BEFORE THE ARIZONA CORPORATION COMMISSION

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

DIRECT TESTIMONY

OF

MICHAEL L. BROSCH

ON BEHALF OF THE STAFF OF THE ARIZONA CORPORATION COMMISSION

PUBLIC VERSION

("Highlighted" Text Denotes Confidential Material)

NOVEMBER 18, 2004

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MICHAEL L. BROSCH

INTRODUCTION AND QUALIFICATIONS

Q. Please state your name and business address.

A. My name is Michael L. Brosch. My business address is 740 North Blue Parkway, Suite 204, Lee's Summit, Missouri 64086.

Q. By whom are you employed?

A. I am a principal in the firm Utilitech, Inc., a consulting firm engaged primarily in utility rate and regulation work. The firm's business and my responsibilities are related to special services work for utility regulatory clients. These services include rate case reviews, cost of service analyses, jurisdictional and class cost allocations, financial studies, rate design analyses and focused investigations related to utility operations and ratemaking issues.

Q. On whose behalf are you appearing in this proceeding?

A. I am appearing on behalf of the Arizona Corporation Commission Utilities Division Staff ("Staff"). Utilitech entered into a contract with the State of Arizona to review and respond to certain elements of the Filing of Renewed Price Cap Plan of Qwest Corporation ("Qwest or QC"). In particular, Utilitech was charged with responsibility for analysis and testimony regarding the test period 2003 adjusted earnings and revenue requirement of Qwest Corporation, employing the recommended rate of return sponsored by Staff witness Mr. Joel Reiker and recommended depreciation accrual rates sponsored by Staff witness Mr. William Dunkel. Mr. Steven Carver and I have prepared and jointly sponsor Staff's Accounting Schedules that are identified as Staff Joint Accounting Schedules, as more fully described in his testimony.

Q. Will you summarize your educational background and professional experience in the field of utility regulation?

A. My qualifications are summarized in Attachment MLB-1

I have testified before utility regulatory agencies in Arizona, Arkansas, California, Florida, Hawaii, Illinois, Indiana, Iowa, Kansas, Michigan, Missouri, New Mexico, Ohio, Oklahoma, Utah, Washington and Wisconsin in regulatory proceedings involving electric, gas, telephone, water, sewer, transit, and steam utilities. A listing of my past testimonies is set forth in Attachment MLB-2.

Q. Have you previously participated in Qwest or U S West Communications ("USWC") regulatory proceedings?

A. Yes, on many occasions. My firm has represented various clients in prior Qwest/USWC proceedings in several states. In Arizona, I participated in the last four Arizona general rate cases involving Qwest/USWC on behalf of the Arizona Corporation Commission Staff and supported the Staff in negotiating the Price Cap Plan in settlement of the most recent rate case.[1]

In Washington, I assisted the Washington Attorney General's Office, Public Counsel Section, in negotiation and subsequent review of that State's first Alternative Form of Regulation (AFOR) plan.[2] I was also a witness in the two subsequent Washington general rate cases involving USWC and in a 1998 proceeding dealing exclusively with directory imputation issues.[3] In New Mexico, I served as a witness for the Commission Staff in the most recent USWC rate case.[4] In Utah, I served as witness for the Committee of Consumer Services in USWC's last general rate case before commencing price cap regulation and sponsored the directory imputation amount approved by the Commission in that Docket.[5] I also represented consumer advocate clients in three states, Iowa, Utah and Washington in regulatory proceedings associated with the acquisition of USWC by Qwest.[6]

Most recently, I addressed issues raised by the sale of Qwest Dex in Arizona and two other states and assisted ACC Utilities Division Staff in the negotiated

[1] ACC Docket Nos. T-1051-88-146, T-1051-91-004, T-1051-93-183, and T-1051B-99-105
[2] WUTC Docket Nos. U-89-2698-F and U-89-3245-P. Washington has since reverted to traditional cost of service regulation for Qwest.
[3] WUTC Docket Nos. UT-950200, UT-970766 and UT-980948.
[4] New Mexico PRC Case No. 3008.
[5] Utah Public Service Commission Docket No. 97-049-08

settlement of that Arizona proceeding, which culminated in a Settlement providing for continued imputation of $72 million per year.[7]

Q. What is the purpose of your testimony in this Docket?

A. My testimony is intended to describe and sponsor, on behalf of the Staff, a series of accounting adjustments that should be made to the Company's revenue requirement R14-2-103 or "Rule 103" filing. The adjustments I sponsor are included in the Staff Joint Accounting Schedules, as listed in the Index page and at the top of specific Schedules therein.

EXECUTIVE SUMMARY OF TESTIMONY

Q. Please summarize the recommendations that are set forth in your testimony.

A. The initial section of my testimony explains what the adjusted test period financial results of Qwest indicate about the Arizona Price Cap Plan in terms of the relative financial strength of the Company's Arizona operations and the apparent impact of competition upon financial results. I also describe financial reporting that should be beneficial to the Commission in any future reviews of Price Cap Plan performance.

The second major area covered in my testimony has to do with removal of certain costs that should not be charged to Qwest ratepayers, including corporate image advertising, extraordinary re-audit fees and insurance costs associated with Qwest's accounting investigations, certain public/legislative affairs expenses and excessive charges associated with Qwest Service Corporation senior management personnel. In addition, I have identified corrections to Qwest's filing to recognize updating of centralized and affiliate allocation factors in addition to Qwest's proposed updating of corporate headquarters factors. My final operating expense adjustment is to exclude certain excessive affiliate charges to QC, including consulting fees paid by an affiliate to the prior CEO and excessive prices charged by Qwest Wireless for cellular phone service.

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[6] Utah PSC Docket No. 99-049-41, Iowa Case No. SPU-99-27, Washington Docket No. UT-991358.

[7] ACC Docket No. T-0105B-02-0666, Decision No. 66230.

My testimony next addresses the year-end annualization of Qwest's test period revenues. Qwest witness Mr. Philip Grate applied a linear regression analysis tool to monthly revenues in the various local service, access revenue, toll revenue and miscellaneous revenue accounts throughout a 36-month analysis period. Mr. Grate recognized the need to annualize revenues because the test period employs a year-end investment level to which the adjusted income statement should be "matched".[8] My testimony explains an inconsistency embedded throughout Qwest's originally filed revenue annualization adjustments caused by the failure to first restate the 36-month historical data to a "constant price" basis prior to applying regression calculations. This "constant price" restatement was accepted as a revision by Qwest and is necessary so as to avoid double counting the rate adjustments that are separately addressed in other adjustments in the Company's filing. However, even though Qwest agrees to correct for this global problem, my testimony explains several other concerns and proposes additional incremental adjustments to best capture ongoing revenues at the end of the 2003 test period, further adjusted for the price cap rate reductions implemented in April of 2004.

With regard to rate base, I have reviewed the Company's lead lag study of cash working capital and propose several adjustments to refine the lag day calculations included therein. I also explain in my testimony how the fair value rate base has been determined in Staff's filing, employing certain revisions to Qwest's Reproduction Cost New Less Depreciation ("RCND") study that are sponsored by Staff witness Mr. Dunkel.

Finally, my testimony explains why Staff's revenue conversion factor is different from Qwest's with regard to the uncollectible element of the factor, so as to incorporate Qwest's own uncollectible normalization adjustment in the determination of the factor.

Q. How is the balance of your testimony organized?

[8] Direct Testimony of Philip Grate, page 76.

A. My testimony is arranged by major topical area. A Table of Contents appearing at the beginning of the testimony sets forth this organization.

PRICE CAP PLAN FINANCIAL PERFORMANCE

Q. Will Qwest's financial performance in Arizona continue to support access to capital markets on reasonable terms?

A. Yes. The primary indicator of financial health in terms of access to capital markets is the consistent generation of cash flows sufficient to cover fixed charges. The Arizona Intrastate operations of Qwest Corporation produce sufficient cash flows to service the allocated interest expense reasonably attributed to Arizona. On a pro-forma test period basis, Intrastate Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA") in Arizona exceeds $397 million annually in Staff's filing.[9] This measure of cash flow is well in excess of annual new construction expenditures of $198.5 million per Qwest's Schedule A-4 in its Rule 103 filing, and exceeds annual interest expense allocated to Arizona Intrastate operations of $66 million on Qwest's Schedule A-2 Detail.

Qwest continues to suffer from above-average debt leverage as a result of the protracted financial difficulties of the parent company and other non-regulated Qwest affiliates, but such difficulties do not arise from any failure of the Arizona Intrastate business of QC to produce consistent positive cash flows well in excess of debt service obligations.

Q. What does Staff's position regarding Qwest's revenue requirement tell us about the treatment of competition within the Arizona Price Cap Plan?

A. The initial Price Cap Plan was designed with a requirement that financial information be available in this Docket to provide a scorecard of financial performance for use in evaluating the terms of the Plan. Staff's quantification of Qwest's revenue requirement is neither a large positive, nor a significant negative value, supporting a

9 See Joint Staff Accounting Schedule C, Column D, Income from Operations of $186 million plus Depreciation Expense of $211 million.

general conclusion annual revenue are presently adequate to meet ongoing costs, after adjustment is made to reduce depreciation accrual rates.

With respect to competition, it is obvious that Intrastate revenues have declined considerably since the inception of the Plan, due to both volume reductions associated with competition and economic conditions as well as the price reductions implemented pursuant to the Plan. However, Qwest has managed to reduce its cost levels and maintain revenues at levels adequate to produce adequate returns on Intrastate rate base investment on after adjustments to normalize test year information. As noted above, Arizona Intrastate cash flows are strong and more than adequate to service the existing high debt levels reasonably allocated to Arizona.

Q. In the event the Commission approves continued use of a Price Cap form of regulation for Qwest in the future, should the Company be required to prepare and submit financial information indicating its achieved operating income, rate base and return on investment?

A. Yes. Intrastate earnings and revenue requirement data will continue to be useful in future Commission review and modification of Price Cap Plan regulation in Arizona. Therefore, during the term of any renewed Price Cap Plan, I recommend that, the Commission require annual filings each April 1 that report summarized earnings and revenue requirement data for each calendar year. These filings should present detailed test period intrastate earnings and rate base results prepared on a basis of accounting consistent with ratemaking principles established by the Commission, inclusive of the Commission's resolution of the following adjustments that should narrow disputed issues at that time:

- Imputation of $72 million of directory revenues
- Calculation of Depreciation expense/reserves at ACC approved rates
- Accrual basis accounting for OPEBs (per Carver testimony)
- Fixed cash working capital amount (per Brosch testimony)
- SOP 98-01 accounting for software (per Carver testimony)
- Pension asset in rate base (per Carver testimony)

- Treatment of FCC Nonregulated Services (per Carver testimony)

An understanding of traditional cost of service-based revenue requirement is necessary in any Price Cap review, in my opinion, in order to evaluate how alternative regulatory approaches are tracking with the underlying costs to provide service. This form of monitoring report would provide Staff with a periodic tracking tool to evaluate the financial performance of Qwest. In addition, such an analysis is important in assuring that regulators have sufficient financial data to understand how alternative regulation plan parameters are apportioning economic risks and opportunities between shareholders and customers – information that management tracks and can rely upon in formulating its alternative regulation recommendations. However, the filing of this information should not preclude the Staff or Commission from requesting the full R14-2-103 filing upon the Plan's termination if the Staff believes such a filing is necessary for complete evaluation of the Plan's effectiveness or to effectively review and evaluate the modifications proposed by Qwest.

