BEFORE THE ARIZONA CORPORATION COMMISSION

WILLIAM A. MUNDELL
CHAIRMAN
JIM IRVIN
COMMISSIONER
MARC SPITZER
COMMISSIONER

IN THE MATTER OF THE APPLICATION OF U S WEST COMMUNICATIONS, INC. A COLORADO CORPORATION, FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY, THE FAIR VALUE OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN.	DOCKET NO. T-01051B-99-0105
IN THE MATTER OF U S WEST COMMUNICATIONS, INC. TARIFF FILING FOR APPROVAL OF A $.25 SURCHARGE FOR A CALL TO A U S WEST 800 SERVICE LINE FROM A PAY TELEPHONE.	DOCKET NO. T-01051B-00-369 DECISION NO. _____ **OPINION AND ORDER**

DATES OF HEARINGS: September 16, 1999; April 4, April 12, May 3, June 16, July 25, July 28, October 16, November 2, November 22, 2000 (pre-hearing conferences), November 29, November 30, December 1, and December 4, 2000.

PUBLIC COMMENTS: June 21, 2000 – Flagstaff, Arizona; July 6, 2000 – Prescott, Arizona; July 11, 2000 – Payson, Arizona; July 26, 2000 – Globe, Arizona; August 3, 2000 – Phoenix, Arizona; August 14, 2000 – Tucson, Arizona; August 30, 2000 – Yuma, Arizona; September 5, 2000 – Sierra Vista, Arizona; and September 6, 2000 – Bisbee, Arizona.

PLACE OF HEARING: Phoenix, Arizona

ADMINISTRATIVE LAW JUDGE: Jane Rodda

IN ATTENDANCE: Carl J. Kunasek, Chairman
Jim Irvin, Commissioner
William A. Mundell, Commissioner

APPEARANCES: Mr. Timothy Berg and Ms. Theresa Dwyer, FENNEMORE CRAIG, and Mr. Thomas Dethlefs, U S WEST COMMUNICATIONS, INC., on behalf of U S WEST COMMUNICATIONS, INC.;

Ms. Joan S. Burke, OSBORN MALEDON, P.A., Mr. Robert S. Tanner and Ms. Mary Steele, DAVIS,

WRIGHT TREMAINE, LLP, and Mr. Richard S. Wolters, on behalf of AT&T Communications of the Mountain States, Inc.;

Mr. Raymond S. Heyman, ROSHKA, HEYMAN & DEWULF, PC, on behalf of the Arizona Telephone Retiree Association and Arizona Payphone Association;

Mr. Thomas H. Campbell and Mr. Gregory Y. Harris, LEWIS AND ROCA, LLP, on behalf of Rhythm Links Communications;

Mr. Michael W. Pattern, BROWN & BAIN, P.A., on behalf of Cox Arizona Telecom and e-spire™ Communications;

Mr. Thomas F. Dixon, Jr., on behalf of MCI WorldCom;

Mr. Scott S. Wakefield, Chief Counsel, and Ms. Jessica L. Carpenter, Staff Attorney, on behalf of the Residential Utility Consumer Office;

Mr. Richard Lee, SNAVELY, KING & MAJOROS, and Mr. Peter Q. Nyce, Jr., General Attorney, on behalf of the Department of Defense and Federal Executive Agencies;

Mr. Bradley S. Carroll on behalf of Cox Arizona Telecom, Inc.;

Mr. James McGillivary on behalf of intervenors J.E. and B.V. McGillivary;

Mr. Darren S. Weingard on behalf of Sprint Communications Co., L.P.;

Mr. Joseph Gosiger and Ms. Diane Bacon on behalf of the Communications Workers of America;

Mr. Michael M. Grant, GALLAGHER & KENNEDY; on behalf of Citizens Utilities Company; and

Mr. Christopher Kempley, Assistant Chief Counsel, and Ms. Maureen Scott, Staff Attorney, Legal Division, on behalf of the Utilities Division of the Arizona Corporation Commission.

BY THE COMMISSION:

On January 8, 1999, Qwest Corporation ("Qwest") formerly known as US West Communication Co., Inc. filed an application for an increase in rates with the Arizona Corporation Commission ('Commission").

Procedural Background

Our Procedural Order dated March 4, 1999, established a schedule for filing testimony and set a hearing for November 4, 1999. In October 1999, Qwest and Commission Utility Division Staff ("Staff") filed a joint motion to continue the procedural dates pending resolution of Qwest's pending depreciation case (Docket No. T-1051-97-0689). A Procedural Order filed January 7, 2000, continued the hearing pending resolution of the depreciation docket and suspended the time clock rules.

In January 2000, Staff filed a Motion for Qwest to update the test year. A Procedural Conference was held on April 4, 2000 and Qwest was directed to re-file its schedules using a calendar year 1999 test year. Qwest filed updated testimony on its revenue requirement and rate of return on May 3, 2000, and updated testimony on rate design, cost studies and RCND on May 19, 2000. Our Procedural Order filed May 5, 2000, set dates for filing testimony and scheduled a hearing for September 25, 2000. Our July 27, 2000 Procedural Order set revised dates for filing testimony of all parties.

Public Comment sessions were held in Flagstaff, Prescott, Payson, Globe, Phoenix, Tucson, Bisbee, Sierra Vista and Yuma throughout June, July and September, 2000. On August 9, 2000 Staff and intervenors filed direct testimony. On August 21, 2000, Qwest filed rebuttal testimony. On September 8, 2000 Staff and intervenors filed surrebuttal testimony. On September 19, 2000, Qwest field rejoinder testimony.

On September 19, 2000, Staff and Qwest filed a motion to continue the hearing pending discussions on possible settlement. By Procedural Orders dated October 4, and October 17, 2000, the hearing was continued until November 29, 2000. On October 20, 2000, Qwest and Staff filed a Settlement Agreement addressing all of the issues raised in the rate case.

