REGARDING THE SETTLEMENT AGREEMENT ARE UNFOUNDED.

In its Testimony in opposition to the Settlement Agreement, RUO identified the following six concerns with the Agreement:

1) The agreement, as a whole, does not address the current status of competition in Arizona, nor will it do anything to further competition in Arizona's telecom industry;
2) Inappropriate placement of certain services in certain baskets;
3) Lack of geographic distinction in classifying competitive services;
4) The degree to which pricing freedom is allowed in Basket 2;
5) The agreement results in a modified price cap plan that, when compared to the existing plan, negatively impacts residential ratepayers; and
6) The manner in which the issue of the April 1, 2005 productivity adjustment (required under the existing plan) is resolved by the settlement.

(Ex. RUO-8 at 2).

The Staff's Brief will address each of these concerns below.

A. The Purpose of this Proceeding Was to Review Qwest's Price Cap Plan; Not to Promote Competition.

RUO's first stated concern is "the agreement, as a whole, does not address the current status of competition in Arizona, nor will it do anything to further competition in Arizona's telecom industry." Id. Not only is this an inaccurate statement, but it reflects a misunderstanding of what this proceeding is about. This same theme was apparent in RUO's counsel's opening statement:
For the next couple of days, we should be here to analyze and facilitate the state of competition in the Arizona telecommunications market and its future in Arizona. As competition continues to intensify in Arizona, we owe it to the public, we owe it to ourselves, to step back, take a comprehensive look at where we are and where we’ve gone.

(Tr. at 22).

This proceeding concerns an Application filed by Qwest to renew, with modifications, its Price Cap Plan. This is not a generic proceeding designed to examine the state of competition in Arizona’s telecom markets. The Commission has a separate docket open to examine competition in Arizona markets. Further, the Commission has processed many other dockets in the recent past designed to promote competition in Arizona telecom markets.

Another reason offered by RU CO for rejection of the Plan, is that it does not “revamp” the current Arizona Universal Service Fund. (Ex. RU CO-14 at 19).

In the absence of a state USF which adequately alleviate the high costs of serving rural customers, there is relatively little potential for competition in the lower density, higher cost parts of the state. As I explained in my direct testimony, if the Commission wants to ensure that rural areas generate revenues which are sufficient to cover the relatively high cost of serving these areas, it should revamp the Arizona universal service fund to provide an appropriate mechanism for dealing with these cost disparities.

However, this is not a generic proceeding designed to review and modify the Arizona Universal Service Fund (“AUSF”), either. The Commission has a separate docket open to examine the AUSF. Moreover, the AUSF is currently structured in a competitively neutral manner to ensure affordable rates in high cost areas. It is not a fund that was designed to promote competition and the Commission has made no determination that the fund should be used in this manner. (Tr. at 327).

Further, changes to the AUSF will affect telecommunications providers throughout Arizona, most of which are not a party in this docket. Although RU CO believes this issue should be addressed in this docket as a means for improving competition in the rural areas, it would not be fair and would not make sense to address this issue outside of the generic docket.

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22 ACC Docket Nos. T-00000A-97-0238; T-00000A-00-0194; T-00000A-03-0369; and T-00000K-04-0927.
B. A Diverse Group of Parties Agreed to the Price Cap Plan's Basket Structure and Placement of Services.

RUCO's second concern is their belief that there has been "inappropriate placement of certain services in certain baskets." (Ex. RUCO-8 at 2). This concern is unfounded. RUO's expert, Dr. Johnson, agreed with the parties, "competitive conditions in the state have intensified since the Commission approved the current plan." It is for this reason that some services were shifted from one basket to another in the Settlement Agreement.

The Parties agreed to the following limited redistribution of services: First, all services (except the six identified below that were placed in Basket 3) that were subject to the 25% annual price increase cap in Basket 1 of the initial Plan were placed into Basket 2 which is subject to the same constraint on annual price increases. In addition, two hard-capped services from Basket 1 were moved to Basket 2: PBX lines and additional residential and business lines.

The following six services subject to the 25% annual price increase cap were moved from Basket 1 to Basket 3: (1) Standby Line Service; (2) Home Business Service; (3) Uniform Call Distribution Service; (4) Uniform Access Solution Service; (5) Code Billing; and (6) Service Packages.