CORPORATE "IMAGE" ADVERTISING

Q. How are Qwest advertising expenses classified on the books?

A. Under FCC Part 32 Accounting Rules, advertising costs are classified into one of two accounts, as either "Product Advertising" or as non-product-related corporate image advertising contained within "External Relations" expense. FCC Part 32 Rules, define this distinction as follows:

Sec. 32.**6613** Product advertising.

> This account shall include costs incurred in developing and implementing promotional strategies to stimulate the purchase of products and services. This excludes nonproduct-related advertising, such as corporate image, stock and bond issue and employment advertisements, which shall be included in the appropriate functional accounts.

Sec. 32.**6722** External relations.

> This account shall include costs incurred in maintaining relations with government, regulators, other companies and the general public. This includes:
>
> (a) Reviewing existing or pending legislation (See also account 7370, Special Charges, for lobbying expenses.);

> (b) Preparing and presenting information for regulatory purposes, including tariff and service cost filings, and obtaining radio licenses and construction permits;
> (c) **Performing public relations and non-product-related corporate image advertising activities**;
> (d) Administering relations, including negotiating contracts (See also Account 6725, Legal.), with telecommunications companies and other utilities, businesses, and industries. This excludes sales contracts (See also Account 6612, Sales.); and
> (e) Administering investor relations. [emphasis added]

In the test period, Qwest Corporation incurred large amounts of both product-specific as well as corporate image advertising.

Q. How has the Commission historically treated each type of advertising costs incurred by the Company?

A. Staff has not challenged Qwest's incurred costs for Account 6613 Product Advertising in prior rate cases and such costs have been allowed by the Commission. However, for Corporate Image Advertising charged to Account 6722, Staff has consistently recommended disallowance of the costs because they are designed to promote a favorable public image, rather than promote specific regulated telephone products and services.

In the 1994 rate case, Docket No. E-1051-93-183, Qwest's own filing eliminated about $1.2 million of "Corporate Brand Advertising" that was incurred in the test year.[10] Decision No. 58927 in that Docket adopted the Company-proposed full disallowance of image advertising direct costs that were not in dispute, and also adopted a 50 percent disallowance of certain additional parent company indirect support costs for media relations, public relations planning and creative services that were challenged by Staff:

> In response, Staff indicated that the majority of USWI's public relations efforts are designed to promote a favorable public image. The direct costs of these efforts have been disallowed by Staff and generally agreed to by the Company. As a result, Staff asserted it

[10] Staff Accounting Schedule C-17 in Docket No. E-1051-93-183 reflects Staff's adjustment to remove certain US West parent-allocated costs, in addition to the Company's own adjustment removing "Corporate Brand Advertising" in the amount $1.226 million.

> would be inconsistent to not also disallow indirect costs of support such as medial [sic] relations, public relations planning, and creative services.
>
> We generally agree with Staff that the company shareholders are normally the beneficiaries of various public relations, legislative and image advertising. However, the Company has listed activities being provided by various support groups which do provide benefits to ratepayers. We recognize that some of these indirect costs of support would promote certain direct costs which we have disallowed. As a result, we will disallow 50 percent of Staff's proposed disallowance or $43,737 for media relations, public relations planning, and creative services. We will approve the remaining portion of Staff's proposed disallowance of $522,178 for public affairs and public relations costs. The net result would be a disallowance of $478,441. (Decision page 31)

In the 1999 rate case, Staff recommended disallowance of the Company's image advertising along with costs of sponsorship for sports teams and the Olympics. The Company disputed Staff's adjustments in that case, arguing that increased competition justified recovery of such costs. Because of the Settlement Agreement, no ACC Decision addressed the disputed image advertising costs in the 1999 rate case.

Q. Is Qwest disputing the Commission's policy established in the 1994 rate case Decision in its Rule 103 filing in this Docket?

A. Yes. The Company has made no ratemaking adjustment to remove its corporate image advertising in the 2003 test year. Company witness Mr. Grate states his opposition to such an adjustment at page 131 of his testimony, "Qwest believes that the costs it incurs for advertising, including image advertising are appropriate in the competitive marketplace in which it operates in Arizona. The testimony of David L. Teitzel details the breadth and depth of competition Qwest faces in Arizona. Unless another party comes forward with clear and convincing evidence that the cost of Qwest's image advertising is not a reasonable expenditure under current market conditions or is dishonest or obviously wasteful, it should not be disallowed."

Q. Has the Commission or Qwest, in prior cases where image advertising costs were removed, applied any of the new "current market conditions", "dishonesty" or "obviously wasteful" criteria that Mr. Grate now seeks to impose?

A. Not to my knowledge. Nor has Mr. Grate offered any "clear and convincing evidence" in support of his proposed change in regulatory policy regarding such costs.

Q. How much image advertising was incurred by Qwest and included in Arizona expenses for the 2003 test year?

A. According to Qwest's confidential response to Data Request UTI 2-19, Arizona recorded on the books approximately [redacted] of corporate advertising expenses, the majority of which were incurred and allocated by the Qwest Services Corporation headquarters entity. A central theme of Qwest's corporate image advertising is telling customers that Qwest provides good customer service, as part of its so-called "Spirit of Service" message and brand tagline. Messages within the advertisements include characterizations of Qwest companies with phrases such as:

- Always there for you
- We Know our Customers
- Our Spirit of Service
- We're On our Way (to timely serve customers)
- It's a Team Effort

Most of the allocations from QSC of corporate marketing and advertising costs are driven by the relative sales or revenues earned by Qwest Corporation, versus other affiliated entities selling long distance, wireless, customer premise equipment or data networking services. I have attached as Attachment MLB-3, a copy of Qwest's print corporate image advertising in the test period.

Q. How much product specific advertising was incurred by Qwest and included in Arizona expenses in the 2003 test year?

A. In addition to the corporate advertising expenses noted above, the Company incurred and booked another [redacted] in product specific advertising expenses for the promotion of specific products such as packaged business services, consumer service bundles with telephone lines, features like caller ID and voicemail, and with wireless and/or long distance services and advertisements for high-speed DSL services.

Q. Have you prepared a table comparing Qwest Arizona advertising costs by category over the past several years?

A. Yes. The costs charged to advertising expense, particularly corporate brand advertising, have fluctuated considerably over the past four years[11]:

Arizona Advertising Costs by Category$000

	2000	2001	2002	2003TY
Product Advertising	[redacted]	[redacted]	[redacted]	[redacted]
Corporate Brand Advertising	[redacted]	[redacted]	[redacted]	[redacted]
Total Advertising - AZ Share	[redacted]	[redacted]	[redacted]	[redacted]
Less: Disallowed Brand Advertising	[redacted]	[redacted]	[redacted]	[redacted]
Allowable Advertising	[redacted]	[redacted]	[redacted]	[redacted]

It should be noted that the full amount of expenses charged to "Corporate Brand Advertising" on the books are shown as "Disallowed Brand Advertising" in the years 2001 and 2002, but in 2003, Staff's adjustment is to remove only a portion of the charges to Account 6722.2 Corporate Brand Advertising. This is because the Company recorded all of the advertising charged to QC by the QSC affiliate as "Corporate Brand Advertising", even though the majority of such charges were related to product promotion rather than brand promotion.[12] What remains as

[11] Confidential Attachments UTI 18-04A, UTI 15-21A, UTI 4-29A and UTI 18-03A.

[12] UTI 15-21A, Note 2 explains, [redacted]

"Allowable Advertising" after Staff's adjustment in the 2003 test year compares reasonably to allowable expense amounts in prior years.

Q. In the previous chart, the amount of "Disallowed Brand Advertising" is less than the total amount of "Corporate Brand Advertising". What is the cause of this difference?

A. Staff has taken a very conservative view of what advertising should be considered brand or image advertising in quantifying the proposed disallowance. Qwest has indicated that corporate advertising allocated from Qwest Services Corporation to QC and recorded as corporate brand advertising is actually mis-classified on the books, because much of this activity and cost should actually be considered product advertising.[13] Staff has accepted this management representation in quantifying the proposed adjustment, even though this result is inconsistent with recorded information.

Q. Please explain the reasons why corporate image advertising should not be included in Qwest's Arizona Intrastate ratemaking expenses that are recoverable from ratepayers.

A. There are several general policy and other Company-specific reasons why image advertising should not be allowed for Qwest in this proceeding:

- Expenditures made to promote favorable public opinion, such as charitable contributions, image advertising and event sponsorship are discretionary costs that are not required to provide regulated services and provide no tangible direct benefit to the Company or its customers.
- Image advertising is no substitute for consistent provision of high quality regulated services and simply providing good service at reasonable rate levels will contribute to favorable public opinion with no need for self promotion within image advertising.
- If the reputation of a regulated entity has been harmed by poor service quality or questionable business practices, customers of regulated services should not be required to bear image advertising costs designed to improve the corporate image.

[13] Qwest responses to Data Request 4-20 and 18-04, Attachment A.

- Image advertising is redundant to product specific advertising that is used by telephone companies to promote specific services – product specific advertising can be used to maintain public awareness of the availability and value associated with using regulated products and services.
- Promotion of the corporate brand or image may provide a subsidy for non-regulated services offered by corporate affiliates as a result of either the incurrence of costs not needed for the regulated business or because of excessive allocation of such costs to the regulated entity.
- Test year image advertising cost levels were increased relative to prior years, in an apparent effort to enhance Qwest's reputation, credibility and image after experiencing widely publicized financial difficulties, accounting investigations and senior management turnover.

For these reasons, Staff is recommending elimination of Qwest corporate image advertising that was allocated to Arizona operations in the test period. This proposed elimination is consistent with ACC precedent established in prior rate cases involving Qwest, as noted above.

Q. You noted that in the 1993 rate case, Qwest included a ratemaking adjustment to exclude its incurred corporate advertising costs. Does increased competition or do other changed circumstances justify inclusion of corporate advertising costs at this time?

A. No. There has always been a degree of competition facing many of Qwest's regulated products and services and Staff has always been supportive of rate recovery for product specific advertising to promote regulated services. However, the Company's reputation and public image can best be promoted by providing consistently high quality regulated services and avoiding corporate acts damaging to the firm's business reputation. It is not reasonable to burden ratepayers of regulated services with corporate image advertising costs simply because markets have become more competitive.

Q. Does Qwest Corporation realize substantial public exposure for its brand name and corporate identity at no incremental cost by virtue of its incumbent local exchange telephone company ("ILEC") status?

A. Yes. The Company has a business and/or consumer connection with a majority of households and businesses in Arizona simply by being the ILEC. Monthly billing statements are branded by Qwest and customers pay their bills to Qwest. The Company's vehicles and buildings display Qwest's brand name and logo and each call center, internet contact, service call and other customer contact exposes the public to the Qwest brand.[14] Considerable brand recognition benefit is realized by Qwest Corporation and its non-regulated affiliates within the 14 state service territory of Qwest Corporation as a result of the Company's ILEC status.

Q. Does Qwest Corporation receive any compensation for the brand awareness arising from its ILEC business operations from the QCII parent entity or the other subsidiaries of QCII that sell long distance, wireless or other competitive services?

A. No. The Qwest companies share a common brand name, marks and business reputation with no compensation or transfer payments, aside from the allocation and sharing of corporate marketing and advertising activities that are incurred by Qwest Services Corporation for the common benefit of all affiliates. According to the Company's response to Data Request UTI 6-16, "Qwest Services Corporation manages all advertising costs for the family of Qwest Companies. Advertising costs are not tracked by affiliate at an advertising campaign level. It would require an extensive special study to provide this information."

Q. Did Staff attempt to evaluate Qwest advertising costs in detail, so as to understand the basis for attributing different types of ad costs among the Qwest family of companies?