On October 27, 2000, Qwest, Staff and Communication Workers of America ("CWA") filed direct testimony on the Settlement Agreement. On November 8, 2000 and November 13, 2000, the Residential Utility Consumer Office ("RUCO"), AT&T Communications of the Mountain States, Inc. ("AT&T"), Cox Arizona Telecom L.L.C. ("Cox") and the Department of Defense ("DOD") filed direct testimony on the Settlement Agreement. On November 15, 2000, RUCO filed additional direct

testimony on the Settlement Agreement. On November 20, 2000, Qwest and Staff filed rebuttal testimony on the Settlement Agreement. On November 28, 2000, the American Payphone Association ("APA") filed testimony in support of the Settlement Agreement.

On November 29, 2000, through December 4, 2000, the Commission conducted a hearing on the Settlement Agreement. Public comment was heard prior to the commencement of the evidentiary proceeding. Following the hearing, on December 18, 2000, the parties filed post-hearing briefs. On December 18, 2000, Staff filed a revised Settlement Agreement that incorporated language clarifications that had been discussed during the hearing. On December 26, 2000, Staff and Qwest filed a Response to Suggested Revisions of RUCO, Cox and AT&T, attaching a Second Revised Settlement Agreement and Price Cap Plan. On January 8, 2001, AT&T filed a Reply to Price Cap Plan Revisions of Staff and Qwest, stating that the proposed revisions do not address AT&T's major concerns.

Settlement Agreement Terms

In the Settlement Agreement and its attendant Price Cap Plan,[1] Staff and Qwest proclaim that in reaching the settlement of the rate case, it is their intent to create incentives for Qwest to improve efficiency, to provide new and innovative service offerings and to reduce the opportunity for cross-subsidization of competitive services by non-competitive services. The Price Cap Plan has a term of three years, and is intended to provide rate stability to consumers by capping rates for essential services and could lead to rate decreases as a result of productivity gains.

In the Settlement Agreement, Qwest and Staff agree that the "fair value" of Qwest's Arizona rate base for the test year ending December 31, 1999 is $1,446.0 million and that a reasonable rate of return on the fair value rate base is 9.61 percent. The fair value rate base and rate of return are the same figures that Staff proposed in its testimony filed prior to negotiating the Settlement Agreement. Based on the foregoing rate base and return figures, Staff and Qwest negotiated a revenue requirement deficiency of $42.9 million.

The Price Cap Plan divides Qwest's services into "baskets". Basket 1 consists of Basic/

[1] A copy of the Second Revised Settlement Agreement and Price Cap Plan are attached hereto as Exhibit A, and incorporated herein by reference.

Essential Non-competitive Services, such as basic residential service, basic business service, directory assistance, private line services, among others. Basket 2 consists of wholesale services, and Basket 3 consists of flexibly-priced competitive services. The parties to the Settlement Agreement agreed that the revenue requirement deficiency would be recovered through 1) a combination of increases and decreases in rates for services in Basket 1 amounting to a net increase of $17.6 million and 2) the opportunity to recover $25.3 million from the flexibly-priced competitive services in Basket 3. Qwest and Staff also agreed that rates for Intrastate Switched Access Service, part of Basket 2, would be reduced by $5 million in each year of the Plan. Revenues from Basket 3 services are allowed to increase by $5 million in each year of the Plan to correspond to the reduction in access revenues.

Under the terms of the Settlement Agreement, Staff and Qwest have agreed to a Price Cap Plan. The Price Cap Plan provides that Basket 1 Services will be capped and subject to an "Inflation minus Productivity" indexing mechanism. Thus, when productivity exceeds inflation, rates will decrease. The Productivity Factor for the initial term of the Plan is 4.2 percent, which includes a 0.5 percent consumer dividend. Certain Basket 1 services (including Basic Services such as flat rate residential, flat rate business, telephone assistance programs, caller ID block, toll blocking, among others) are subject to a "hard cap". These "Basic" services are capped at their initial levels throughout the term of the Price Cap Plan and may be reduced according to the Price Cap Index, but cannot increase. Individual rate elements for the other Basket 1 services may not increase by more than 25 percent within a year.

Basket 2 services are primarily wholesale in nature and generally governed by their own specific pricing rules and will continue to be governed by such rules. Thus, except for the reduction in Switched Access rates described above, Basket 2 services (including Discounted Wholesale Offerings, Unbundled Network Element Offerings, and wholesale services such as PAL lines) will remain at their current rates until the specific pricing rules are changed or the Commission determines that other prices are appropriate.

Basket 3 contains services already accorded pricing flexibility or determined by the Commission to be competitive, and new services and service packages. Basket 3 services are subject

to a price cap that allows a 10 percent increase in gross revenue over the term of the Plan, not to exceed $25.3 million on a test year basis (subject to an increase of $5 million, in the second and third years to compensate for the lower switched access revenues).

The Price Cap Plan contemplates that new services and packages of services will be placed in Basket 3, and provides that Basket 1 services may be combined with other services and be placed in Basket 3, but must also remain available as a Basket 1 service. The Price Cap Plan subjects new service offerings to Commission review in the same manner as tariff filings have been considered in the past. The Plan permits Qwest to offer new services and packages in Basket 3 to selected customer groups based on purchasing patterns or geographic location, but prohibits Qwest from red-lining based on wealth or race or discriminating against any class of customers in violation of A.R.S. Section 40-334. Basket 1 services may be moved to Basket 3 upon Qwest meeting the criteria of R14-2-1108 (which requires a finding that the service is competitive).

The Settlement Agreement requires Qwest to submit an application for continuation or modification of the Price Cap Plan nine months prior to its expiration, to be reviewed by Staff and RUCO. Continuation or modification of the Plan is subject to Commission approval and the Plan remains in effect pending a Commission decision renewing, modifying or terminating it.

The Settlement Agreement also amends the terms of Qwest's Service Quality Plan tariff to provide that in the event Qwest is subject to penalties under two or more categories in the Service Quality Plan tariff, it will be required to pay additional credits of $2.00 per residential or business access line, above those which would already be required under the tariff. The Settlement Agreement provides that no additional service quality penalties or credits will be imposed during the initial term of the Price Cap Plan, but clarifies that it does not preclude the imposition of penalties or standards for wholesale services.