First, RUO alleges that the Settlement Agreement inappropriately moves some services "that are currently subject to a hard cap" to Basket 2, where they will be subject to price increases of 25% per year. Id. RUO witness Johnson identifies additional local exchange lines used by residential and small business customers as being one of two services inappropriately placed in Basket 2 under the proposed Settlement Agreement. Yet, the testimony in the record clearly demonstrates that Qwest is facing a dramatic increase of competition in this market. (Ex. Q-36 at 13-14). The testimony establishes that the rise in wireless phones is impacting the additional line market more than any other right now. (Ex. S-39 at 10). Qwest is also facing increased competition by Cox in this market. Id. Thus, given these alternatives and the degree to which competition has increased in this market, Basket 2 placement is certainly appropriate.

RUO also takes issue with moving PBX trunks to Basket 2. PBX trunks are used exclusively by business customers and primarily by larger business customers. Id. Staff's analysis (Ex. RUCO-14 at 10).
indicated that there are legitimate competitive alternatives for Qwest’s PBX trunk service. *Id.*

Again, given these circumstances, placement in Basket 2 was appropriate.

RUCO witness Johnson also takes issue with the six services that are being moved from Basket 1 to Basket 3, apparently believing that Qwest will be able to achieve “monopoly profit-maximizing price levels” on these services in the future. (Ex. RU CO-14 at 13). Yet, Dr. Johnson’s concerns are belied by the record evidence.

For Standby Line Service, the testimony of Qwest’s witnesses indicates that the customer base has declined by 50% over the past three years.\(^{24}\) For Home Business Service, Qwest’s customer base has nearly disappeared.\(^{25}\) According to the testimony of Qwest witnesses, for Uniform Call Distribution Service, Qwest had a small portion of this business in 2000 and it has since decreased 20%.\(^{26}\) Qwest’s testimony indicates that for Uniform Access Solution Service, its customer base has declined precipitously over past three years.\(^{27}\) With respect to Code Billing, Qwest’s testimony indicates that demand is de minimis.\(^{28}\)

Finally, Dr. Johnson’s testimony reflects a misunderstanding of the Agreement’s treatment of Service Packages. Qwest’s testimony indicates that it has lost a substantial portion of this business.\(^{29}\) Dr. Johnson testified “[t]he limited degree of competition which currently exists for local exchange services is not sufficient to justify giving Qwest complete freedom to increase prices for these local exchange service packages.” (Ex. RU CO-14 at 14). But, as Staff witness Rowell testified, the proposed Settlement Agreement does not give Qwest complete freedom to increase prices for its packages. (Ex. S-39 at 11). Section 23 of the proposed Settlement Agreement includes safeguards that specifically apply to packages that would make unlimited price increases impossible. The price of a package is capped at the sum of the highest prices of the individual services in the package. *Id.*

\(^{24}\) (Ex. Q-36 at 16).
\(^{25}\) *Id.* at 18.
\(^{26}\) *Id.* at 20.
\(^{27}\) *Id.* at 22.
\(^{28}\) *Id.* at 24.
\(^{29}\) *Id.* at 26-27.
C. Geographic Zones Have Not Worked Well in Some Jurisdictions and the Evidence Does Not Support a Workable Geographic Zone Proposal or that It Would Benefit Consumers.

RUCO recommends that the Commission also reject the Settlement Agreement because it does not incorporate geographic zones. However, the geographic zone concept put forward by Qwest was not supported by either Staff or RUCO; and there was much division over how such an approach should be structured and implemented. Nor is there any evidence in the record to suggest that such an approach would benefit consumers more than the current approach, which does not incorporate geographic zones. In fact, one of Staff’s witnesses who has had direct experience with competitive zones testified that in Utah they have not worked well, and the Commission has encountered a lot of problems in implementing the concept. When asked about his experience with competitive zones, Staff witness Dunkel testified as to the many problems encountered in Utah. See, Tr. at 2.

While Staff did not oppose the competitive zone “concept” in its Direct Testimony filed in this case in response to Qwest’s Application, Staff witness Rowell pointed out many problems with Qwest’s proposal and suggested that if the Commission adopted such a proposal, further proceedings would be necessary. Id. at 309-12.

Q. As a general proposition, would you agree that Qwest would be better able to respond to its competitors where geographic pricing is allowed as opposed to the situation where pricing is the same?

A. Well, under the current situation, perhaps not, because the competitors that Qwest is facing here have statewide tariffs as well. Which particularly if you look at the residential market, their primary competitor is Cox and Cox doesn’t have any geographic pricing flexibility within the tariffs at this point. So Cox and Qwest are sort of on equal footing in that respect.