[14] Qwest response to UTI 18-06.

A. Yes. However, despite numerous questions and attempts to understand how Qwest categorizes and manages the costs of advertising and other marketing, the Company was not able or was unwilling to produce information in formats useful for such an analysis.[15] I was unable to conclude, from the information produced by Qwest, whether the cost assignments and allocation factors used to apportion corporate advertising and marketing costs among affiliates was reasonable. In particular, it appears that allocations based upon the relative size of revenue streams among affiliates would disadvantage Qwest Corporation's mature ILEC business with large and stable revenue streams resulting in higher cost allocations, to the potential benefit of newer and more rapidly growing wireless and long distance business segments.

Q. Has the Company produced any information supporting the notion that Qwest's corporate image advertising should now be included in test period expenses?

A. No. Aside from Mr. Grate's testimony stating his opinion that increased competition justifies full recovery of such costs, no information has been produced analyzing Qwest marketing or demonstrating the need for, or quantifying any benefits arising from, such activities. Clearly, the Company understood ACC policy with respect to image advertising, yet no studies, analysis, reports or other cost/benefit information were included in the Company's filing on this issue.

In its response to Data Request UTI 4-29, the Company argues for a burden of proof upon Staff in the area, stating, "In its last rate case, image or brand advertising was disallowed because the Commission considered it unnecessary to the provision of telephone service in the 1992-1993 test year. The costs of brand advertising is not disallowable unless a party comes forward with clear and convincing evidence that shows why, under an appropriate standard of disallowance, it should be disallowed. Qwest is aware of no evidence that its test year brand advertising was unnecessary or imprudent in the 2003 test year, which was characterized by significant competition for telephone service and significant access line losses. Accordingly, a disallowance of unnecessary brand advertising in the 2003 test year yields an adjustment of zero."

[15] See, for example, Data Requests UTI 1-12S1, UTI 2-18S1, UTI 2-19S1, UTI 2-20, UTI 6-15, UTI 6-

Q. Is there evidence that Qwest's corporate advertising costs were incurred in response to the Company's widely publicized financial problems, accounting investigations, restatements of financial reports and replacement of senior management, so as to re-establish corporate credibility and improve the corporate public image?

A. Yes. In a highly confidential report titled "The Qwest Report – Draft First Quarter 2003 Results", provided in response to RUCO Data Request No. 2-72 that Staff was allowed to review but not copy in Denver, the following narrative was included:

[redacted]

The Company's [redacted] may be attributed to past service quality problems, or the accounting investigations and restatements or the senior management replacements that have occurred, but cannot be attributed to actions of Arizona ratepayers. Therefore the costs of advertising designed to [redacted] need not be funded by ratepayers.

In its response to Data Request UTI 4-30, Qwest produced as Confidential Attachment A a document titled [redacted] and is included as confidential Attachment MLB-4 to this testimony. It documents that [redacted] also illustrates the nature and origin of the corporate image problems that Qwest was trying to overcome with its

16 and UTI 14-03, which all ask for cost breakdowns of advertising to accommodate Staff analysis.

corporate brand advertising and clearly shows why ratepayers should not be held accountable for such costs.

Q. Earlier in this section of your testimony, you presented a table illustrating the growth in corporate image advertising that occurred in the test period, relative to prior years. Were their any particular months in the test period with concentrated advertising expenditures?

A. Yes. In the last two months of the test year, November and December of 2003, the Company recorded [redacted] of corporate advertising expense. This represents about 42 percent of total annual expenses for the entire year. Then, in the first five months of 2004, expenditures declined to a range of [redacted] per month, with a total year to date expense in 2004 of [redacted] Thus, it would appear that, if corporate advertising were judged recoverable from ratepayers over Staff's objections, a more normal run rate for corporate advertising in all months other than November and December 2003 would support a downward normalizing adjustment of at least [redacted] to total Arizona expenses.

Q. Did Qwest produce any studies of its corporate image, branding, customer perceptions or positioning in the marketplace prior to the decision to commence the "Spirit of Service" campaign and prior to the large increase in expenditures for image advertising in 2003?

A. Yes. In July 2002, a [redacted]. This confidential document was produced in response to Data Request UTI 14-6 as Attachment B and is included in its entirety as Attachment MLB-5 to my testimony. This document clearly shows that the problems and concerns causing Qwest to increase its image advertising and engage in the "Spirit of Service" campaign relate to issues arising from Qwest's self-inflicted damage to its public reputation and not concerns properly attributed to customers of QC regulated services in Arizona.

Q. Please explain Staff Joint Accounting Schedule C-9.

A. This Staff Adjustment removes test period corporate image advertising, based upon allocations performed by Qwest to segregate such amounts in the response to Data Request UTI 4-29, confidential Attachment A.

PUBLIC AFFAIRS & COMMUNITY RELATIONS COSTS

Q. What activities are undertaken by the Company's Public Policy Personnel?

A. Qwest Services Corporation staffs a Public Policy Organization that is responsible for the [redacted].[16] This organization defines and carries out the Company's [redacted]. This structure incorporates [redacted]. Each [redacted]. Additionally, [redacted] within a centralized Public Policy Organization that [redacted].

Q. Does the Company include the costs of its regulatory, community relations and legislative affairs activity within its operating expenses and asserted revenue requirement?

A. For the most part, yes. In the Arizona Public Policy Organization, only the direct costs of lobbying, including all test period labor and benefits charges for the [redacted], were charged below the line as "lobbying" costs, to be borne by shareholders rather than customers. As a result, the test period revenue requirement includes other costs associated with line management supervision of this position, corporate planning and support of legislative advocacy, as well as incurred costs for Community Affairs personnel and local event sponsorship and for managing Qwest Foundation grants.[17]

Q. What is the purpose of the adjustment set forth on Staff Joint Accounting Schedule C-14?

A. This adjustment excludes additional costs within the Arizona Public Affairs organization that appear to [redacted].[18]

Staff's proposed disallowance can be considered conservative, because it does not reach above the Arizona Public Affairs organization, even though corporate-level Public Policy executives and QSC support staff are also clearly involved in the development and administration of such advocacy at the State level.

Q. Why should costs incurred by Qwest involving public and legislative affairs not be included within above-the-line expenses and fully recovered from ratepayers?

A. When regulated companies engage in public affairs issues, both ratepayer and shareholders may benefit, but the interests of shareholders are a fiduciary responsibility of management in dealing with such issues. The costs of monitoring and attempting to maintain relationships and influence legislation are routinely disallowed by regulators. Staff's proposal in this instance is to provide some above-the-line recovery of costs to represent ratepayers' interests regarding legislative and

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16 UTI 4-11, Confidential Attachments A and B.
17 Qwest response to UTI 4-11B and UTI 6-10.
18 UTI 4-09, Confidential Attachment A.

regulatory issues of concern, while increasing the likelihood that lobbying and public affairs support costs are not excessively charged to ratepayers.

Q. What approximate percentage of Qwest's Arizona Public Policy Organization wage and benefit costs were recorded below the line as lobbying costs in the test period?

A. Approximately [redacted] percent of Arizona Public Policy Organization costs were charged below the line in the test year, even though a primary role of Public Policy is the [redacted].[19]

Q. Is there also a corporate Public Policy Organization that engages in Federal legislative affairs matters?

A. Yes. The principle responsibility for Federal legislation rests with five persons in the QSC corporate Public Policy organization, including Qwest's Vice President of Federal Relations, its Director Legal Issues, the Vice President of Government Relations, the Director Legal Issues and Senior Staff Advocate. Notably, about [redacted] percent of the salary and benefits cost for these QSC positions was charged to below-the-line lobbying accounts[20], a much higher percentage than was considered lobbying by Qwest within the Arizona Public Policy organization. Staff has proposed no further adjustment to the Qwest corporate Public Policy organization.

Q. Is the Public Affairs adjustment you propose for the Arizona Public Policy group consistent with disallowances approved by the Commission in prior Qwest rate proceedings?

A. Yes. In the last litigated Arizona rate case in 1993, I sponsored a similar disallowance that was addressed by the Commission at page 45 of Decision No. 58927 in Docket No. E-1051-93-183, with the following discussion:

[19] Confidential responses to UTI 1-19, Attachment A, indicates Public Policy charges above the line to Arizona Account 6722.9 from Qwest Services Corporation totaling [redacted] charged below the line as "lobbying".

[20] Confidential Attachment B to Data Request UTI 18-2 indicates [redacted] in salary and benefits costs was charged to Below-the-Line Account 7370.3.

> The Company incurs certain public policy organization costs related to public affairs and public relations personnel. A portion of these costs are accounted for below the line to recognize the need for shareholders funding of lobbying, charitable contributions, and other community welfare programs. The Company defined the below-the-line activities as expenditures for the purpose of advocating the Company's position to the public or to public officials with respect to legislation, referendum, or ordinances. During the TY, the Company recorded only six percent of overall public policy organization expenses below the line.
>
> Staff reviewed various position descriptions provided by the company and concluded that the Company's recording of only six percent of overall public policy costs below-the-line was unreasonable. Staff asserted that legislative/public affairs and image enhancement expenditures are not necessary to provide telephone service. Further, Staff indicated that the Company has failed to provide justification of the assignment of the public affairs/public relations costs to the ratepayers. As a result, Staff recommended that 50 percent of the public affairs and public relations costs be disallowed. Staff's recommendation would reduce TY expenses by $615,000.
>
> We concur with Staff. The Company has not justified over 94 percent of the public affairs and public relations costs being passed through to ratepayers. These are areas which clearly provide benefit to shareholders. We find that Staff's proposal to split the costs between ratepayers and shareholders to be a fair resolution.

The adjustment proposed by Staff in this proceeding is again a partial disallowance of Qwest's Arizona public affairs supervisory and support function costs, based upon the ratio of legislative and external/community relations direct costs to total public policy costs incurred in the test period. The details of the ratio calculation are set forth in Confidential Schedule C-14. Staff's adjustment effectively disallows about 48 percent of Arizona Public Policy wage and benefit costs, with no disallowance of corporate supervisory and administrative support personnel shared with the other states.

Q. Did you inquire into the nature of legislative positions undertaken by Qwest to see if the Commission's past conclusions regarding benefits to shareholders remain valid today?

A. Yes. Data Request UTI 6-11 asked if the Qwest Public Policy Organization prepares or participates in the preparation of strategic plans or other formally documented planning processes that are submitted for review and approval by senior management and, if so, to provide copies of all such documentation. The Company responded "No" and provided no documentation.

To evaluate Qwest's legislative activities beyond directly assigned lobbying costs that are booked below the line, Staff submitted Data Requests UTI 9-14 and 9-15 asking Qwest for "any records associated with its legislative activities, its assessment of pending legislation or its position on legislative matters" at the State and Federal levels, respectively. In reply to both questions, the Company stated, "Qwest objects to this data request on the grounds that the request violates Qwest's First Amendment rights of free speech and to petition the government by seeking information with respect to Qwest's actions taken in lobbying, its assessments of legislation and its position with respect to legislation. Qwest also objects that the request seeks in part information that is protected by the attorney client and work product privileges."

Q. Should the adjustment Staff has proposed to disallow a portion of Public Policy costs be considered conservative and generous to shareholders?

A. Yes. Rather than disallow 50 percent of Qwest Service Corporation charges to Account 6722 External Relations expenses in the test period, Staff proposes a more detailed adjustment. Specifically, a disallowance of two Director position salaries and a pro-rated share of the related supervisory wage and benefit costs within the Public Policy Organization to below the line accounts is proposed, based upon position descriptions and the supervisory relationship of management personnel over such positions. This results in a relatively modest adjustment that does not disallow any of Qwest's corporate Public Policy support personnel, even though to some extent they are involved in support of State legislative activities.