The Settlement Agreement provides that in the event there is a change of controlling state or federal law, or the Price Cap Plan is found to be unlawful, Staff and Qwest shall discuss whether the Plan can be modified, and that Qwest shall have no obligation to refund revenues collected during the period of the Price Cap Plan.

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Arguments For and Against the Settlement Agreement

Staff and Qwest argued that the Settlement Agreement and Price Cap Plan present an alternative form of regulation that benefits consumers by providing the stability of a rate cap on essential basic services, reducing switched access rates and encouraging competition by allowing Qwest pricing flexibility in areas where there is competition. Staff noted that if the Commission approves the Settlement Agreement it will become one of 41 states to use Price Cap regulation. Staff believed that the benefits of Price Cap regulation are to encourage a company to become more efficient and innovative but still protect still captive consumers and competitors during the transition to fully competitive markets. Consumers will benefit from an "inflation less productivity" cap which will reduce Basket 1 non-competitive services in the aggregate when the productivity offset exceeds inflation. In addition, there are certain basic/essential services that are subject to a hard cap and cannot increase over the term of the Plan. Other basic services and individual rate elements may increase no more than 25 percent in each year. Some customers will see reductions in their monthly bill due to the elimination of zone charges in exchanges with expanded base rate areas and the Plan reduces rates for installation of basic residential service and eliminates the initial charge to connect service in rural areas.

The DOD, the CWA and the APA support the Settlement Agreement.

RUCO, the Arizona Consumers Council, AT&T and Cox opposed the adoption of the Settlement Agreement and Price Cap Plan because they believed the Plan's structure does not meet the goal of benefiting consumers and promoting competition. They argued that one of the Plan's purposes to allow Qwest to "compete more effectively" is wholly inconsistent with the Telecommunications Act of 1996 and the Commission's policy of encouraging competition. These parties believed that the tools of competition afforded to Qwest under the Plan allow Qwest to operate in an anti-competitive way. They also assert that the Settlement Agreement and Price Cap Plan contain too much ambiguity and uncertainty to be in the public interest. Furthermore, they argue, introducing a new form of regulation in the context of a settlement agreement between two parties compromises the issues and does not lead to the best long-term policy. The major issues of debate are discussed below.

Proposed Revenue Requirement

RUCO and AT&T argued that the proposed revenue requirement is too high. Prior to the Settlement Agreement, Qwest had requested a revenue increase of $201 million; Staff recommended an increase of $7.2 million, RUCO recommended a decrease of $34 million, the DOD recommended a decrease of $52 million and AT&T recommended a decrease of either $45 million or $308 million (depending on the method of imputing directory revenue).

RUCO argued that when adopting a price cap plan, the starting level for rates is critically important to its optimum success, because if rates are set too high Qwest's over-earnings would continue for the term of the plan. RUCO noted that in several other states local exchange carriers have been required to implement rate reductions or additional infrastructure investment as a trade for pricing flexibility under a price cap plan.

AT&T and RUCO complained that Staff and Qwest considered only Staff's recommended adjustments in deriving the negotiated revenue deficiency, ignoring other parties' adjustments. RUCO noted that it proposed several adjustments not proposed by Staff and some that were similar to, but exceeded Staff's adjustments.

Staff believes the overall revenue requirement increase contained in the Settlement Agreement provides just and reasonable rates. Staff noted that several of the disputed revenue issues have no guiding precedent in Arizona and Staff believed that if Qwest prevailed on only a few, the resulting rate increase would be much higher. Both Staff and Qwest explained they did not engage in issue specific negotiations, but rather negotiated the revenue requirement on an overall basis. Staff noted that if a "split the baby" approach was taken to deriving the revenue requirement, it would have taken the midpoint between Qwest's $201 million request and the DOD's lowest recommendation (minus $52 million)[2] to arrive at a revenue requirement of $74.5 million. Even a "split the baby" approach between Staff and Qwest proposals alone would have resulted in a revenue requirement deficiency of $97 million.

DOD found the Settlement Agreement to be a reasonable compromise given the many

[2] Setting aside AT&T's recalculated directory imputation, which Staff characterized as aberrant.

contentious issues raised by the parties and the inherent uncertainty of revenue requirement projections.

After consideration of the entire record, the negotiated revenue requirement is reasonable. It is based in part on Staff's proposed fair value rate base and rate of return. Staff's recommended fair value rate base was the lowest of the three parties who submitted testimony on the issue.[3] In accepting the agreed upon revenue increase, we of course, are not determining how the Commission would decide any particular issue. In the context of the Settlement Agreement before us, which includes the allocation of the increase between competitive and non-competitive services, hard caps of certain basic essential services, lower prices for other basic services, lower switched access rates and a productivity index capped at zero, the evidence supports a finding that the negotiated increase of $42.9 million is within the range of reasonable results.

Of the $42.9 million increase, $17.6 million will derive from an increase in some basic non-competitive services, primarily from directory assistance rates and rates for private line services, while the remaining $25.3 million increase will derive from competitive services. Currently, all the services in Basket 3 are already flexibly priced. Depending on market conditions, Qwest may or may not be able to attain the authorized increase in revenue allocated to these services.

Productivity Factor

AT&T and RUCO argued that the proposed productivity factor is too low. The purpose of the productivity offset in a price cap plan is to pass a carrier's reasonably anticipated increases in productivity on to consumers through rates. They believed that the proposed productivity factor of 4.2 percent fails to adequately represent the productivity increases that Qwest is likely to experience over the life of the Price Cap Plan. Recently, the Federal Communications Commission ("FCC") adopted a 6.5 percent productivity offset. Additionally, Qwest recently agreed to a 6.2 percent productivity factor in Utah. RUCO believed that those states that set productivity factors in the 3-4 percent range several years ago discovered that carriers are over-earning, which indicates the 3-4

[3] Staff's recommended return on equity was 11.75 percent; RUCO's was 11.5 percent; and Qwest's was 14 percent.

percent range is too low.