Q. Why, the, was Staff not opposed to the general idea of competitive zone pricing?

A. Well, you know, as Staff of the utilities division, we’re charged with balancing the interests of the company and the customers. I know that’s a cliché but it’s true. That’s what we have to do. And to say we weren’t generally opposed to it really doesn’t — it really doesn’t give an accurate depiction of Staff’s position.

While we didn’t generally oppose it, we did point out several problems we saw with Qwest’s proposal, and we advocated a separate proceeding to address all of those problems.

So we believed — you know, in balancing the interests of the customers and the company, we saw that the company needed additional flexibility
and we were willing to work with the company to get them there, but we weren’t willing to take what they – their original position on its face either – in specifics or in sort of a general sense, either.

RUCO also did not support Qwest’s competitive zone proposal. (Ex. RUO-14 at 18-19). While RUO offered testimony on the type of competitive zone proposal it favored, RUO’s testimony on this point fell far short of a comprehensive plan that could be implemented in the context of this case. Id. at 19-20. However, the complexity of RUO’s suggestions was of such magnitude, that the Company was not in favor of it. (Ex. Q-35 at 16). RUO’s witness Johnson suggested the use of wire centers of which there are approximately 130 in Arizona. (Tr. at 459-62). Those individual 130 wire centers would each be placed in separate baskets depending upon the degree of competition in each. Proceedings would be held to reclassify wire centers as competitive or noncompetitive. (Tr. at 456-57). RUO’s suggestions were unworkable given the complexity of structuring competitive zones in the manner suggested by RUO, the need for endless proceedings and litigation and the many unanswered questions surrounding it. In addition, there were concerns regarding administration of such a plan; along with administration of similar plans likely to be implemented by Qwest’s competitors.

There was also considerable disagreement between the parties on the geographic area that should comprise a competitive zone, the criteria for determining whether a zone was competitive, the safeguards that would be needed, that in the end the parties determined the current price cap plan was better and more workable. Finally, there has been relatively little discussion or evidence on the customer confusion that may result from such a deaveraged rate plan. Consumers are not familiar with the concept of wire centers and may not understand why basic rates are lower in one part of Phoenix and not another. Rural customers may not understand why their rates are considerably higher than the rates of urban customers. Customers may not understand why they are experiencing a succession of rate increases every year which is possible under such a Plan. Considerable consumer education would be necessary before such a plan could be implemented. In sum, Staff believes that the provisions of the Settlement Agreement which provide for the continuation of statewide averaged rates for the term of the Plan are in the public interest.
D. The Degree of Pricing Flexibility Afforded Qwest under the Agreement Is Appropriate.

RUCO next takes issue with the degree of pricing flexibility afforded Qwest under the Agreement. (Ex. RURO-8 at 2). Dr. Johnson makes many statements throughout his testimony as to the "high degree of pricing freedom" that would be granted Qwest under the proposed settlement not being consistent with the limited, inconsistent state of competition in much of Qwest's Arizona service territory. See, e.g., Ex. RURO-14 at 3. However, it is paradoxical to Staff, that RURO is claiming this as a basis for the Commission to reject the Settlement Agreement, when the degree of flexibility afforded under RURO's proposal was far greater than anything ever envisioned by the proposed Settlement Agreement.

More specifically, RURO criticizes the Basket structure under the proposed Settlement Agreement claiming that under both Baskets 2 and 3 Qwest has too much flexibility to extract monopoly profits. Yet the proposed Basket structure advocated by RURO contained much more pricing flexibility than is contained in the proposed Settlement Agreement, and would allow the Company to raise basic local service rates in all areas of the state by a significant amount over the term of the Plan, or more in the Phoenix and Tucson metropolitan areas.

RURO proposed the following 3 Baskets: (1) Moderate Pricing Flexibility Services Basket (25% individual rate cap and an overall revenue cap and GDP-PI minus 4.2 percent productivity offset); (2) High Pricing Flexibility Services Basket (25% individual rate cap that increases annually by two times the change in GDP-PI; and (3) Total Pricing Flexibility Services Basket (Individual rate caps pursuant to A.A.C. R14-2-1109 and R14-2-1110 and no overall revenue cap).