EXTRAORDINARY ACCOUNTING AND INSURANCE COSTS

Q. Did Qwest incur certain extraordinary costs in the test period as a result of various investigations and litigation surrounding the validity of its accounting records and the propriety of its public disclosures?

A. Yes. The Qwest Corporation SEC Form 10Q filed May 5, 2004 describes a series of investigations, lawsuits and asserted claims against Qwest Corporation and its parent company, that are described under the headings "Securities Action" and "Investigations" and "Securities Actions and Derivative Actions". I have attached as Attachment MLB-6, a copy of this documentation. According to these disclosures, the SEC investigation, "…includes, without limitation, inquiry into several specifically identified QCII accounting practices and transactions and related disclosures that are the subject of the various adjustments and restatements described in the QCII annual report in Form 10-K for the year ended December 31, 2002. The investigation also includes inquiry into disclosure and other issues related to transactions between QCII and certain of its vendors and certain investments in the securities of those vendors by individuals associated with QCII." A U.S. Attorney's Office investigation into similar matters is also discussed, along with U. S. Congressional hearings that have occurred. With knowledge of these recent and pending matters, Staff inquired of the Company regarding related test period costs that may be included in the asserted revenue requirement.

In a supplemental response to Data Request UTI 1-24, the Company stated, "All external legal costs for Special Litigation referred to in the 10-Q were recorded on QCII's books and not QC's books. The disclosure was included in QC's 10-Q because, as a subsidiary of QCII, QC may be impacted by any judgments or fines QCII is required to pay in the future. Internal legal costs associated with these litigations were incurred at Qwest Services Corporation and allocated and billed back to QC. See Confidential Attachment A for the QC Arizona intrastate amounts associated with these internal legal costs." Upon review of these costs, Staff concluded that QC internal charge amounts allocated to Arizona in the test period were minimal and required no adjustment.

However, additional costs associated with the extraordinary investigation and litigation involving Qwest were incurred for the re-auditing of prior years' financial statements and for vastly increased costs for directors and officers ("D&O") liability insurance. Staff is proposing adjustments to normalize for these extraordinary costs that are included within the test year expenses and in the Company's Rule 103 filing.

Q. Please describe Staff's adjustments associated with Qwest's activities in response to the investigations and litigation you reference.

A. Staff Joint Accounting Schedule C-12 sets forth three adjustments, first to remove the direct costs associated with re-auditing prior years' financial statements, then to remove costs associated with shareholders litigation and finally to restate the Arizona share of Qwest's Directors and Officers ("D&O") Liability Insurance to a normalized level. The sources for the amounts included for these adjustments are Qwest's confidential responses to UTI 1-26, UTI 1-24 and UTI 11-13, respectively. A normalized level for the D&O insurance costs was determined to be the highest cost level incurred in any of the three years prior to the 2003 test period.

Q. Were any of the accounting restatements resulting from the re-auditing activity that were reflected in Qwest's publicly filed SEC financial statements for 2002 or 2003 associated with the books of Qwest Corporation, the regulated utility?

A. No.[21]

Q. Was the overall level of accounting services costs in the test year much higher than incurred costs in prior years as a direct result of the extraordinary costs associated with re-auditing previously audited and reported financial periods?

A. Yes.[22] The Arizona Intrastate share of accounting fees in 2003 was approximately [redacted] percent higher than comparable costs in 2002. Staff's adjustment is conservative in light of the magnitude of this cost increase, because it removes the discrete costs of additional accounting fees, leaving within the test year

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21 Qwest Supplemental Response to UTI 1-27S1.

any additional labor, contractor and other expenses incurred to support Qwest's response to the various investigations and lawsuits that were active in 2003.

Q. With respect to the costs of D&O insurance incurred by QCII, is it fairly obvious that insurance costs have increased as a direct result of pending claims against Qwest and its officers?

A. Yes. In 2002, the year the SEC and U.S. Attorney's investigations and most of the putative class actions were commenced, and in the two years prior to 2002, the cost of D&O insurance incurred by QCII for the entire business never exceeded [redacted] million, with approximately [redacted] allocated to Arizona Intrastate expenses.[23] There is reference in the Qwest Corporation SEC Form 10-Q to "$200 million of insurance proceeds" related to such proceedings. Starting in 2003, D&O insurance premiums paid by QCII were increased to about [redacted] million, of which more than [redacted] is allocated to Arizona intrastate operations. Clearly, these costs are extraordinary and should be normalized.

UPDATED ALLOCATION FACTORS

Q. Did Qwest include in its filing an adjustment to update certain allocation factors to January 2004 levels?

A. Yes. Qwest adjustment PFN-06 is captioned "Headquarters Factors Update" and has the effect of restating allocations recorded during the 2003 test year as if the new factors that were effective on January 1, 2004 had been effective throughout the test year. In his testimony at page 51, Mr. Grate describes this adjustment as:

- PFN-06, adjusting "headquarters" allocated expenses to reflect the multi-state allocation factors most reflective of the end of the test year;

Mr. Grate provided additional details for this adjustment at pages 93 and 94 and explains, "In a nutshell, headquarters factors are declining in Arizona because Qwest is losing customers significantly faster in Arizona than in other states."

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22 Qwest response to UTI 5-06, Attachment A.
23 Qwest response to UTI 11-13, Confidential Attachment A.

Q. Do you agree with this adjustment and explanation?

A. I agree that the adjustment should be made, but would observe that there are more variables than simply customer counts that impact the adjustment. Most of the headquarters costs being allocated are actually subjected to a "weighted three" factor that includes a combination of access lines, telecommunications plant in service and expense values among the states to derive the factor. Thus, Mr. Grate's explanation of apparent trends ignores the role of relative expenses and investment in determining the factor. More importantly, his adjustment is incomplete in that it fails to make corresponding adjustments for the shifts in regional "centralized" factors or for the updated Qwest Services Corporation allocation factors that were also made effective on January 1, 2004.

Q. What is Qwest Services Corporation and how does it employ relative size-based allocation factors to attribute costs to Qwest Corporation's Arizona operations?

A. Qwest Services Corporation ("QSC") is an affiliated company that provides centralized executive, administrative, marketing and technical services on a shared basis for the various subsidiaries of Qwest Communications International, Inc. ("QCII"). In this capacity, QSC incurs labor and non-labor costs that are accumulated within responsibility centers ("RCs") which then assign or allocate such costs among affiliated companies, including Qwest Corporation. In the test year, the Qwest Corporation "share" of QSC allocated charges was approximately [redacted], or about [redacted] percent of total QSC costs of [redacted].[24] While some QSC costs are directly assigned or attributed among affiliates based upon positive time reporting (timesheets), most of the costs are allocated using a series of allocation factors that are periodically updated to reflect more current financial and statistical indicators of the relative size of QC versus the other QCII affiliates.

Q. Please explain the adjustment set forth at Staff Joint Accounting Schedule C-13.

[24] Derived from Confidential Attachment A to Data Request UTI 1-21.

A. This Schedule adjusts for the impact upon test period QSC charges if one simply updates the relative size-based QSC allocation factors to January 2004 levels. In keeping with the philosophy of Qwest's PFN-06 updating of headquarters pro-rate factors within Qwest Corporation, there should be a comparable updating of the QSC allocation factors to the same point in time. This adjustment relies upon information contained in Qwest's confidential responses to Data Requests UTI 8-44 and 8-46, with confidential details redacted in the detailed calculations within Schedule C-13.

Q. At line 40 of Staff Joint Accounting Schedule C-13, there is reference to "Centralized" allocations. What are "centralized" allocation factors?

A. Many of Qwest Corporation's employees are directly assigned to a particular state, while others are "headquarters" employees that work for the benefit of all 14 states. Another category of personnel and costs are for regional or centralized employees and functions that benefit more than one state, but less than all 14 states. There are a series of relative size-based "centralized" allocation factors that should have also been updated as of January 1, 2004 by Mr. Grate.

Q. Have you quantified the adjustment needed to update for the centralized allocation factors, in a manner consistent with Qwest's PFN-06 updating of headquarters factors?

A. Yes. Actually, Qwest was asked to perform these calculations and they were provided to Staff in response to Data Request UTI 2-008. The ratemaking adjustment that is set forth in Staff Joint Accounting Schedule C-13 includes the Company's calculation of the impact of updated centralized allocation factors upon test period charges to Arizona.

QWEST SERVICE CORPORATION COSTS

Q. In previous testimony regarding other adjustments, you referenced corporate advertising costs and public policy costs that were incurred by Qwest Service Corporation ("QSC") and then allocated to Qwest Corporation and other affiliates.

Are there other costs incurred at QSC that require adjustment for ratemaking purposes?

A. Yes. Staff Joint Accounting Schedule C-15 sets forth one other element of QSC expenses charged to QC Arizona operations in the test period that requires adjustment. This cost involves consulting payments made to Qwest's former Chief Executive Officer pursuant to his "Resignation and Consulting Agreement". Staff does not believe these costs are reasonable or necessary for the provision of service in Arizona.

Q. Please explain the consulting payments made to Qwest's former CEO, Mr. Nacchio, that are disallowed in Staff Joint Accounting Schedule C-15.

A. Mr. Joseph Nacchio was Qwest's CEO during the years when significant accounting problems, financial investigations, a precipitous decline in credit ratings and disastrous financial performance were experienced. Ultimately, QCII and Mr. Nacchio entered into a "Resignation and Consulting Agreement" dated as of June 16, 2002 that provided for his resignation and the termination of an existing Employment Agreement, as well as payment of a lump sum $10.5 million severance benefit, continuation of pension, welfare and medical benefits, continued indemnification and insurance payments, disposition of certain stock-based compensation and an ongoing consulting arrangement.[25] This latter provision caused Qwest to pay Mr. Nacchio $125,000 per month through June 30, 2004 to serve as a consultant to the Company "with respect to transitional matters relating to the Company's business, and shall perform such other services for the Company, its subsidiaries and affiliates as reasonably requested by the Board during the Consulting Period."

Staff has disallowed these consulting payments to the prior CEO, as allocated to Arizona, because Qwest has made no showing that any services of benefit to QC in Arizona were received from Mr. Nacchio and because no ongoing services are to be provided upon expiration of the agreement.

[25] Qwest response to Data Request UTI 15-23, Non-confidential Attachment C.

QWEST WIRELESS AFFILIATE PRICING

Q. Please explain the purpose of Staff Joint Accounting Schedule C- 10.

A. This adjustment is made by Staff to "re-price" cellular phone charges paid by Qwest Corporation to its wireless affiliate, Qwest Wireless, so as to reduce per minute pricing to the lowest and best prices Qwest Wireless charges certain large, non-affiliated customers. Qwest Corporation incurs significant costs for internal communications among its employees using cellular phones and has selected Qwest Wireless as its vendor for such services. The effect of Staff's adjustment in this area is to reduce actual test year wireless charges that were priced at $.08 per minute to the lower "GOLD" plan pricing paid by other Qwest Wireless customers of only $.05 per minute.[26]

Q. What is the stated basis for Qwest Wireless pricing of cellular phone services to Qwest Corporation?

A. According to Qwest's response to Data Request UTI 3-26, Qwest Wireless pricing is based upon Prevailing Company Price –"the price that is billed to existing customers for service with the similar features and similar volumes. Generally, these prices are included in the company's billing systems for non-affiliate customer billing. For each PCP service, 25% of the revenue must be from outside parties." A confidential Attachment B to the same Data Request indicated that third party customers of Qwest Wireless pay a wide variety of nominal and effective per minute of use ("MOU") prices for service and that several of such customers were paying prices lower than Qwest Corporation was being charged by its wireless affiliate in the test year.