Because the productivity factor used in the Settlement Agreement was based on an analysis of Qwest's historic productivity from 1985 to 1998, RUCO and AT&T argued that it fails to recognize the productivity increases expected from the Qwest/ US West merger or the sale of rural exchanges to Citizens Communications Co.

Staff argued that the 6.5 percent X-factor adopted by the FCC as part of the CALLS settlement plan is used as a transition mechanism to reduce access charges to targeted levels, rather than simply as a productivity offset. Staff believed that Qwest accepted a major concession with respect to the productivity factor when it agreed that the productivity calculation is capped at zero and has no lower bound. Thus, in this Agreement Qwest has accepted the risk of inflation for the term of the Plan. This provision is not contained in the FCC CALLS settlement plan or the plans of other state commissions, as those plans allow increases in prices to the extent inflation exceeds productivity. Staff also noted that the 6.2 percent productivity rate agreed to in Utah was the result of a settlement of the Qwest/ US West merger and is only in effect for one year.

DOD believes the 4.2 percent productivity factor was realistic and that the three year term of the Price Cap Plan represents a long enough period to provide Qwest with a real incentive, but a short enough period to prevent Qwest from reaping a windfall if the productivity factor turns out to be too low.

The Productivity Factor contained in the Settlement Agreement is reasonable in light of all the evidence. The Price Cap Plan term is for only three years, and if the Commission finds Qwest has, or is expected to, enjoy greater productivity gains than it has in the past, this factor, as well as other terms of the Agreement, can be adjusted. At that time the expected benefits from the merger will be measurable. Each state in determining an appropriate productivity factor has different starting points and issues that concern them. We note that in the past year in approving the Qwest/U S West merger and the sale of certain exchanges to Citizens Communications Co., the Commission has required Qwest to make substantial investments in the state.

Basket Structure

RUCO argued that the Price Cap Plan is flawed because it does not separate residential and

business services into separate baskets. RUCO claimed that by placing business and residential services together in one basket permits Qwest to raise the price of some residential services (those not subject to the "hard cap") while at the same time reducing the price of business services. RUCO believed that any price restructuring of residential rates should be revenue neutral only within the residential class of rates and that price restructuring of business services be revenue neutral within the business class, and that without this protection, Qwest could raise residential rates while lowering business rates.

RUCO also believed the plan was flawed because it fails to provide separate baskets for services facing various degrees of competition. RUCO claimed the Price Cap Plan denies the Commission the opportunity to classify services in accordance with the subtle nuances of actual market conditions.

Staff believed that those advocating additional baskets did not consider that Basket 1 is essentially subdivided into essential services which are subject to the hard cap and non-competitive/non-essential services that are subject to the less stringent pricing rules, including a 25 percent limit. Staff claimed that the hard cap on essential services prevented the drastic rate restructuring between business and residential rates of which RUCO warned.

We believe that the number of baskets in the Price Cap Plan is appropriate and does not need to be modified at this time.

Access Rates

AT&T argued that the Plan fails to reduce intraLATA toll switched access rates to a competitive level. AT&T claimed that because Qwest still maintains monopoly power in the local market, Qwest is able to charge substantially more than its cost of providing switched access services and this injures Arizona consumers by inflating the cost of toll services. AT&T notes that although prior to the Settlement Agreement Staff recommended that Qwest's access charges be reduced to a level equivalent to interstate access charges, the agreed reduction from approximately $.045 to $.033 over three years falls far short of the goal. AT&T advocates that Qwest's intrastate switched access

rates should be reduced to the level of its interstate rates over five years.[4] Further, AT&T also charged that the Plan is ambiguous in how the access reductions would occur in the second and third years of the Plan, and consequently, carriers can not determine how they will be affected.

Staff contended that the Plan's reduction of intrastate switched access rates is reasonable in light of the entire Plan. Staff notes that if access charges are reduced further, rates for other services would have to be increased to compensate for the lost revenue.

Qwest also argued that in advocating parity between intrastate and interstate switched access charges, AT&T ignores the fact that interstate and intrastate structures are not the same. The interstate rate structure contains an End User Common Line Charge that generates significant revenue. In reducing interstate access charges, the FCC has shifted significant revenue requirements from the carriers to the end user customers.

DOD supports the reduction in access charges and urges the parties to make further reductions with the lost revenue being made up from an End User Common Line charge or a further increase in the Basket 3 cap.

Although the Settlement Agreement professes a goal of reaching parity between Qwest's intrastate and interstate switched access charges, it does not, at least in its initial three year term reach that goal. It does, however, take a step forward. While we agree that achieving parity between intrastate and interstate switched access rates is a laudable goal, there are many other public policy issues that impact our ability to reach that goal, such as the desirability of imposing an End User Common Line charge. Such decision concerning the structure of toll service charges should occur in a generic docket as it affects more than just Qwest. The $15 million reduction in switched access revenue is reasonable at this time and in the context of this Settlement Agreement. In approving the Settlement Agreement, the Commission reserves the right to modify the structure of intra-state toll rates.

Treatment of New Services and Packages

Section 4) e) of the Price Cap Plan provides that a Basket 1 service can become the

[4] The proposed interstate rate in the CALLS proposal is $0.005 cents per minute.

component of a new service package in Basket 3 as long as the Basket 1 service is combined with at least one Basket 3 service. Any new service or package in Basket 3 is subject to Commission consideration as provided in A.R.S. § 40-250.

AT&T, Cox and RUCO claimed that the Price Cap Plan circumvents existing Commission rules by giving Qwest flexible pricing for any new service and for any service presently classified as non-competitive simply by offering the service in a package with a competitive service. Under its current rules (R14-2-1108, and –1109), the Commission grants pricing flexibility to a telecommunications carrier only after the Commission has determined that the carrier lacks market power in the provision of a service.