RURO witness Johnson testified that the Phoenix and Tucson metropolitan areas should be placed in the High Pricing Flexibility Services Basket which has a 25% individual rate cap that increases annually by two times the change in GDP-PI. (Ex. RURO-12 at 26). He further testified that all other wire centers in the state should be placed in the Moderate Pricing Flexibility Services

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30 For comparison purposes with the current plan, the current plan capped the calculation at zero so that if inflation was greater than productivity, there would not be an increase resulting from application of the productivity factor. Dr. Johnson's proposal would not contain this cap which was agreed to by the Company. Another point of comparison that should be considered is that the quantity of services in Basket 1 would decline under RURO's proposal as well, which would also decrease the level of any offset. RURO also offered no support for the productivity factor of 4.2% and acknowledged in its testimony that existing plans in other states which still have productivity factors, had lower factors, which would decrease the level of any offset.
Basket which also includes a 25% individual rate cap. *Id.* Thus, Dr. Johnson’s proposal would subject even the most monopolistic wire centers in the state to potential local service price changes of up to 25% per year.

When questioned about this disparity in his filed testimony, Dr. Johnson replied as follow:

Q. If you go back to Mr. Rowell’s characterization of your various baskets, the 25 percent individual rate cap that’s contained in baskets – in the first two baskets, is that on a per-year basis?

A. Yes. So the end result is that you would not want to put something into a basket like that, whether it’s our basket or a slightly different named basket in the settlement plan unless you’re confident that the competition is already strong enough to preclude those kinds of extreme rate changes.

Q. Okay. Extreme rate changes. Let me refer you to page 26 of your surrebuttal testimony. Could you please read lines 15 through 22.

A. Given current market conditions and uncertainties concerning future trends and competition, RUCO recommends that residential local exchange services be placed in the moderate pricing flexibility basket within all wire centers except for Phoenix main and Tucson main.

Within these two wire centers residential local services should initially be placed in the high pricing flexibility basket.

Once experience has been gained with the impact of this reassignment, it would be reasonable to consider a request for movement into the total pricing flexibility basket.

Q. So, Dr. Johnson, it’s your testimony, then, based upon what you just said, that the residential local exchange services and all wire centers except Phoenix main and Tucson, but then also Phoenix main and Tucson, since they would be in the high pricing flexibility basket, be subject to extreme rate changes?

A. Yes, that’s true in a sense. But the thrust is that based on the trends – and I believe the data since my testimony was filed confirms that I was correct about the trends, that there is enough competition in Phoenix main and Tucson main that we were willing to use that as the guinea pig, shall we say, where we tried giving the company more freedom.

We really don’t think they’re going to be raising rates 25 percent in an area where they’ve already lost half the market.

Q. Is it wise, Dr. Johnson, do you think, to subject that many residential customers to extreme pricing changes and to utilize them as a guinea pig?

A. It is wise to avoid extreme price change and that’s what we’re doing.

* * * * *
Q. I believe you said all other wire centers other than Phoenix and Tucson main would go into the moderate pricing flexibility basket, and that also allows for a 25 percent individual rate increase per year.

A. That is a basket in which all of the services that are not competitive are being placed in.

Now, to the extent the company then has some flexibility in deciding to what extent they want to raise residential prices given the competition they're facing from Cox versus raising business services, or allowing business services, they would have some flexibility to do that, I agree.

But that is a situation – if you look at the data, okay, in which – given the rate caps that are in effect for the service, we did not think that was unreasonable.

(Tr. at 459-62).

In spite of this Dr. Johnson states: “The high degree of pricing freedom that would be granted Qwest under the proposed settlement is not consistent with the limited inconsistent state of competition in much of Qwest’s Arizona service territory.” (Ex. RU CO-14 at 3; Ex. S-39 at 6). Apparently, Dr. Johnson does not recognize that under the Settlement Agreement, all basic local rates for residential and business customers are capped at their current levels. Moreover, as discussed earlier, both Baskets 2 and 3 contain a cap on the level of rate increases. In addition, the services in Basket 2 are individually capped so that they may not increase over 25% per year. Finally, the services in both Baskets 2 and 3 are subject to maximum rate levels which the Company may increase only with Commission approval.

The following side by side comparison demonstrates that RU CO’s basket proposal contains considerably more pricing flexibility than that provided for under the Settlement Agreement.