Q. How does Qwest explain charging the regulated business higher per MOU prices for wireless service than Qwest Wireless charges non-affiliated large customers?

A. Staff requested an explanation in Data Request UTI 7-10. In its response, the Company offered a listing of Current Price Plans for wireless service broken down between "MOU Plans" and "Fixed Plans" that charge a per phone recurring charge

[26] Qwest response to Data Request UTI 7-10, Non-confidential Attachment A.

with an allowance of free minutes. The lowest priced 'MOU Plan" was a grandfathered "GOLD" plan that has no monthly recurring per phone charge and a flat rate of $.05 per minute for usage. In the narrative response to this request, Qwest stated that, "As indicated in Non-Confidential Attachment A, QW no longer offers most of these plans. In many instances, QW has permitted existing customers to retain the more attractive plans because of the revenue those customers generate for other Qwest products (including regulated products)."

The Company admitted in this response that, "QW bills QC at a higher nominal rate per MOU than the identified third parties. However, a full evaluation of the cost of wireless service must consider other factors besides the nominal rate per MOU. For example, in order to receive discounted units, third party customers must agree to either a one-year or two-year contract for each wireless line they purchase; QC has no obligation to sign contracts and, thereby, avoids the cost of administering contracts. Third party customers who terminate service prior to the end of the contract period pay a $200 deactivation fee; QC pays nothing for deactivation prior to the end of a one year or two year time period." The Company also offered a comparison showing QC prices superior to two other currently offered Fixed Plans, but no comparison was offered to the grandfathered GOLD plan.

Q. Who are the third party wireless customers that receive the lower GOLD plan prices?

A. According to Qwest's response to Data Request UTI 16-19, "Gold Plan customers are business customers that purchased the plan when it was available to new customers. This plan was not actively marketed to business customers after 2002. In 2004, when QW began migrating customers to the Sprint Network, QW did not require these customers to choose another plan because the company wanted to retain them and the revenue they generate for all Qwest products." Non-confidential Attachment C to this response lists 46 customers that commenced "Gold Plan" service between September of 1998 and August of 2001, of which 17 have since discontinued Gold Plan service as of September of 2004.

There is no explanation given for why Qwest Corporation did not purchase this lower priced plan while it was available or why the wireless affiliate seems less concerned about "retaining" QC as a wireless customer.

Q. Did Staff ask the Company to quantify its avoided service deactivation fees by taking wireless service under the higher priced plan during the test period?

A. Yes. Staff was interested in understanding whether QC realized any offsetting benefits in the form of avoided deactivation fees, in return for paying higher per minute prices. In response to Data Request UTI 16-19f, the Company stated, "Charges other than deactivation fees would have been the same under the Gold Plan as under QC's actual agreement with Qwest Wireless (QW). Deactivation fees that QC avoided by being on the 8 cent plan cannot readily be determined because QC's contract expiration date, required for this calculation, is not present on QW's databases. An extensive special study would have to be performed to gather the necessary information to calculate QC's avoided deactivation fees."

Q. How is Staff's adjustment to reprice wireless service purchased from the QW affiliate quantified?

A. Schedule C-10 reflects a simple reprice of the MOU in the test year at the lower five cents per minute Gold Plan rate. If Qwest can document the avoided "deactivation fees" that is would have paid under the Gold Plan, such fees would be an appropriate offset to Staff's ratemaking adjustment.

CASH WORKING CAPITAL

Q. How has Qwest determined its Cash Working Capital estimate for inclusion in rate base?

A. The Company compiled a lead-lag study of cash working capital. A lead-lag study measures the timing of cash flows through the company, so as to determine whether cash is collected from customers more quickly or more slowly than the Company is required to pay its employees, vendors, taxing authorities and creditors. If the Company can collect its revenues more quickly than it must pay its expenses, a negative cash working capital value is included in rate base, so as to recognize that the Company can finance part of its operations from favorable timing of operational cash flows. Alternatively, if revenue collection occurs more slowly than expenses must be paid, a positive rate base value for cash working capital is recognized, so as to provide additional return amounts to service the additional capital required of investors.

Q. What is Qwest's asserted cash working capital for rate base inclusion?

A. In its Rule 103 filing, at Schedule B-1, Qwest included negative $32.17 million of cash working capital in both the original cost and fair value rate base. However, the Company agreed to correct this value to negative $52.2 million after Staff identified a problem with the Qwest study that caused it to inadvertently include certain non-cash expenses including depreciation, deferred taxes and net income (return on common equity).[27]

Q. Are the Company's proposed corrections to its lead lag study result included in the Staff Joint Accounting Schedules?

A. Yes. Schedule B-1 incorporates the revisions Qwest would make to its asserted Rate Base in the Rule 103 filing. The single most significant rate base adjustment is the correction to cash working capital to remove the effects of non-cash expense elements that were inadvertently included.

Q. What other adjustments has Staff made to the Company's lead lag study?

A. The Company made certain simplifying assumptions in estimation of lag days to be applied to payroll costs, employee benefit costs and a portion of interest expense. With respect to payroll, the amount of gross pay was assumed to be subject to lag days associated with actual payments made to employees. However, a significant portion of payroll dollars are actually withheld for payment of payroll taxes, 401k savings plan contributions and other payroll deductions. Staff has refined the

[27] Data Request UTI 2-13. The Company also made other, less individually significant corrections in this

composite payroll lag day value for the estimated pay dates associated with these withholding items, using estimates of actual cash disbursement timing for each individually significant item. Additionally, Qwest included incentive compensation payments with a very long assumed lag in payment in its computation of the payroll lag and Staff has removed this element, so as to conform with the recommendation to eliminate most of the costs for test year incentive compensation.

Another area modified by Staff involves the computation of certain employee benefit lag days. Qwest assumed in its lead lag study that a zero payment lag day is properly applied to pension and group insurance expenses. Staff conducted additional discovery in this area and has more specifically analyzed and computed lag days to replace the assumed zero value, based upon estimated cash flow timing associated with such payments. For self-insured medical, dental, pharmaceutical and vision claims for both active and retired employees, Staff estimated the payment lags based upon the timing of claims paid.

With respect to payroll taxes, Qwest has treated Federal Unemployment Taxes as if the front-loading effect caused by the low annual taxable wage base causes these taxes to be significantly prepaid in relation to when employees actually accrue such costs and benefits. Staff has revised this calculation to reflect a FUTA tax payment lag equal to the FICA tax lag, since regulations governing tax remittances for these items are identical.

Another Staff lag day adjustment relates to interest payments. Qwest has included debt issuance expense amortization expenses with an assumed "zero" payment lag day value. However, debt issuance expense is a non-cash expense comparable to debt discount and premium amortization. Rather than include the expense with a zero expense lag, this expense element should be treated the same as Qwest's treatment of discount and premium amortization, by setting the expense lag equal to the revenue lag to yield no impact upon cash working capital.

Finally, the Staff lead lag study is tied to pro-forma expense levels associated with Staff's adjusted test period revenue requirement. This causes Staff's result to

Data Request response and provided revised workpapers reflecting such corrections.

more directly linked to relevant costs used to set rates and is an improvement upon the Company's study that incorporates unadjusted per books expense levels.

Q. Does Staff Joint Accounting Schedule B-2 incorporate the lag day modifications described in your testimony?

A. Yes. The lag days in Column E for many of the expense rows in Schedule B-2 have been modified to reflect revisions made by Staff to the underlying wage and benefits lag days. The specific rows affected are noted in footnote 1. The modified interest payment lag appears at line 22 of Schedule B-2.

LOCAL NETWORK SERVICES REVENUES

Q. What are Local Network Services Revenues and how are they treated in determining revenue requirement?

A. Local Service Revenues are derived from providing various services to retail end-user customers that rely upon the local exchange. These include recurring and non-recurring charges for basic local telephone services such as 1FR and 1FB lines, as well as a multitude of secondary features like call waiting, caller ID and call forwarding as well as local directory assistance. The recurring monthly charges associated with many of Qwest's basic local service revenue types enable revenues to be annualized at the end of the test period by simply multiplying recorded revenues in December times twelve. Along with Qwest's other smaller categories of intrastate revenues, such as access revenues, toll revenues and miscellaneous revenues, it is important to quantify a reasonable, ongoing level of revenues at present rate levels in order to determine whether existing rates are sufficient, excessive or inadequate relative to the Company's overall cost to serve.

In Arizona, the ratemaking formula employs an end-of-period rate base. This means that in this Docket the net amount capital investment in the Company's Telecommunications Plant in Service is measured at December 31, 2003. Additionally, depreciation expense is annualized at December 31, 2003 and any other known expense level changes at that date should also be recognized to properly synchronize all measures of the Company revenue requirement. In past rate cases, Staff has insisted that increasing trends in the Company's overall sales volumes and revenues be considered as of the same date rate base is measured. In this Docket, Qwest appears to agree with Staff that revenues should be annualized at year-end.

Q. Does "annualization" of revenues at test year-end intend to adjust for sales volumes at that date as well as price changes that have occurred?

A. Sales volumes need to be annualized at year-end, so as to match sales and customers at that date with the amount of plant investment and expenses required to meet that level of demand. The revenue impact of price changes, on the other hand, must be updated to current data if one is to determine whether "present" rate levels are inadequate or excessive. For this reason, Qwest has proposed separate adjustments in its Rule 103 filing to quantify revenue reductions associated with ACC-Ordered rate changes as of April 1, 2003 and at April 1, 2004 and intends its revenue annualization adjustments to account for only the annual volume of sales being experienced at year-end.[28]

Q. How are Local Network Services Revenues treated in the Company's R14-2-103 filing?

A. In Qwest's Rule 103 filing, the Company has proposed an adjustment to annualize declining revenue trends as of December 2003, in an attempt to match the cutoff of sales and revenues with the timing of rate base measurement. However, unlike Staff's annualization methods used in prior cases, Qwest employed a more complex analytical approach based upon linear regression. Recorded revenues in each individually significant revenue account were analyzed over an extended 36 month period; in a multi-step process that process that is described generally at pages 76 through 91 of Mr. Grate's Direct Testimony in support of Qwest's Adjustment PFN-

[28] An acknowledged problem with Qwest's Adjustment PFN-03 is the failure to separate volume from price level changes in the underlying data that is subjected to linear regression. This problem was conceded in Qwest's response to Staff Data Request No. UTI 2-06, "...the Company agrees that all price changes that occurred during the 36 month regression period should have been reflected in the regression data revenue stream. The company will supplement its response to this request when it has completed the analysis required to reflect this change."

03. Under Qwest's new approach, monthly financial data for a 36-month period January 2001 through December 2003 is first reviewed to identify any known out-of-period transactions requiring normalization. Then, Qwest applied data regression procedures to determine if a particular independent variable "driver" statistic over the same 36-month period can be reliably used to predict a year-end revenue level. Where the selected "driver" produces acceptably high sum of the residuals or "R-squared" result and sufficiently high T-test statistics indicating a meaningful correlation, Mr. Grate has calculated a predicted December 2003 revenue value that is multiplied times 12 months to annualize revenues.

Q. How does Qwest's new approach compare with the approach Staff has used in prior Qwest rate proceedings for local service revenues?

