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

STEVEN C. CARVER

ON BEHALF OF THE STAFF OF THE ARIZONA CORPORATION COMMISSION

PUBLIC VERSION

("Highlighted" Text Denotes Confidential Material)

NOVEMBER 18, 2004

TABLE OF CONTENTS

DIRECT TESTIMONY OF STEVEN C. CARVER

Attachments

BEFORE THE
ARIZONA CORPORATION COMMISSION
DIRECT TESTIMONY OF
STEVEN C. CARVER

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

Q. Please state your name and business address.

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

Q. What is your present occupation?

A. I am a principal in the firm Utilitech, Inc., which specializes in providing consulting services for clients who actively participate in the process surrounding the regulation of public utility companies. Our work includes the review of utility rate applications, as well as the performance of special investigations and analyses related to utility operations, cost allocation and ratemaking issues.

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

A. Utilitech was retained by the Staff of the Arizona Corporation Commission (hereinafter "Staff" or "ACC Staff") to review and respond to the revenue requirement filed by Qwest Corporation ("Qwest" or "Company"), as ordered by the Arizona Corporation Commission ("ACC" or "Commission") pursuant to R14-2-103. The scope of work undertaken by Utilitech included submission of testimony with this Commission regarding the results of our review, primarily regarding Qwest's test year revenue requirement under the traditional approach to utility regulation.

Q. Have you previously testified before this Commission in proceedings that involved Qwest or its predecessor companies?

A. Yes. Mr. Michael Brosch, also of Utilitech, and I have prepared and presented revenue requirement recommendations in a number of proceedings involving Qwest or U S West

Communications. I have filed testimony in three of the Company's previous Arizona rate cases (Docket Nos. E-1051-88-146, E-1051-93-183 and T-1051B-99-105) dating back to 1989. I have also filed testimony in two proceedings before the Washington Utilities and Transportation Commission (Docket Nos. UT-930074 and UT-950200) as well one proceeding before both the Utah Public Service Commission (Docket No. 97-049-08) and the New Mexico Public Regulation Commission (Utility Case No. 3008).

Q. Please summarize the purpose and content of your testimony.

A. Generally, my responsibilities in this docket encompass the review and evaluation of various elements of rate base and operating income included within the overall revenue requirement. As a result, I address various adjustments to rate base and operating income, identified on the earlier table of contents, as well as introduce Staff's proposed capital structure (Schedule D) sponsored by Staff witnesses Joel Reiker and Alejandro Ramirez. The additional ratemaking adjustments, which I do not sponsor, are separately addressed in the direct testimony of Staff witnesses Michael Brosch and William Dunkel. The revenue requirement effect of the various Staff adjustments and recommendations are reflected within the Staff Joint Accounting Schedules.

EDUCATION AND EXPERIENCE

Q. What is your educational background?

A. I graduated from State Fair Community College, where I received an Associate of Arts Degree with an emphasis in Accounting. I also graduated from Central Missouri State University with a Bachelor of Science Degree in Business Administration, majoring in Accounting.

Q. Please summarize your professional experience in the field of utility regulation.

A. From 1977 to 1987, I was employed by the Missouri Public Service Commission ("MoPSC") in various professional auditing positions associated with the regulation of public utilities. In April 1983, I was promoted by the Missouri Commissioners to the position of Chief Accountant and assumed overall management and policy responsibilities for the Accounting Department. I provided guidance and assistance in the technical development of Staff issues in major rate cases and coordinated the general audit and administrative activities of the Department.

I commenced employment with the firm in June 1987. During my employment with Utilitech, I have been associated with various regulatory projects on behalf of clients in the States of Arizona, California, Florida, Hawaii, Kansas, Illinois, Iowa, Indiana, Mississippi, Missouri, Nevada, New Mexico, New York, Oklahoma, Pennsylvania, Texas, Utah, Washington, West Virginia and Wyoming. I have conducted revenue requirement and special studies involving various regulated industries (i.e., electric, gas, telephone and water). Since joining the firm, I have also appeared as an expert witness before the MoPSC on behalf of various clients, including the Commission Staff. Additional information regarding my professional experience and qualifications are summarized in Attachments SCC-1 and SCC-2.

EXECUTIVE SUMMARY

Q. What is the overall revenue requirement proposed by Staff for Company's Arizona intrastate regulated operations?

A. Qwest submitted its prefiled testimony and required schedules[1] on May 24, 2004, subsequently revised on June 21, 2004. The Company's revised filing presents an overall intrastate revenue deficiency of $318.5 million (original cost) and $458.8 million (fair value).[2] The revised filing (June 21, 2004) was based on a historical test year ended December 31, 2003, with certain known and measurable ratemaking adjustments recognizing various prospective changes. In comparison, Staff has assembled a revenue requirement recommendation, based on an internally consistent test year approach, supporting an overall revenue increase of approximately $3.53 million. A series of accounting schedules supporting the Staff's recommended adjustments are set forth in the Staff Joint Accounting Schedules.

1 Qwest Corporation filing pursuant to A.A.C. R14-2-103(B)(7) or "R14-2-103" filing.

2 See Qwest Schedule A-1, filed June 21, 2004.

Q. Did the Company propose to recoup the entire $318.5 million deficiency through changes in existing tariff rates and price lists?

A. No. The Company did request an increase in AUSF support of approximately $64 million as well as several million dollars in increased miscellaneous revenues. However, the Company has also sought significant additional pricing flexibility, which may provide an opportunity for Qwest to recoup a larger portion of the remaining deficiency.