**RU CO Basket Proposal**

<table>
<thead>
<tr>
<th>Pricing Flexibility</th>
<th>25 percent individual rate cap and an overall revenue cap - GDP-PI minus 4.2 percent productivity offset.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moderate Pricing Flexibility</td>
<td>25 percent individual rate cap and an overall revenue cap that increases annually by two times the change in GDP-PI.</td>
</tr>
<tr>
<td>High Pricing Flexibility</td>
<td></td>
</tr>
</tbody>
</table>

31 (Ex. RU CO-10 at 184).
32 Id. at 188.
Total Pricing Flexibility  Individual rate caps pursuant to A.A.C. R14-2-1109 and R-14-2-1110 and no overall revenue cap.  

### Settlement Agreement Baskets

<table>
<thead>
<tr>
<th>Service Type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Hard-Capped Retail Services</strong></td>
<td>All services are hard-capped for the duration of the Plan at their existing levels.</td>
</tr>
<tr>
<td><strong>Limited Pricing Flexibility Retail Services</strong></td>
<td>Additional revenue for this Basket is capped at $13.8 M. Services subject to a 25 percent individual price increase cap. Services subject to maximum rate requirements.</td>
</tr>
<tr>
<td><strong>Flexibly-Priced Competitive Services</strong></td>
<td>Additional revenue for this Basket is capped at $30.0 M plus the remainder of the $13.8 Million not used for Basket 2. Services subject to maximum rate requirements.</td>
</tr>
<tr>
<td><strong>Wholesale Services</strong></td>
<td>Prices are capped at the tariffed or contract price levels until contracts are renegotiated or the Commission, Courts or FCC determine that other prices are appropriate.</td>
</tr>
</tbody>
</table>

### E. The Agreement Benefits Residential Consumers.

RUCO asserts "[t]he agreement results in a modified price cap plan that, when compared to the existing plan, negatively impacts residential ratepayers." (Ex. RUCO-8 at 2).

1. **The productivity adjustment is no longer appropriate.**

One of RUO’s primary criticisms with the Settlement Agreement is that the Plan agreed to  
by the parties does not include a productivity adjustment. The reasons why a productivity factor is no  
longer appropriate were perhaps best summarized by Staff witness Rowell at the hearing:

The most significant change to the plan discussed in my testimony is the elimination of the productivity adjustment factor.  

Staff advocated elimination of the productivity adjustment factor primarily because of Qwest’s loss of revenues and customers.

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33 Id. at 190.
In an environment where revenues are growing, a productivity adjustment might be appropriate to provide incentives for the company to operate efficiently. However, in an environment where revenues are declining and customers are being lost, a productivity adjustment is no longer appropriate. In such an environment, competition provides an incentive for the company to operate efficiently.

(Tr. at 306-307).

Staff believes that Qwest's inability to meet its revenue requirement would be exacerbated if the productivity adjustment were continued throughout a renewed price cap plan. Qwest's revenues declined severely from 2001-2004 due to increases in competition, and this trend does not seem likely to reverse.

The sole critic of canceling the productivity adjustment has been RUCO. According to their expert, Dr. Johnson, "[a]n offset continues to be appropriate . . . it is not inappropriate for these cost reductions to be passed through to consumers, even if it results in a net reduction in Qwest's revenues (e.g., where Qwest's market share is declining)."34 Dr. Johnson agreed that during the current price plan, "because inflation has been low relative to the productivity factor, Qwest has been forced to lower its prices."35

It is for these reasons that the Parties determined that continuation of the productivity adjustment mechanism would be counter productive to the goal of assisting Qwest, as the provider of last resort, to meet its revenue requirement. In addition, Staff believes it is counterproductive to require a productivity adjustment on top of a large revenue deficiency.

2. There are many benefits to residential ratepayers under the Settlement Agreement.

Staff counsel's opening statement enumerated all of the many benefits to residential ratepayers under the Settlement Agreement:

The settlement reduces the company's claimed revenue deficiency of over $300 million to $31.8 million. It reduces the revenue deficiency calculated by RUCO of $160 million down to $31.8 million. That is good for consumers in Arizona.

34 (Ex. RUCO-10 at 94).
35 Id. at 26.
It eliminates the company’s request for AUSF funds of $64 million in this proceeding. AUSF issues affect more than just Qwest, and they are being resolved in the generic docket. This is good for consumers in the state of Arizona.

It provides for no increase in basic rates beyond current levels for another three years. It also provides a moratorium on Qwest’s ability to request rate increases. This is good for Arizona consumers.