A. The Staff's approach to annualize revenue accounts containing <u>recurring</u> monthly local service revenue accounts has been to carefully remove or normalize any accounting abnormalities from the recorded data in the last month of the test period and then multiply the "last month" data by twelve to annualize. For example, in Docket No. T-1051B-99-105, Staff's Joint Accounting Schedule C-2 illustrates how I normalized December 1999 recorded local recurring revenues within 14 specified sub-accounts and then multiplied by twelve (months) to calculate an annualized ongoing revenue level at year end for these recurring local revenue accounts.

For accounts containing revenues that are <u>not</u> driven by recurring monthly charges to customers, such as access revenues or intraLATA toll revenues that are priced primarily on a per minute of use ("MOU") basis, the Staff has in past rate cases analyzed usage and revenue trends and generally applied a "fourth quarter times four" approach to annualize revenues if a trend in revenue is clearly present. This alternative annualization method was also applied only after carefully reviewing the recorded revenue data within the annualization quarter to be sure no unusual or out-of-period transactions would introduce any distortion into the resulting adjustment.

Q. Mr. Grate must have been aware of the Staff's past rate case methodology. How does he explain his preference for the more complex 36-month normalization and regression technique he employs?

A. At page 88 of his testimony, Mr. Grate compares his technique to the Staff's prior rate case methodology using Account 5001.21 recurring residential local service revenues as an example. After noting that his linear regression method would yield "an adjustment of $22,170,201" for this Account, Mr. Grate states:

> Had I multiplied normalized December revenues by twelve, the resulting annual revenues would have been $252,468,116 and the corresponding adjustment would have been $21,914,129. Though the results of multiplying the last month of the test period by twelve and using regression analysis are quite close, regression analysis is the clearly superior annualization methodology.
>
> Only the regression analysis method eliminates the risk of introducing distortion into the data that can occur when any unidentified anomalies in a single month's financial data are multiplied by twelve. The risk of such anomalies is most pronounced in the month of December, which is the last month of the fiscal year and so subject to year end true-ups and accruals.
>
> The advantage of a properly conducted linear regression analysis over multiplication of a limited sample (one month's or one quarter's worth) of financial data is that linear regression analysis relies on drivers that are less subject to anomalies and more likely to be representative of end-of-period conditions than are end-of-period financial data. Hence, regression analysis is more likely to yield results that are representative of end-of-period conditions than is multiplication of December financial data by twelve.

In the instance of this single account, the difference in methodology is relatively insignificant. However, in other accounts the linear regression approach now advocated by Qwest produces a less reliable annualized revenue result than alternative methods that will be explained in my testimony.

Q. In the last rate case, did Qwest concur in Staff's longstanding use of a one-month-times-twelve approach to annualize recurring local service revenues?

A. Yes. Mr. Grate acknowledges at page 90, "In Qwest's last rate case, Mr. Redding adjusted the test year so that each account reflected the recorded amount of financial results in the last month of the test period multiplied by twelve." He then distinguishes the Company's changed philosophy in stating, "In this filing the adjustments are made based on statistically meaningful and reliable drivers at the end of the test period. Using drivers instead of as-recorded actual financial results avoids the introduction of anomalies or unusual entries that may be present in just one month's financial data."

It should be noted that Mr. Redding also applied his "last month times twelve" method indiscriminately to many revenue and non-labor expense accounts in the last case, producing results that were found unreasonable and were rejected by Staff. Mr. Carver will address necessary adjustments to annualize expenses to year-end in his testimony.

Q. Is Qwest's new revenue annualization approach necessarily more accurate or reasonable than reliance upon a single month or quarter of financial data?

A. Not necessarily. Either the Staff or Company approach can produce reasonable results if carefully applied to relevant data. Qwest's new regression approach employs more data points and introduces a trending or smoothing effect into the calculations, which tends to reduce the dependence upon any single month of data. However, this smoothing may dilute the weight given the most recent financial data and underlying sales trends of greatest importance in annualizing sales volume changes occurring during the last six months of the test year. Inclusion of more historical data also brings with it an obligation to critically analyze much more information to identify and properly normalize for unusual, non-recurring or out-of-period entries in each of the 36 financial data points as well as any aberrations in 36 months of the so-called "driver" statistics. Additionally, over extended periods of time, changes in accounting procedures, regulatory requirements, prices of specific services and shifts in overall levels of economic activity can become embedded in the regression results, even though such historical changes have little to do with recent changes in demand and sales volumes from the average or mid-point of the test period to year-end. I believe we should be concerned with the reasonableness of the end-result of the annualization, in relation to actual factual data, and not rigidly apply a calculation process that may produce results inconsistent with reality.

Q. Is there a fundamental problem with Mr. Grate's regression approach that causes the prefiled Qwest Adjustment PFN-03 amounts to be inaccurate?

A. Yes. In separate adjustments PFN-02 and PFN-04, Mr. Grate has reduced test year revenues to account for ACC-ordered Price Cap Plan revenue reductions effective on April 1, 2003 and on April 1, 2004, respectively. Staff has reviewed and does not dispute these price level adjustments. Unfortunately, the 36 months of recorded revenue data relied upon by Mr. Grate for regression analysis also reflects declining prices associated with these same rate reductions, as well as certain other pricing changes incorporated in early 2001 at the inception of the Price Plan. The changing and generally declining price levels embedded in the 36 months of financial data influence the regression-derived revenue trend coefficients in Qwest's prefiled PFN-03 adjustment, which has the effect of distorting Mr. Grate's intended calculation of a volume only revenue annualization. Stated differently, Qwest's prefiled Adjustment PFN-03 tends to overstate declining revenue trends because the underlying revenue data is impacted by Price Cap rate reductions ordered by the Commission that are already included in Qwest Adjustments PFN-02 and PFN-04. Thus, the Price Cap rate reductions are double counted in PFN-03 because the embedded revenue amounts used for linear regression reflect declining prices that tend to exaggerate the actual downward trend in sales volumes.

Q. Has Qwest admitted this problem and submitted to Staff revisions to its PFN-03 Adjustment that the Company believes should be reflected in its revenue requirement?

A. Yes. In its Supplemental Response to Data Request UTI 2-06, the Company provided revisions to its PFN-03 adjustment workpapers. Then, in response to Data Request UTI 7-02, Qwest concurred in the posting of revisions to its filing that are set forth at Staff Joint Accounting Schedule C-1.

Q. What is the purpose of Staff Joint Accounting Schedule C-1?

A. This Schedule is included in Staff's filing simply to reflect a series of adjustments Qwest now recognizes as appropriate revisions to its filing, so as to avoid the need for a formal revision to the Company's R14-2-103 information. These are Company proposed revisions, arising primarily from information revealed in responding to Staff data requests. By posting these adjustments, Staff is not concurring in all of the Company's revisions, but merely updating the information in the Company's Rule 103 filing that is used as a starting point for the Staff Joint Accounting Schedules. In fact, in testimony Mr. Carver and I sponsor, some of Qwest's revisions are disputed and subjected to further adjustment.

Q. Given the nature of the double counting problem in Qwest's regression calculations associated with the price reductions ordered by the Commission, why does the Company's proposed revision to the PFN-03 regression adjustment to revenues not significantly change the amount of the adjustment?

A. The Company has now, upon revision, expanded the scope of its initial adjustment. The corrections made by Qwest to all of the "regulated" intrastate revenue accounts have the effect of increasing adjusted test year revenues, as expected. However, Qwest also seeks to now include FCC Deregulated revenue trends within its adjustment. These changes were not part of the Company's prefiled PFN-03 Adjustment. The following table compares Qwest's prefiled versus revised adjustment by primary revenue account, illustrating this expansion of scope.

Revenue Trending PFN-03 Revisions		Revised $000	Original $000	Impact $000
Local Service	Recurring	[redacted]	[redacted]	[redacted]
	Non-Recurring	[redacted]	[redacted]	[redacted]
	Directory Assistance	[redacted]	[redacted]	[redacted]
Access Revenues		[redacted]	[redacted]	[redacted]
Toll Revenue		[redacted]	[redacted]	[redacted]
Miscellaneous	White Pages	[redacted]	[redacted]	[redacted]
	Wholesale	[redacted]	[redacted]	[redacted]
	Late Payment Fee	[redacted]	[redacted]	[redacted]
	Billing and Collection	[redacted]	[redacted]	[redacted]
FCC Nonregulated Revenues (Newly Added)		[redacted]		[redacted]
Total Revision to Qwest Adj. PFN-03		[redacted]	[redacted]	[redacted]

Q. Should Qwest's inclusion of new downward adjustments for declining FCC Nonregulated revenue accounts be included within the Company's revenue requirement?

A. No. These are discretionary services offered by Qwest that produce low or negative returns on investment and that have been affirmatively deregulated by the FCC. Mr. Carver sponsors Staff's testimony addressing the treatment of FCC Nonregulated service revenues, expenses and investment in determining intrastate revenue requirements. However, in order to assist the Commission with a full record evidencing Qwest's position on this matter, Staff has included all of the revisions Qwest would make to its Rule 103 filing in Staff Adjustment C-1. Mr. Carver will separately address the Company's proposal to include FCC Nonregulated services as jurisdictional to the ACC.

Q. Turning back to the Local Service revenue category, can you summarize Qwest's original and corrected PFN-03 Adjustment?

A. Yes. In its initial filing, Qwest proposed to reduce annual Local Service revenues by $47.2 million. After correction, the Company's adjustment on a constant-price regression basis is a smaller reduction of $37.8 million. The direction and size of this adjustment is reflective of the ongoing declines in the number of access lines being served by Qwest in Arizona.

Q. Is it appropriate, in your opinion, to recognize sales volumes declines through December 31, 2003 and the related revenue impacts in this proceeding?

A. Yes. These declining volumes of business are a reality of Qwest's business environment at this time. Related downward trends in the size of the Company's work force and in the amount of net Plant in Service invested can be observed and Staff has "cut-off" the measurement of labor costs and rate base as of the same December 31, 2003 date to effect a matching of sales, revenues and costs at a common point in time.[29]

Q. Have you accepted Qwest's revised adjustment to annualize Local Network Services revenues?

A. Yes. The Company's revised adjustments for local recurring and nonrecurring revenues, at lines 3 and 4 of Schedule C-1, appear to produce reasonable results relative to the observed trends in recorded revenues at test period end and should be accepted. Staff proposes no substantive further adjustment in this revenue category after posting the corrections to Qwest's PFN-03 adjustment to restate the prefiled adjustment to a constant price basis, because the end-result of Qwest's revised calculations are reasonable in this revenue category. Staff's acceptance of only the local service portion of the Company's adjustment is not because Qwest's more complex linear regression approach is inherently more precise than alternative methods, but only because the results are reasonable in this instance.

Q. In your prior response, you stated Staff proposed no substantive adjustment to Qwest's revised Local Service Revenues. What is the purpose of Staff Joint Accounting Schedule C-2?

[29] Staff witness Carver discusses employee headcount trends in his testimony in support of Staff Adjustment C-19 Declining Net Plant investment in Arizona can be observed in the Company's Rule 103 filing at Schedule E-1, Row 3 and in greater detail at Schedule E-5.

A. There is a remaining error Staff is aware of in the Company's revised Local Service Revenue Annualization adjustment and a further Out-of-Period Adjustment to Local Service Revenues that Qwest's filing did not include.

Regarding the regression calculations, an accrual was recorded in November 2002, related to business activity from October 1999 through December 2000, that received a pro-rate treatment across the other months of 2002 in the Company's regression data. Upon inquiry by Staff, the Company responded to Data Requests UTI 6-06 and UTI 12-03 with further information about this entry and an acknowledgment that "The amount should not be prorated since it reflects revenues earned prior to the beginning of the regression period." This issue has been discussed with Qwest and I understand that the Company concurs that this further correction to its updated calculations is appropriate.