Opponents of the Plan argue that new services should not automatically be placed in Basket 3. Just because a service is new does not mean that competitive alternatives exist. They charge the danger is particularly evident for new services that are ancillary to existing services that are not yet classified as competitive. For example, a new Custom Calling feature that cannot be obtained apart from local exchange service (which is not yet classified as competitive). Customers desiring the new Custom Calling feature would not have sufficient opportunities to obtain the new feature from other providers because it can only be obtained from the carrier who provides dial tone to the customer. Competitors believed the danger of permitting Qwest to bypass Rule 1108, and a specific finding that the service or package is competitive, is exacerbated by the provision permitting flexible pricing in a limited geographic location.

They also argue all services or service packages, regardless of whether they are new or not, should meet the requirements of Rule 1108 before they are afforded flexible pricing.[5] Such treatment would comport with existing Commission rules. Alternatively, Cox argued new services or packages should be placed into Basket 1.

Cox noted that the Price Cap Plan also modifies Rule 1108 when Qwest requests to move a Basket 1 service to Basket 3 because it sets a six month time period for Rule 1108 determination by Staff. No such time period is set forth in Rule 1108 and this provision of the Price Cap Plan may

[5] As written, the Plan provides that if Qwest wants to move a Basket 1 service to Basket 3, it must comply with Rule 1108.

give Qwest the right to expedited treatment under Rule 1108.

Staff and Qwest have agreed to modify the Price Cap Plan by including language in section 4)e) that states: "The Commission retains the right to reject any proposed classification or filing." They believe this should alleviate concerns that non-competitive services will find their way into Basket 3. Staff claims that one thing opponents overlook is that pursuant to § 40-250, Qwest must submit tariffs containing any "new services" or "new service packages" to the Commission at least 30 days in advance of the proposed effective date. Staff states that one of the things the Commission will be looking at is whether the proposed classification is appropriate or not. Staff believed subjecting new product offerings to the criteria and procedures of A.A.C. 14-2-1108 is counter to consumers' interests. Staff believed that including new services in Basket 3 placed the risk of the failure of the new service on shareholders and not on ratepayers and that allowing a streamlined approval for new services will facilitate the rapid development of new technologies.

Staff and Qwest believe they have further clarified their intent with the language in subpart 4) e) ii) that states: "The mere repackaging of existing Basket 1 services does not create a 'new service' or 'new service package' for purposes of the Price Cap Plan." The Plan does not define the term "mere repackaging" and we believe that this language does not add the degree of protection that Staff and Qwest evidently rely on. The Plan permits Basket 1 services to be combined with Basket 3 services, but does not provide guidance to Staff when reviewing requests for new services.

Despite statements that competitors are protected under the Plan because all of the Commission's rules apply, section 4) e) removes new Basket 3 offerings from the provisions of R14-2-1108. Under Rule 1108 competitors and consumers receive notice of the request and Qwest would have to show the conditions in the relevant market that demonstrate the service is competitive, including the names and number of alternative providers, their ability to make functionally equivalent or substitute services available and other indicators of market power.

We recognize the benefits of permitting companies to respond quickly to the market and offer new services rapidly. However, we also want to ensure that our actions encourage rather than stifle competition. Thus, we approve this section of the Settlement Agreement that allows new services and service packages to be included in Basket 3 without having to meet all of the requirements of

R14-2-1108, only after modification. We approve this section with the express understanding that in reviewing new service and service package filings, Staff will specifically look at market conditions and whether the service or package is truly competitive, and with the understanding that under A.R.S. § 40-250, Staff may request additional time for its review. The six month time period for a review under Rule 1108 when Qwest requests a Basket 1 service be moved to Basket 3, appears reasonable, however, there may be circumstances when Staff requires additional time for its review. We believe that Staff should have the ability to request additional time from the Commission. Furthermore, given the current early stage of competition, we believe that it is critical that whenever Qwest desires to combine a Basket 1 service with a Basket 3 service, that request should be subject to all of the provisions of a filing under R14-2-1108. Finally, we believe that at least during the initial term of the Plan, that it is in the public interest for Qwest to provide notice to competitors of all new Basket 3 filings.

Pricing Provisions

Basket 1

RUCO believed the pricing provisions for Basket 1 are too lax. As originally proposed, the Price Cap Plan provided that prices for non-hard capped services may be increased by up to 25 percent for year. At the hearing Qwest clarified that despite the language of the Plan, the intent was for this provision to apply to individual price elements. In their Second Revised Settlement Agreement and Price Cap Plan filed after the hearing, Qwest and Staff changed the language to specify rate elements. Despite the clarification, RUCO believed the permitted increase was still too high.

The modified Price Cap Plan alleviates some if not all of RUCO's concerns. In the context of the Settlement Agreement as a whole, the modification is reasonable and should be approved.

Price Floors for Basket 3 Services

AT&T and RUCO argued that the price floor provisions that apply to Basket 3 services undermine competition. The Price Cap Plan creates an exception to the Commission's Imputation Rule (R14-2-1310.C) by allowing the 1FR (flat rate basic residential) to be priced below TSLRIC. Thus, under the Plan, Qwest could combine the 1FR service with any Basket 3 service to create a

new package subject to flexible pricing and that package could be priced below TSLRIC. The current 1FR rate is $13.18. The price competitors pay to purchase the loop as an unbundled network element ("UNE") is $21.98 on a statewide average. RUCO argued this sort of price squeeze discourages competition for residential customers.

AT&T claimed that the pricing floor is ambiguous and that testimony revealed that Staff and Qwest may have different views as to what imputation may be required. It appeared to AT&T that Staff may believe that imputation will be required for features and other essential services. Qwest appears to interpret the Plan as permitting it to price a package containing features at TSLRIC. It also appears Qwest does not believe that originating access is an essential service for purpose of imputation, while Staff believes it is. AT&T charges that the ambiguity will result in the Commission being called upon repeatedly to determine the extent to which Qwest is required to impute its own prices for retail services into the price floor or new packages and services, and such ambiguity is detrimental to competition and contrary to the public interest.

Cox recommended that if the Commission believes it is appropriate to keep 1FR at its current retail rate, the Commission can eliminate the anti-competitive effect by prohibiting a new Basket 3 service package from including 1FR service or by having the price floor for 1FR packages in Backet 3 include the Rule 1310.C amount for 1FR.