Q. Please summarize the ratemaking adjustments proposed by Staff that contribute to this difference between the revenue requirement recommendations of Company and Staff.

A. Schedule E of the Staff Joint Accounting Schedules represents a reconciliation of the various differences between the overall revenue requirement recommendations of Company and Staff.

Q. How are the Staff Accounting Schedules organized?

A. Within the joint accounting schedules, the components of the Staff's proposed revenue requirement appear on Schedule A, Change in Gross Revenue Requirement. The Staff's proposed rate base is brought forward from Schedule B, Summary of Jurisdictional Rate Base. Similarly, Staff's adjusted net operating income recommendation is brought forward from Schedule C, Summary of Operating Income. The components comprising Staff's cost of capital recommendation (i.e., rate of return) are detailed on Schedule D, Capital Structure & Costs.

Jurisdictional separation factors, applied to isolate the Arizona intrastate portion of each Staff adjustment, are summarized on Schedule F – based on revised composite intrastate separations factors resulting from the exclusion of FCC nonregulated services as discussed in a subsequent testimony section. The development of the gross revenue conversion factor used to convert the net operating income deficiency on Schedule A into the appropriate revenue requirement amount is set forth on Schedule A-1.

Staff's recommended adjustments to rate base and operating income are supported by individual schedules, also contained within the joint accounting schedules. The witness sponsoring each adjustment and schedule comprising the Staff's overall revenue requirement recommendation is identified in the upper left-hand corner thereof and listed on the schedule index located at the front of Staff Joint Accounting Schedules.

Q. How will you identify and refer to the individual accounting adjustments?

A. Both rate base and operating income adjustments have been numbered sequentially, but separately, beginning with the number "one". In order to distinguish the first rate base adjustment from the first operating income adjustment, the adjustment number is preceded by a reference to the schedule on which the adjustment was posted. For example, the posting schedule for the rate base adjustments is Schedule B. So, the first rate base adjustment would then be referenced as Schedule (or Adjustment) B-1. Similarly, the first operating income adjustment would be identified as Schedule (or Adjustment) C-1, since Schedule C is the posting schedule for the income statement adjustments. For purposes of testimony presentation in this proceeding, Mr. Brosch and I will use the words "schedule" and "adjustment" interchangeably when referring to the individual adjustments proposed by Staff.

Q. Do the joint accounting schedules provide calculation detail supporting each Staff adjustment?

A. Yes. The joint accounting schedules contain individual adjustment "schedules" that show the quantification of each rate base and operating income adjustment, with footnote references to supporting documentation. Since virtually all information relied upon by Staff in developing these adjustments was supplied by Qwest in response to written discovery, the adjustment schedules will refer to the relevant data sources, already in the Company's possession, that represent the primary support for the Staff adjustments affecting overall revenue requirement.

Q. Please describe Staff's approach to quantifying revenue requirement in this proceeding.

A. The Staff's joint accounting schedules use Qwest's "prefiled" amounts (as revised on June 21, 2004) for rate base, revenues and expenses as a starting point. The Company's proposed amounts were then adjusted to reflect the impact of the various revisions provided by Qwest[3] as well as modifications recommended by Staff witnesses.

By starting with the Company's proposed amounts, each ratemaking adjustment recommended by Staff represents a reconciling difference, positive or negative, between the overall revenue requirement recommendations of Staff and Qwest. In fact, Staff's Schedule E represents a reconciliation of the individual revenue requirement differences between the Company and Staff, by individual item.

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

A. The remainder of my testimony is arranged by topical section, following the table index presented previously. This index identifies the specific areas I address in testimony and references the testimony pages as well as any related adjustment support located in the joint accounting schedules.

TEST YEAR

Q. Please briefly describe the test year approach used in this proceeding.

A. As discussed previously, Qwest's revenue requirement is based on a historical test year ended December 31, 2003, with various ratemaking adjustments discussed in the direct testimony of Company witness Philip E. Grate[4]. Although Mr. Grate identifies only one post-test year pro forma adjustment proposed by Qwest, the Company sponsors ten (10) rate base and twenty-three (23) operating income adjustments that fall into three basic categories: accounting pro forma adjustments; normalizing pro forma adjustments; and ratemaking pro forma adjustments.[5] However, the Company is not seeking to recover the full amount of its asserted revenue deficiency through increases in its various tariff rates, as indicated by Mr. Grate:[6]

> Schedule A-1 of Qwest's Rule 103 filing computes Qwest's Arizona revenue requirement. Given the intensity of competition Qwest now faces

---

3 Staff Adjustments B-1 and C-1, jointly sponsored with Mr. Brosch, recognize corrections Qwest has identified to its June 21, 2004, filing in response to Staff Data Requests UTI 1-1 and 7-2.

4 Grate direct testimony, pp. 37-41.

5 Grate direct testimony, pp. 46-52.

6 Grate direct testimony, p. 10.

> in Arizona and the pace of Qwest's Arizona access line loss, Qwest does not believe the revenue requirement computed in the schedules of its Rule 103 filing is fully recoverable from its Arizona customers. Therefore, Qwest is not proposing rates to fully recover its revenue requirement. Instead, Qwest is proposing modifications to its price regulation plan that will allow the Company to compete on a more equal footing with its competition in Arizona.

Utilitech was retained by the ACC Staff to review Qwest's traditional revenue requirement filing and to present the results of our review, not to address Qwest's proposed modifications to the Company's price regulation plan. