**BEFORE THE ARIZONA CORPORATION COMMISSION**

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

**SURREBUTTAL TESTIMONY**

**OF**

**STEVEN C. CARVER**

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

**PUBLIC VERSION**

("Highlighted" Text Denotes Confidential Material)

**JANUARY 12, 2005**

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

Q. Please state your name and business address.

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

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

A. Yes.

Q. What is the purpose of your testimony?

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

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

A. No.

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

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

## ADEQUACY OF OVERALL REVENUE REQUIREMENT

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

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

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

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

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

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

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

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

> **Q. IS QWEST ASKING FOR RATES TO RECOVER ITS REVENUE REQUIREMENT?**
>
> A. No. Given the intensity of competition Qwest now faces in Arizona as described by Mr. Teitzel, and the pace of Qwest's Arizona access line loss as shown above, Qwest does not believe the revenue requirement computed in the schedules of its Rule 103 filing is fully recoverable from its Arizona customers.
>
> My direct testimony explained that Qwest was not proposing rates to fully recover its revenue requirement and that instead, Qwest was proposing modifications to its price regulation plan that will allow the Company to compete on a more equal footing with its competition in Arizona. Qwest's position remains unchanged.
>
> **Q. THEN OF WHAT RELEVANCE IS QWEST'S REVENUE REQUIREMENT IN THIS DOCKET?**
>
> A. Given the intense pressure on Qwest's revenues and the relatively fixed cost nature of its business, revenue requirement has substantially less relevance than in the traditional rate case of a traditional monopoly utility because the recoverability of cost-of-service rates is uncertain. By Qwest's calculation, Qwest's revenue requirement now stands at $271.3 million on an original cost rate base and $351.7 million on a fair value rate base. By RUCO's calculation Qwest's revenue requirement is $160 million. Staff claims it is $3.5 million. <u>Any of these revenue requirements would be sufficient to provide for the rates Qwest has requested in this case. Consequently, the debate over Qwest's revenue requirement is, in some respects, academic</u>.
>
> Accordingly, I have prepared a more limited rebuttal than might be called for were revenue requirement critical to this case. The fact that I am not commenting specifically on every adjustment proposed by Staff and RUCO does not necessarily mean that I agree with their methods or their results. <u>My testimony does not attempt to address every potentially contestable ratemaking issue. Instead, it focuses principally on issues that have broad Arizona regulatory accounting and ratemaking significance beyond this case</u>.
>
> [emphasis added]

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

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

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

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

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

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

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

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

## REGULATORY ACCOUNTING METHODS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Q. IS A RIDER THE BEST OPTION?

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

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

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

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

- Oppose any regulatory recognition of SOP 98-1 in Docket No. T-1051B-99-105, denying ratepayers the opportunity to enjoy the transition benefits of such adoption;

- Establish and maintain offbook accounting records for Arizona intrastate accounting purposes as if SOP 98-1 had never been implemented; and

- Now that Mr. Grate has concluded that SOP 98-1 should be recognized for Arizona intrastate regulatory purposes, adopt the accounting change retroactively to 1999.

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

[9] These discovery responses clearly document that Qwest did not intend to adopt SOP 98-1 in 1999 for Arizona regulatory purposes.
[10] Grate rebuttal testimony, page 29 and Qwest response to Data Request UTI 4-1S1.

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

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

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

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

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

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

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

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

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

## HISTORY OF ACCOUNTING METHOD CHANGES IN ARIZONA

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

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

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

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

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

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

Q. Why is that?

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

12 Grate rebuttal, page 10.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Q. How would you have answered that question?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

**FAS106 OPEB Costs**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

**RATEMAKING METHODS**

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

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

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

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

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

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

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

Q. Mr. Grate states:

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

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

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

Do you agree?