Cox also argued that neither a TSLRIC nor an imputed price floor recovers all costs of a service because neither one recovers common costs. Cox argued that the appropriate price floor should be at least the imputed price for a particular service, plus an additional amount to cover the common costs attributable to the particular service. Cox proposed an 18 percent markup (which is the current Qwest retail discount to CLECs – an amount that is supposed to represent Qwest's savings on marketing and other retail activities that it need not incur if it is selling service wholesale to a CLEC).

Staff believed that the Commission should address concerns relating to the Commission's imputation rules or their application in a separate proceeding. Staff noted that in response to issues raised at the hearing, Staff and Qwest have modified the Price Cap Plan by adding language to subpart 4) e) that the price of the new package or service shall exceed the TSLRIC of the package or

service and comply with the imputation requirements of A.C.C. R14-2-1310 (C). Staff and Qwest have also clarified that "For purposes of combining Basket 1 services with Basket 3 services and setting the floor for that package, the imputed price of 1FR service shall be the existing retail price of 1FR."

DOD agreed that the Commission's imputation rule must be clarified. DOD disagreed with Qwest's interpretation of the imputation rule as to originating access. DOD recommended that the Commission promptly clarify this section of its rules to confirm that originating access is an essential component of retail toll service, and that in any case, for the purpose of this Settlement Agreement, the Commission should specify that originating access is an essential component and subject to imputation.

To encourage competition we must resolve any ambiguities in our Rules. Consequently, we are ordering Staff to open a docket to investigate and rectify possible ambiguities involving the pricing of telecommunication services and imputation in particular. In the meantime, until the Commission has made a final determination regarding Rule 1310, for purposes of this Settlement Agreement, we require that originating access be considered an essential component of retail toll service.

Geographic Pricing

Subpart 4) g) of the Price Cap Plan allows "[n]ew services and packages in Basket 3 . . .[to] be offered to selected customer groups based on their purchasing patterns or geographic locations, for example. This provision shall not be construed to permit red-lining based on criteria such as wealth or race, or to permit Qwest to discriminate against any class of customers in violation of A.R.S. Section 40-334." Section 40-334 prohibits any unreasonable difference as to rates, charges, services, service facilities or in any other respect, either between localities or between classes of service.

AT&T and Cox argued that section 4) g) permits Qwest to undercut prices of services offered by competitors in limited geographic areas where Qwest faces competition while maintaining its monopoly profit margin in other areas. As written, they claim section 4) g) allows Qwest to target areas for flexible pricing even if there is little or no competition in those areas. There is no minimum size for the geographic location and it appears that new services and service packages may be

approved under section 4) g) without consideration of the level of competition within the geographic location. Cox and AT&T argued this results in giving Qwest the ability to spot price and to quash emerging competition in particular areas. Higher prices for the services in areas with no competition will subsidize the lower rates in select areas.

Cox compared the section 4) g) provisions to the "competitive zone" proposal which Staff's consultants criticized prior to negotiating the Settlement Agreement. Under the "competitive zone" proposal, Qwest would be allowed to have flexible pricing for all services offered in a particular wire center provided there were other competitors who could serve that wire center, regardless of whether they were actually serving the wire center in any significant way. Under Qwest's proposal, it would not have to meet the requirements of Rule 1108 to flexibly price in a competitive zone.

Prior to the Settlement Agreement, Staff had taken the position that whatever regulatory structure is adopted, it should include a requirement that prices in different geographic areas may not vary by an amount that is greater than the variation that is justified by any variation in the cost of providing service.

Cox argued that if section 4) g) remains in the Plan, terms such as "selected customer groups" "purchasing patterns" and "geographic location" need further explanation and definition. For example, could geographic location constitute a single office building? AT&T and Cox believe that the supposed protections offered by reference to A.R.S. § 40-334, are toothless, and essentially abrogated by section 4) g).

Staff disagreed and believed that A.R.S. § 40-334 will prevent the anticompetitive behavior about which Cox and AT&T complain. Staff argues that A.R.S. § 40-334(a) expressly prohibits the granting of any preference or advantage to any person or subjecting any person to any prejudice or disadvantage. Further, Staff states, § 40-334(b) expressly prohibits any public service corporation from establishing or maintaining any unreasonable differences as to rates, charges, service, facilities or in any other respect between localities or between classes of service. Subpart (c) vests the Commission with the responsibility to determine any question of fact arising under the section. Staff claims that all offerings under section 4) g) must be submitted to the Commission at least 30 days in advance of their going into effect, and that any inappropriate classification or anticompetitive pricing

which Qwest may attempt to engage in on a limited geographic basis would result in Commission denial.

Qwest argued the Settlement Agreement does not mirror the proposed competitive zone plan in its original rate case application. Under its competitive zone proposal, all services in Qwest's Phoenix and Tucson wire centers would have been flexibly priced. The price cap established for these competitive zones permitted a 100 percent ceiling above Qwest's existing rates and, in effect, would allow Qwest to double its prices. Qwest notes that under the Price Cap Plan there is a hard cap on essential services in Basket 1 and a ceiling of 10 percent in the aggregate for Basket 3 services. Furthermore, all services in Basket 3 have already been determined to be competitive or flexibly priced by the Commission.

Staff's assurances do not provide sufficient comfort to over-ride our concerns about Qwest's ability to price a competitive service very aggressively in a targeted area, but be able to price the same service or package much higher in areas where it doesn't face competition. At this time, we find ourselves agreeing with Staff's original position taken in response to Qwest's competitive zone proposal. Before we can approve the concept of geographic pricing variances, we believe that terms describing when, where and to whom such services may be offered need more definition. Given the apparent opposition between what section 4) g) allows and what A.R.S. § 40-334 prohibits, we believe the Commission will be subjecting itself to resolving numerous complaints. Consequently, this section should be removed from the Price Cap Plan. In the future, the parties may be able to fashion a provision that allows Qwest to compete in areas where it truly faces established competition, but such provision must better describe the geographic areas and population served as well as promote specific and clear protections against anti-competitive behavior.