It reduces the company’s revenue requirement in year one of the plan by $12 million to account for the 2005 productivity adjustment, and results in dismissal of the associated appeals by the company. This is good for consumers in Arizona.

Basic rates will continue to be calculated on a statewide basis rather than at the [de]average[d] basis under a competitive zone approach. This is good for consumers in Arizona because they will continue to benefit by the company’s responses to competitive conditions in non-rural markets.

The existing service quality tariff is strengthened to encourage the company to give consumers the highest quality service available. This is good for consumers in the state.

Qwest will increase the line extension credit from $3,000 to $5,000. This is good for underserved customers in the state.

Qwest directory assistance rates will remain at existing levels, and Qwest will continue the monthly one free call allowance. This is good for consumers in the state.

Qwest depreciation expenses will be reduced by 255 million annually for the first five years, and 225 million annually thereafter. This is good for consumers in the state.

The services in Basket 2 and 3 will be subject to both maximum rate levels and an overall revenue cap. This is good for customers.

The company will implement other important consumer benefits equal to approximately 5.5 million a year. These include a reduction in zone increment charges by 50 percent, a reduction in non-published and non-listed number rates by 50-cents, and an increase in funding for the medically needy program of $1 million annually with additional publicity. This is good for Arizona consumers.

The company will be allowed to include package offerings in Basket 3, allowing it to more effectively respond to competition. This is good for consumers, including rural consumers.

Switched access rates will be reduced by 12 million a year with no effect on basic rates. This is good for consumers. And to the extent this reduction is passed on to consumers through lower toll rates, this is good also.

The agreement spreads the revenue increase allowed through the plan to Baskets 2 and 3 only.
Finally, the agreement limits the amount of the revenue increase that may be applied to Basket 2, which contains less competitive services. Basket 2 also caps the increase on any individual service by 25 percent per year. This is good for consumers.

(Tr. at 34-36).

F. **RUCO's Proposal with Respect to the April 1, 2005 Productivity Adjustment Is not Required under the Existing Plan's Provisions.**

Last, RUCO takes issue with "[t]he manner in which the issue of the April 1, 2005 productivity adjustment (required under the existing plan) is resolved by the settlement." (Ex. RUCO-8 at 2).

Qwest has the option under the current price plan of reducing prices in Basket 1, which include services which are hard capped as well as takes services subject to the 25% individual annual rate increase cap. During the three years that the productivity adjustment was applied, Qwest reduced the rates of 15 different services, none of which was residential basic service. Of these fifteen services, 60% are within the proposed Basket 2 of the Settlement Agreement. Thus, the Settlement Agreement applies the $12 Million offset to Basket 2 because it is consistent with how the Productivity Adjustment had been applied in the past.

RUCO argues that this settlement term does not provide credit for the “full” value of the April 1, 2005 adjustment. To the contrary, the compromise that the Parties reached shields the ratepayers from $12 million of the rate increase otherwise possible in Year 1 of the renewed Plan. Staff believes that the provisions of the proposed Settlement Agreement satisfy the April 1, 2005 productivity adjustment because there is an immediate $12.0 Million reduction in Qwest’s revenue requirement for Year 1 of the Plan.

RUCO instead recommends that residential and business basic rates be reduced by an amount equal to a twelve month amortization of the value of the April 1, 2005 productivity adjustment that

36 Year 1, 2002 - (1) non-recurring charges for business and residence custom calling and listings, (2) basic business services non-recurring and recurring rates, (3) digital switched service and uniform access solution rates; Year 2, 2003 – (1) residential additional line rate, (2) basic business service non-recurring and recurring rates, (3) custom calling feature recurring rates, (4) market expansion line rates, (5) hunting service rates, (6) residence package rates; Year 3, 2004 – (1) residential additional line rates, (2) basic business service recurring rates, (3) business listing service rates, (4) market expansion line rates, (5) basic exchange enhancement rates, (6) residential package rates. (Ex. S-38 at 4-5).
was foregone during the suspension period.\textsuperscript{37} Yet, this recommendation is not consistent with the current price plan provisions since the Company has the discretion to apply the offset to any services in Basket 1 that it desires. Given Qwest's history with past adjustments, it is unlikely that any adjustment would have been made to basic residential and business rates. At no time since the current plan was approved has the residential basic rate decreased as a result of the operation of the productivity adjustment. Staff does not believe that RUCO's proposal to apply the entire $12 Million adjustment to basic rates reflects what was likely to occur had Qwest made the April 1, 2005 adjustment.