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

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

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

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

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

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

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

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

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

Medical and dental expenses are also driven by their own unique set of facts and circumstances. Changes in employee levels can influence the overall costs charged by the providers. The offering of various provider options (PPO, HMO, etc.) and employee participation rates can impact the quantity component. Changes in employee copayments, deductibles and coverage levels can impact both the per unit charge from the provider and the company's out of pocket cost.

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

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

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

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

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

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

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

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

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

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

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

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

**Year-End Wage & Salary Annualization**

Q. Mr. Grate states:

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

Do you agree?

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

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

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

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

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

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

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

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

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

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

Adjustment C-17).

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

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

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

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

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

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

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

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

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

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

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

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

A. I do not know. Staff Data Request UTI 2-23 requested a copy of the Company's monthly expense matrix for calendar years 2001-2003 by EXTC and by FCC account. In response, Qwest provided three confidential attachments in the form of extremely large Excel workbooks that contained monthly expenses by EXTC by FCC account and by matrix category (i.e., benefits, depreciation & amortization, rents, salaries, other, etc.). My analyses focused on sorting the tens of thousands of lines of data Qwest supplied by EXTC and by matrix category for only the FCC expense accounts. At first, I expected the total number of non-labor EXTCs included in my review to match Mr. Grate's 446 EXTC count, since his rebuttal testimony seems to characterize that number as related to only expense accounts. However, our counts clearly do not tie. Presuming that Qwest provided all of the data requested in response to Data Request UTI 2-23, I am left to wonder whether Mr. Grate's EXTC count might also include non-operating expense accounts.

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

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

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

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

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

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

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

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

How do your respond?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

**Pro Forma Depreciation & Reserve Adjustments**

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

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

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

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

Do you agree?

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

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

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

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

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

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

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

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

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

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

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

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

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

[50] Grate rebuttal testimony, page 61.
[51] Grate rebuttal testimony, pages 54-57, and Exhibit PEG-R11, consisting of Qwest's 29-page response to RUCO Data Request 4-1.

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

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

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

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

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

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

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

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

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

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

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

[52] Grate rebuttal testimony, page 56.

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

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

## DISALLOWANCE STANDARDS

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

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

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53 Carver direct testimony, pages 5-6, Docket No. E-1051-88-146.
54 This same logic applies to the FAS106 OPEB accrual basis accounting issue in Docket No. T-1051B-99-105.

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

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

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

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

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

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

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

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

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

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

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

[59] Grate rebuttal testimony, page 75.
[60] The following quotes from Commission orders were previously provided to Qwest in response to Data Request Qwest 16-1.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Do you have any comments on this rebuttal testimony?

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

## OTHER REVENUE REQUIREMENT ISSUES

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[71] Grate rebuttal testimony, page 122.

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

> year. Second, even if the well were in service during the test year, we are not convinced that it is necessary to serve the Company's customers. It is clear that LPSCO has been able to provide service to its customers without Well No. 23A.

> [13] Generally, although CWIP is not included in the rate base because it is not yet part of the fair value of property devoted to public use, *see Arizona Water Company*, 85 Ariz. at 202, 335 P.2d at 414, it is within the Commission's broad discretion to consider a plant under construction in determining a utility's fair value…*Arizona Corporation Commission v. Arizona Public Service Company*, 113 Ariz. 368, 371, 555 P.2d 326, 329 (1976). Although the Commission properly could have considered the cost of Well 23A, construction of which was subsequent to the test year, *see id.*, the record does support the Commission's exclusion of the construction of this well from the rate base. LPSCO has not cleared its hurdle on review of a satisfactory demonstration that the Commission acted unreasonably or unlawfully in determining LPSCO's just and reasonable rates.
> [178 Ariz. 431, 874 P.2d 988]

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

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

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

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

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

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

Q. In rebuttal, Mr. Grate states:

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

Is he correct?

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

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

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

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

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

Do you concur with this representation?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

## UNADDRESSED REBUTTAL ISSUES

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

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

Q. Does this conclude your surrebuttal testimony?

A. Yes.