Q. Does Staff dispute other elements of the Company's PFN-03 adjustment that pertain to other categories of intrastate revenues?

A. Yes. The revised Qwest PFN-03 adjustment does not reasonably account for end of period revenue levels associated with Intrastate Access Revenues, Intrastate Toll Revenues, Directory Assistance or other Miscellaneous Revenues. These differences are discussed in the following sections of my testimony.

ACCESS CHARGE REVENUES

Q. Did Qwest prepare an annualization of year-end State Access revenues using the same linear regression methods you described for local service revenues?

A. Yes. Mr. Grate has annualized State Access revenues at year-end using a "Minutes of Use" driver in his regression calculations. After revising his calculations to a "constant price" basis in response to Data Request UTI 2-06, the Company's adjustment serves to increase State Access revenues by $3.1 million or about 3.7 percent.[30] This result is quite different from the Company's prefiled original adjustment PFN-03 that served to reduce State Access revenues by $0.3 million. Correcting for constant price levels was essential to recognize the substantial State

Access rate reductions that have occurred over the last 36 months that created a misleading impression of declining sales trends (if unadjusted dollars are trended) even though actual usage volumes are growing.

Q. Does Staff accept Qwest's revised, constant-dollar State Access revenue annualization in determining the Company's revenue requirement?

A. No. The Company's adjustment does not produce reasonable results, particularly with regard to revenues recorded in Account 5084.31 Private Line Transport Recurring. Qwest's proposed annualized revenue for this specific sub-account is overstated, relative to actual revenue trends at the end of the test period. Staff is proposing an annualized State Access revenue level that is approximately $0.3 million lower than Qwest, based upon the "fourth quarter times four" annualization approach that has been employed in prior rate proceedings for revenue categories that fluctuate based upon usage levels from month to month.

Q. What causes the Company's linear regression methodology to be less reliable for revenues that are usage driven, rather than accounts containing recurring monthly charges?

A. Qwest's proposed linear regression State Access revenue annualization determines a coefficient that represents revenues per minute of use ("MOU"). Then, actual December 2003 actual, recorded MOU are multiplied by the coefficient and added to a constant (Y-intercept) value to yield a normalized December 2003 dollar amount that is multiplied by twelve to annualize. The Company's annualized revenue amount is, therefore, dependent entirely upon how many MOU were recorded in the single month of December 2003. Because State Access MOU usage varies significantly from month to month, the resulting annualized revenue level under Qwest's methodology can be volatile. Staff's alternative approach uses an entire fourth quarter usage and revenue data, which tends to smooth out any usage variability from month to month.

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[30] See Line 6 of Staff Accounting Schedule C-1.

Q. Can you illustrate the variability problem introduced by Qwest's method that employs single-month actual MOU data to calculate the annualized revenue?

A. Yes. Using the State Access MOU information and regression results from a single sub-account where the problem is most acute, the following table compares the annual revenue amount that Qwest's methodology would produce if the data month were shifted to any of the three months prior to December (the month that was actually used by Qwest):

Data Month	Actual MOU	Coefficient	Intercept	Monthly Amount	Annual Amount
September	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
October					
November					
Dec. (used)					

The impact of fluctuating monthly MOU statistics undermines the ability of Qwest's linear regression method to produce a smoothed indication of annualized revenues. As illustrated in this table, annualized revenues from this single sub-account can vary by as much as $1.9 million depending upon which month's MOU data is used.

Q. How does Staff's approach smooth out monthly fluctuations in observed MOU?

A. Three months of actual revenues are used to capture a larger and more representative data period near test year-end under Staff's approach. Additionally, the effects of shifting usage and revenues from up to 36 months prior to test year end influence the Company's result, while only the most recent and relevant information is considered under the Staff approach.

Q. At page 88 of his testimony, Mr. Grate claims, "Only the regression method eliminates the risk of introducing distortion into the data that can occur when any unidentified anomalies in a single month's financial data are multiplied by twelve. The risk of such anomalies is most pronounced in the month of December, which is the last month of the fiscal year and so subject to year end true-ups and accruals." How do you respond?

A. It is important to identify and correct for financial data anomalies using any methodology that employs such data. Qwest's methodology requires that 36 months worth of data be analyzed and "scrubbed" for unusual transactions. Yet, Qwest has applied its regression coefficient result to a single month's actual statistical data to annualize revenues using a "times twelve" calculation. Thus, Qwest's method suffers from the risk that statistical measures of business volumes, such as access lines, or business orders, or access minutes of use in the month of December are not representative of annual volumes throughout the entire test period. Much of the advantage Mr. Grate claims in avoidance of "unidentified anomalies in a single month's financial data" from his complex regression calculations are diminished by his utilization of a single month's statistical volume data, taken "times twelve" to annualize, without regard to the normalcy of such data.

Q. Are certain types of revenue accounts more stable from month-to-month when looking at statistical measures of business volumes?

A. Yes. Recurring revenues associated with services that are billed monthly, such as basic local service or central office features, because business volumes are large and relatively stable and monthly variations in usage by customers do not impact billings. On the other hand, usage driven accounts, such as access revenues, toll revenues, or directory assistance revenues, can see volumes of business fluctuate significantly from month to month. For these categories, Mr. Grate's approach does little to ensure that December volume statistics are representative of business throughout a full year.

Q. How has Qwest responded to this concern when raised in Staff's discovery?

A. After submitting two data requests (UTI 11-09 and UTI 16-18), Qwest conceded that, "In all instances, the regression coefficient was multiplied by the end of test period value for December 2003", yet the Company would not explain the basis for its assumption that this single month of statistical data is representative and provided no analyses, reports, workpapers or other information relied upon to determine that the

December 2003 unadjusted volume statistic is reasonable to multiply by twelve and by the regression coefficient to annualize revenues.

Q. What is the purpose of Staff Joint Accounting Schedule C-3?

A. This Schedules sets forth the incremental adjustment required to restate Qwest's State Access Revenue annualization adjustment, after correction in Accounting Schedule C-1, to the lower amounts recommended by Staff using the "last quarter times four" approach that has been employed in prior rate cases. In addition, Staff's Access Revenue adjustment reflects a further restatement of Intrastate Access Revenues to reflect the amount of such revenues actually recorded on the Arizona Ledger, reversing an informal ratemaking adjustment Qwest apparently made without documentation based [redacted].[31]

TOLL SERVICE REVENUES

Q. Has Qwest included Intrastate Toll Revenues in its linear regression-based annualization adjustments?

A. Yes. Using a regression methodology similar to that used for State Access revenues, the Company has adjusted its Intrastate Toll Revenues to an annualized year-end level using either monthly Intrastate Toll Message statistics or Consumer Line counts as the "driver", or independent variable. The overall adjustment proposed by Qwest, after correction to a constant-price basis, would reduce actual test year Intrastate Toll Revenues by $2.3 million. This represents a decline of 21 percent from the average or mid-point of the test year to year-end, which suggests an annualized rate of decline of about 42 percent.

[31] See Qwest's response to Data Request UTI 13-12, Highly Confidential Attachment A, which appears to [redacted] In its response to UTI 19-02, Qwest argues that GAAP accounting requires it to recognize reduced revenues for "a claim against Qwest [that] satisfies GAAP and Part 32 recognition requirements which the subject of UTI 6-12 (which pertains to Qwest's claims

Q. What is causing the serious downward trend in Intrastate Toll Revenues?

A. The Company's intrastate only long distance service has long been in decline. Information provided in response to Data Request UTI 6-03 indicates that such revenues have declined from more than $90 million annually in 1995 to only $11 million in 2003, a decline of approximately 88 percent. Competitive entry with Equal Access for the interexchange carriers into the IntraLATA toll business in April of 1996 contributed significantly to unfavorable revenue trends in the 1990's as consumers exercised their competitive options with dialing parity. Competition increased post-merger from Qwest LD Corporation (an affiliated reseller) and the recent entry of Qwest Communications Corporation (the facilities based toll affiliate) in December of 2003 can be expected to continue the trend in toll market losses.[32]

Q. Do you dispute Qwest's calculation of annualized IntraLATA Toll revenues?

A. Yes. The Company's adjustment exhibits relatively low R-squared values below .55 for several accounts, barely satisfying Mr. Grate's judgmental screening criteria at the.50 value, below which he would propose no adjustment. Additionally, the overall result of Qwest's annualized IntraLATA Toll revenue adjustment is not consistent with recorded revenue levels in the test period. Specifically, Qwest's proposed annualized monthly revenue level of $[redacted] / 12 months) is lower than every single month of the test period. The lowest recorded test period month IntraLATA Toll revenue was $[redacted] in June of 2003.

Q. How has the Staff calculated annualized IntraLATA Toll revenues?

A. Staff used the same "fourth quarter times four" methodology applied to normalized per books revenues in the last three months of the test year, as was used to revise Qwest's proposed State Access revenue calculations in the prior section of my testimony. This approach has the effect of moderating monthly fluctuations in usage data, while focusing directly on toll market conditions and revenue levels being experienced at the end of the test year. Staff's result is consistent with actual test

against AT&T) does not."

year data and is not dependent upon Mr. Grate's data that is up to 36 months old and subject to relatively poor regression results.

Q. What is the purpose of Staff Joint Accounting Schedule C-4?

A. This Schedule displays the calculations supporting Staff's proposed annualization of IntraLATA Toll revenues, and then compared the result to Qwest's proposed annualized level to yield an incremental adjustment.

DIRECTORY ASSISTANCE REVENUES

Q. What adjustment is proposed by Qwest to annualize Directory Assistance ("DA") revenues?

A. The Company's revised regression-based adjustment reduces test year DA revenues by more than [redacted],[33] which represents a quite large [redacted] percent reduction in just six months, moving from test year average volumes to year-end annualized volumes. Most of the reduction proposed by Qwest is to annualize declining Residential DA revenues, using the number of residential access lines as the chosen "driver" in the regression analysis.

Q. Does Staff agree that Qwest's DA revenues are experiencing substantial reductions in volumes at the level suggested by Qwest's adjustment?