Moreover, one of the concerns expressed in Decision 67734 was the potential for customer confusion with a temporary rate decrease followed by a subsequent rate increase. Staff believes RUCO's proposal could cause customer confusion.\textsuperscript{38}

\textbf{IV. CONCLUSION.}

The Arizona Supreme Court has noted, "[i]t has always been the policy of the law to favor compromise and settlement; and it is especially important to sustain that principle in this age of voluminous litigation. . ." \textit{Dansby v. Buck}, 92 Ariz. 1, 11, 373 P.2d 1, 8 (1962). This case has already had voluminous litigation and threatens to generate much more, since the controversy began two and one half years ago and there are now two consolidated cases pending before the Appellate Court.\textsuperscript{39}

Based on the foregoing and given the difficulty the Parties encountered in reaching agreement, the complexity of the compromises, the length of the preceding litigation, the desire to keep further litigation to a minimum, and the benefit to consumers, the Parties request that the Commission approve the Settlement Agreement.

\textsuperscript{37} \textit{Id.} at 6.
\textsuperscript{38} (Ex. Q-37 at 7).
\textsuperscript{39} \textit{Qwest v. Arizona Corporation Commission}, et. al., Nos. 1-CA-CC 04-0001, 1-CA-CC 04-0002 (Consolidated).
RESPECTFULLY submitted this 2nd day of December, 2005.

Christopher C. Kempley, Chief Counsel
Maureen A. Scott, Attorney
Linda Fisher, Attorney
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007
Telephone: (602) 542-3402

Original and 15 Copies of the foregoing filed this 2nd day of December, 2005, with:

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

Copy of the foregoing mailed this 2nd day of December, 2005, to:

Jane L. Rodda
Administrative Law Judge
400 West Congress Street
Tucson, Arizona 85701

Todd Lundy
Qwest Law Department
1801 California Street
Denver, Colorado 80202

Jeffrey W. Crockett
Snell & Wilmer
One Arizona Center
400 East Van Buren
Phoenix, Arizona 85004-2202

Michael W. Patten
Roskhka DeWulf & Patten, PLC
400 E. Van Buren Street, Suite 800
Phoenix, Arizona 85004

Timothy Berg
Theresa Dwyer
Darcy R. Renfro
Fennemore Craig, P.C.
3003 North Central Avenue, Suite 2600
Phoenix, Arizona 85012-2913

Martin A. Aronson, Esq.
Morrill & Aronson, PLC
One East Camelback, Suite 340
Phoenix, Arizona 85012-1648
Attorneys for Arizona Dialtone, Inc.

Scott S. Wakefield, Chief Counsel
RUCO
1110 West Washington Street, Suite 220
Phoenix, Arizona 85007

Mark A. DiNunzio
Cox Arizona Telcom, LLC
MS: DV3-16, Bldg. C
1550 West Deer Valley Road
Phoenix, Arizona 85027
Thomas H. Campbell
Michael T. Hallam
Lewis and Roca
40 North Central Avenue
Phoenix, Arizona 85004
Attorneys for MCI and Time Warner

Peter Q. Nyce, Jr.
Regulatory Law Office
U.S. Army Litigation Center
901 N. Stuart Street, Suite 713
Arlington, Virginia 22203-1644

Walter W. Meek
AUIA
2100 N. Central, Suite 210
Phoenix, Arizona 85004

Joan S. Burke, Esq.
Osborn Maledon P.A.
2929 North Central Avenue
Suite 2100
Phoenix, Arizona 85012

Dan L. Poole
Qwest Corporation
1801 California Street, 10th Floor
Denver, Colorado 80202

Thomas F. Dixon
WorldCom, Inc.
707 17th Street, 39th Floor
Denver, Colorado 80202

Richard Lee
Snavely King Majoros O’Connor & Lee, Inc.
1220 L Street, N.W., Suite 410
Washington, D.C. 20005

Albert Sterman
Arizona Consumers Council
2849 East Eighth Street
Tucson, Arizona 85716

Brian Thomas
Vice President Regulatory
Time Warner Telecom, Inc.
223 Taylor Avenue, North
Seattle, Washington 98109

Norman Curtright
Qwest Corporation
4041 North Central Avenue
Room 1100
Phoenix, Arizona 85012

Karyn Christine, Executive Legal Assistant