Service Quality

RUCO did not believe that the Price Cap Plan provides adequate protections against further service quality deterioration, but rather gives Qwest greater incentive to sacrifice service quality for higher profits. AT&T proposed modifying the service quality protections to provide that Qwest must maintain service quality levels at a minimum to those prevailing immediately preceding adoption of the Plan, or the Commission could impose penalties or fines or terminate the price cap plan and

reinstate rate-of-return regulation.

We believe the increased penalties in combination with the relatively short term of the Plan should be sufficient incentive for Qwest to maintain or improve service quality. The term of the Plan is not so long that the Commission will not be able to stiffen penalties for persistent service quality declines in the near future.

Notice and Opportunity for Commission Review

Cox expressed concern about the ability of Staff and interested parties to monitor Qwest price floors. The Price Cap Plan is silent on how often Qwest must file TSLRIC cost studies or other price floor calculations with the Commission and it does not contemplate any particular follow-up to consider updated cost studies or price floor calculations after a new service or package is approved. Cox believed the lack of such review process or standard undermines the effectiveness of the Price Cap Plan from stopping cross-subsidies or predatory pricing.

Opponents of the Settlement Agreement were concerned that the Settlement Agreement did not contain a provision that required notice to consumers or competitors of proposed changes for Basket 1 services or for the filing of proposed new services or new service packages for Basket 3. Cox believed this lack was contrary to the policies expressed in R14-2-1108 which required notice to competitors any time a telecommunications company seeks to have its services deemed competitive and subject to flexible pricing.

AT&T believes it is even more critical that competitors receive notice of new service and package filings because Staff only has a 30 day time frame for its evaluation. AT&T argued that input from competitors is critical to Staff's analysis of anti-competitive pricing. Because AT&T did not believe that Qwest's cost studies should be accepted at face value, other carriers should receive notice of proposed new service offerings and the review time should be extended to 60 days to insure that Qwest is in compliance with all existing Commission rules.

We believe that our modification of the Settlement Agreement regarding the approval of new services addresses the parties' main concerns about notice, and that no further modification is required. We are concerned that Staff have sufficient time and information to make recommendations concerning new services. Thus, we believe Staff should retain the ability to

request extensions of any of the review deadlines established in the Plan.

"No Refund" Provision

RUCO argued the Commission should reject the Settlement Agreement because the provision that excuses Qwest from paying refunds in the event the Price Cap Plan is determined by a court to be unlawful is contrary to Arizona law. RUCO recommended that the Commission should order a refund upon a successful appeal unless doing so would be unjust in the particular circumstances of the case. RUCO did not think the Commission could make such conclusion at this time.

Staff defended this provision of the Settlement Agreement, stating that the Price Cap Plan provides for a wide range of changes in rates for specific services, some of which go up, and some of which go down. Staff believed it would be prohibitively difficult and costly to calculate and administer a refund in the event the Price Cap Plan were found to be unlawful. Further, Staff noted, fairness would seem to dictate that some ratepayers would be entitled to refunds, but others, whose rates went down under the Plan, would be required to pay a surcharge.

In such a situation, the Commission has discretion to determine if refunds should be required. For the reasons Staff cites, we believe this provision is reasonable in this circumstance. The most vulnerable ratepayers, the captive residential consumers are protected from rate increases under the terms of the Price Cap Plan.

Procedural Challenges

RUCO claimed that the Commission acted unfairly by admitting the pre-filed testimony that had been filed prior to the filing of Settlement Agreement but limiting the scope of the hearing to the Settlement Agreement and not allowing cross examination of the prior testimony. RUCO argued that the Commission must evaluate the Settlement Agreement, in part, by evaluating the entire record, but that the Commission cannot base its decision on evidence on which it has not permitted the parties to cross examine.

It is not unusual in the context of a settlement for the Commission to limit the hearing to the issue of the Settlement Agreement. The parties have had adequate opportunity to present their positions and to cross examine witnesses on the terms of the Settlement Agreement and Price Cap Plan. Although we have evaluated the Settlement Agreement in the context of the entire rate

proceeding, the parties were not unfairly prejudiced by limited cross examination of testimony filed prior to the Settlement Agreement.

As modified herein, we believe the Settlement Agreement and Price Cap Plan between Staff and Qwest takes a step along the road to competition and provides benefits to the consumers of Arizona.

* * * * * * * * * *

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

FINDINGS OF FACT

1. Qwest filed an application for an increase in rates with the Commission on January 8, 1999.

2. Our Procedural Order dated March 4, 1999, established a schedule for filing testimony and set a hearing for November 4, 1999.

3. In October 1999, Qwest and Staff filed a joint motion to continue the procedural dates pending resolution of Qwest's pending depreciation case (Docket No. T-1051-97-0689).

4. A Procedural Order filed January 7, 2000, continued the hearing pending resolution of the depreciation docket and suspended the time clock rules.

5. In January 2000, Staff filed a Motion for Qwest to update the test year. A Procedural Conference was held on April 4, 2000 and Qwest was directed to re-file its schedules using a calendar year 1999 test year.

6. Qwest filed updated testimony on its revenue requirement and rate of return on May 3, 2000, and updated testimony on rate design, cost studies and RCND on May 19, 2000.

7. Our Procedural Order filed May 5, 2000, set dates for filing testimony and scheduled a hearing for September 25, 2000. Our July 27, 2000 Procedural Order set revised dates for filing testimony of all parties.

8. Intervention was granted to AT&T, RUCO, MCI WorldCom, Cox, Rhythm Links Communications, e-spire Communications, DOD, Sprint Communications, CWA, Citizens Communications Company, TDS Telecommunications Corp., One Point Communications-Colorado

LLC, Ed McGillivray, ACI Corp. dba Excellerated Connections, Inc., Cable Plus Co. dba Telephone Plus, Valley Telephone Cooperative, Copper Valley Telephone, Teligent Inc., GCB Communications, Inc., Arizona Dialtone, Inc., Arizona Consumers Council, Telephone Retiree Association-Arizona, Excell, Cable Plus Telecommunications and the Town of Gila Bend.