A. No. There is no question that Directory Assistance volumes and revenues are declining. However, the Company's adjustment fails to produce a reasonable ongoing level, particularly with regard to Residence DA revenues. For Account 5060.32 Directory Assistance Revenue – Residence, the Company's revised pro-forma revenue level is only [redacted] per month, or [redacted] annually. When compared to per books residential DA revenues of [redacted], the Company's adjustment represents a [redacted] percent reduction in only the last 6 months of the test period. However, the lowest actual recorded level of residential DA revenues in any

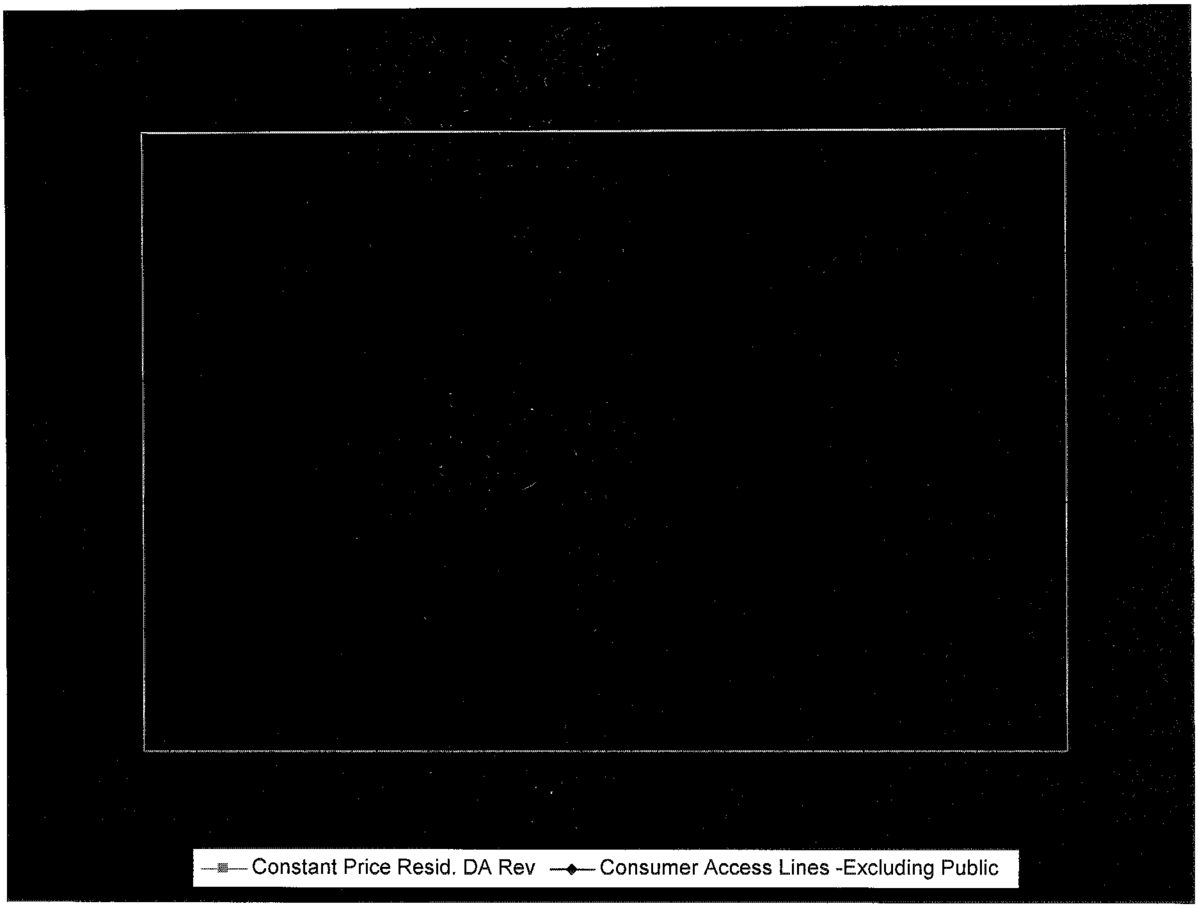
[32] Qwest responses to UTI 13-07 and 15-05.

[33] See Line 5, Column C of Staff Accounting Schedule C-1, where the Company's revised and updated adjustments are summarized.

month of the test year was [redacted] in November 2003. Thus, the Company's adjustment result is not credible in relation to any actual data in the test year and should be rejected.

Q. Is there a reason why the Company's revised, constant-price linear regression approach may produce unrealistic results for the Directory Assistance revenue accounts?

A. Yes. Qwest has implemented quite large price increases for DA services in April of 2001 and again in April of 2002, with much smaller price increases again in April of 2003. The rate of decline in monthly DA volumes and constant price revenues was much steeper in the months prior to 2003 than during the test period. It is possible that the demands of more price sensitive customers were driven down by the large price increases in the early portion of Qwest's 36-month regression period, while volumes and revenues have stabilized along with pricing in 2003. With the 36 month regression period used by Qwest, early periods of rapid decline may be unreasonably extrapolated into the 2003 test year and serve to understate year-end volumes and revenues. The following confidential chart illustrates the trends in constant price Residential Directory Assistance Revenues during the 36 month analysis period employed by Qwest:



This chart illustrates the reduced rate of decline in Residential DA revenues being experienced after 2002 and also clearly shows how unreasonable the Company's proposed annualized level of [redacted] per month is, relative to all months of the test year.

Q. You have not included a comparable graph for the Business Directory Assistance ("DA") monthly revenue in Account 5060.31. Is there any reason why your discussion focuses solely upon the Residential DA revenues?

A. Yes. Most of the difference in results between the Qwest and Staff methodologies can be traced to the Residential portion of DA revenues. Another graph of the Business DA revenues would exhibit a downward trend comparable to the graph of Residential DA data presented above. However, both the Staff and Company-proposed annualized revenue levels would be consistent with the recorded revenue data in the last few months of the graph. I did not include this second graph because most of the difference at issue is within the Residential DA revenue sub-accounts.

Q. What is the purpose of Staff Joint Accounting Schedule C-5?

A. This Schedule sets forth certain revisions to Qwest's revised constant-price DA revenue annualization, so as to produce more representative ongoing levels of such revenues. As with other types of revenues where demand tends to fluctuate based upon month-to-month variations in usage levels, the Staff's proposed adjustment is based upon the last quarter 2003 normalized revenues in each account, multiplied times four to annualize.

Q. Did Staff submit a data request to Qwest asking the Company to explain its apparently excessive reduction in Residence Directory Assistance Revenues?

A. Yes. In its response to Data Request UTI 12-012, the Company did not attempt to defend the reasonableness of its adjustment to this account, instead stating, "When this particular adjustment is viewed in isolation, there is no question that the amount of the normalizing adjustment exceeds the actual revenue decline the Company has experienced in Account 5060.32 since the close of the test period." Then, as part of its further explanation, the Company referenced another account (Local Recurring Revenue Account 5001.21) where Qwest's adjustment result understated the rate of revenue decline, when evaluated relative to actual revenue changes through August of 2004. However, Staff does not believe the test period should be revised through August 2004 and has not tested or compared revenues, expenses or rate base past test year-end. The purpose of the revenue annualization adjustments is to reasonably quantify ongoing, annual revenues as of the end of the 2003 test period.

FAIR VALUE RATE BASE

Q. What is proposed by Qwest with respect to fair value rate base?

A. The Company has employed a 50/50 weighting of an original cost valuation and a reproduction cost new, less depreciation ("RCNLD") valuation of its Arizona

Telecommunications Plant in Service to define fair value rate base. Qwest witness Ms. Heller-Hughes sponsors the RCNLD study and valuation evidence, with results incorporated into Qwest's R14-2-103 filing at Schedule B-4. RCNLD and original cost net plant values are weighted together using the 50/50 approach at Schedule B-3 of the filing. The Company's rate base adjustments are posted directly to the original cost rate base, and are factored up by a ratio reflective of 50/50 weighting of original cost and RCND net plant values for posting to the asserted fair value rate base.

Q. Has Qwest proposed application of a reasonable fair rate of return to its fair value rate base?

A. No. Schedule A-1 of the Company's R14-2-103 filing shows Qwest attributing the same weighted average cost of capital to both its original cost rate base as well as its fair value rate base. This is clearly inappropriate, in that the fair value rate base accounts for the effects of inflation upon the historical cost of plant that was installed in prior years. A fair rate of return applicable to plant investment that has been factored up for inflation would be a return rate that has been "stripped" of the inflation component of the return. Otherwise investors are compensated twice for the effects of inflation upon their invested capital – once through the inflation component embedded in debt interest rates and the equity return; and again through inflation adjustment of the principal amount of their past investments. This double counting produces an overstated revenue requirement, that in Qwest's initial filing increased the $322 million amount discussed in testimony to more than $441 million, as shown at line 10 of Qwest schedule A-1.

Q. Has the Company offered any support in testimony for a fair rate of return on fair value investment equal to its cost of capital, as shown at line 5 of Schedule A-1?

A. No. Mr. Cummings testimony addresses the Company's cost of capital that is applicable to its original cost investment. His testimony supports a return on equity capital of 21.4 percent, which is included in the Company's asserted overall cost of capital at Schedule D-1 of Qwest's filing. However, if the same overall cost of capital is applied to the higher fair value rate base, the resulting income available for book common equity would produce a Return on Equity as high as 41 percent, a result clearly inconsistent with the evidence in this Docket.

Q. How has Staff determined the required rate of return on fair value rate base, for purposes of quantifying Qwest's Arizona intrastate revenue requirement?

A. Staff Joint Accounting Schedule A sets forth a fair rate of return on fair value rate base that will provide Qwest the opportunity to earn income sufficient to meet its overall cost of capital, as sponsored by Staff witness Reiker. To the extent the valuation of rate base is increased to account for estimated fair value, a corresponding reduction in the required rate of return is necessary to recognize that the income required to meet investors' requirements does not change when property valuation approaches are changed. Said differently, Qwest creditors and shareholders don't require more interest income, net income or cash flow in fair value jurisdictions like Arizona, than they require in other states. The business income and cash flow required to attract capital on reasonable terms is the same, irrespective of the basis of property valuation. No bonus income is required or warranted by the Company as a result of its fair value.

Q. Are there differences in the RCNLD value used to determine fair value rate base in the Staff's filing, in comparison to Qwest's RCNLD study?

A. Yes. Staff witness William Dunkel sponsors certain adjustments to the Percent Condition factors used in Qwest's Reproduction Cost New, Less Depreciation study that are explained in his testimony. The adjustments sponsored by Mr. Dunkel in his Schedule WDA-17 and are incorporated into Staff Joint Accounting Schedule A-2 as a revision to Qwest's asserted RCND values. It is necessary to apply a fifty percent weighting to the difference in percent condition proposed by Staff, due to Qwest's 50/50 weighting of the Reproduction Cost New Less Depreciation and the Original Cost rate base amounts to derive Fair Value Rate Base.

UNCOLLECTIBLE REVENUE CONVERSION FACTOR

Q. Please explain the purpose of the Revenue Conversion Factor and how it is employed in determining revenue requirements.

A. The revenue conversion factor is used to translate operating income values that are quantified on an after-tax basis into the equivalent amount of pre-tax revenue that is required to produce the required income effect. For example, application of the rate of return to Qwest's rate base tells us how much operating income is required to meet capital costs for the business. To produce an incremental dollar of after-tax income for this purpose, whenever rate base or rate of return increases, it is actually necessary to increase revenues by significantly more because each dollar of new revenue is subject to incremental tax and uncollectible revenue costs. The "Revenue Conversion Factor" developed on Staff Joint Accounting Schedule A-1 sets forth how this factor is developed by Qwest and by Staff. There are two differences revealed in comparing columns C versus D of Schedule A-1. First, the "Uncollectible Revenue" percentage on line 2 is different, for reasons I will discuss in testimony. The second difference relates to income tax rates, which are discussed by Mr. Carver.

Q. Why is the Staff's uncollectible percentage lower than has been proposed by Qwest in the Revenue Conversion Factor?

A. The Qwest uncollectible percentage is based upon unadjusted, test year actual uncollectible expense levels, divided by certain test year revenue accounts, as shown in the first portion of the "Footnote b" calculations at the bottom of Schedule A-1. However, Qwest made an adjustment elsewhere in its filing to recognize that test year actual uncollectible expenses were unusually high and should be normalized, as part of Mr. Grate's revenue annualization regression calculations.[34] It is necessary to incorporate this Company-proposed adjustment into the Revenue Conversion Factor to accomplish the same normalization of uncollectibles throughout the determination of revenue requirements. If uncollectible expense levels were unreasonable for one

34 Qwest's Uncollectible Adjustment is part of Adjustment PFN-03.

purpose, they are unreasonable for all purposes. Staff has included the Company's uncollectible adjustment within the Revenue Conversion Factor to achieve internal consistency with the adjusted income statement.

Q. Does this conclude your testimony at this time?

A. Yes.