9. Public Comment sessions were held in Flagstaff, Prescott, Payson, Globe, Phoenix, Tucson, Bisbee, Sierra Vista and Yuma throughout June, July and September, 2000.

10. On August 9, 2000, Staff, RUCO, AT&T, Cox, APA and DOD filed direct testimony.

11. On August 21, 2000, Qwest filed rebuttal testimony.

12. On September 8, 2000, Staff, RUCO, AT&T, Cox, APA and DOD filed surrebuttal testimony.

13. On September 19, 2000, Qwest field rejoinder testimony.

14. On September 19, 2000, Staff and Qwest filed a motion to continue the hearing pending discussions on possible settlement.

15. By Procedural Orders dated October 4, and October 17, 2000, the hearing was continued until November 29, 2000.

16. On October 20, 2000, Qwest and Staff filed a Settlement Agreement addressing all of the issues raised in the rate case.

17. On October 27, 2000, Qwest, Staff and CWA filed direct testimony on the Settlement Agreement.

18. On November 8, 2000 and November 13, 2000, RUCO, AT&T, Cox and the DOD filed direct testimony on the Settlement Agreement. On November 15, 2000, RUCO filed additional direct testimony on the Settlement Agreement.

19. On November 20, 2000, Qwest and Staff filed rebuttal testimony on the Settlement Agreement.

20. On November 28, 2000, the American Payphone Association filed testimony in support of the Settlement Agreement.

21. Commencing November 29, 2000, through December 4, 2000, the Commission conducted a hearing to consider the Settlement Agreement. Public comment on the Settlement

Agreement was heard prior to the commencement of the evidentiary proceeding.

22. On December 18, 2000, Qwest, Staff, AT&T, RUCO, Cox and DOD filed post-hearing briefs.

23. On December 18, 2000, Staff and Qwest filed a revised Settlement Agreement that incorporated language clarifications that had been discussed during the hearing.

24. On December 26, 2000, Staff and Qwest filed a Second Revised Settlement Agreement and Price Cap Plan. A copy of the Second Revised Settlement Agreement and Price Cap Plan is attached hereto as Exhibit A, and incorporated herein by reference.

25. On January 8, 2001, AT&T filed a Reply to Price Cap Plan Revisions of Staff and Qwest.

26. The Settlement provides that Qwest's fair value rate base for the test year ending December 31, 1999, is $1,446.0 million and a reasonable rate of return on that rate base is 9.61 percent.

27. For rate making purposes the Settlement Agreement provides that Qwest's revenue requirement deficiency in Arizona is $42.9 million.

28. Under the terms of the Settlement Agreement, Qwest's rates would be determined pursuant to the Price Cap Plan.

29. Under the Second Revised Settlement Agreement and Price Cap Plan, consumers benefit from rate reductions of certain non-competitive services, the hard price cap on essential basic services, lower switched access rates and from increased incentives on Qwest to improve service quality.

30. To insure the Commission has complete information when reviewing new services and service packages, it is reasonable to require Qwest to provide notice to competitors when it files to include a new service or service package in Basket 3.

31. Pursuant to section 4) e) of the Price Cap Plan, it is reasonable for the Commission to retain the right to reject any proposed classification of a new service or package and that such review shall include an analysis of the competitive market for the particular service or package at issue.

32. In reviewing new service offerings pursuant to section 4) e), 4) i) and A.R.S. §40-250,

Staff may request an extension of the prescribed time periods.

33. Because competition in many markets is in its infancy, it is reasonable to modify the Settlement Agreement and Price Cap Plan to provide that if Qwest desires to combine a Basket 1 service with a Basket 3 service and to include the package in Basket 3, Qwest must comply with A.A.C. R14-2-1108.

34. Section 4) g) of the Price Cap Plan is vague and ambiguous and should be removed from the Price Cap Plan.

35. It is in the public interest for the Commission to rectify any ambiguities associated with the pricing of telecommunication services, and specifically the interpretation of R14-2-1310(C).

36. Pending the clarification of the Commission's imputation rule, it is reasonable to include originating access as an essential element of toll service.

CONCLUSIONS OF LAW

1. Qwest is a public service corporation within the meaning of the Arizona Constitution, Article XV, and under Arizona Revised Statutes, Title 40, generally.

2. The Commission has jurisdiction over Qwest and the subject matter of this proceeding.

3. Notice of the application and subsequent proceeding was provided in the manner prescribed by law.

4. The Second Revised Settlement Agreement and Price Cap Plan, as modified herein, are just and reasonable and in the public interest and should be approved.

ORDER

IT IS THEREFORE ORDERED that the Second Revised Settlement Agreement and Price Cap Plan shall be modified as discussed herein and set forth in Findings of Fact Nos. 30, 31, 32, 33 and 34.

IT IS FURTHER ORDERED that the Second Revised Settlement Agreement and Price Cap Plan, as modified herein, is hereby approved.

IT IS FURTHER ORDERED that Qwest Corporation shall file tariffs consistent with the Second Revised Settlement Agreement and Price Cap Plan, as modified herein, no later than

February 28, 2001.

IT IS FURTHER ORDERED that the rates and charges approved herein shall be effective for all services billed on and after March 1, 2001.

IT IS FURTHER ORDERED that Qwest Corporation shall notify its customers of the rates and charges authorized herein and the effective date of the same within 30 days of the effective date of this Decision. This requirement does not modify Qwest Corporation's obligation to provide notice pursuant to the Second Revised Settlement Agreement. Qwest Corporation shall provide copies of the notice it intends to provide to its customers to Commission Utilities Division Staff for approval prior to sending such notice(s).

IT IS FURTHER ORDERED that Commission Staff shall open a docket to investigate and rectify any ambiguities associated with the pricing of competitive telecommunication services, specifically, but not limited to, R14-2-1310(C).

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

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN COMMISSIONER COMMISSIONER

IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive Secretary of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this _____ day of _____, 2001.

_____
BRIAN C. McNEIL
EXECUTIVE SECRETARY

DISSENT _____

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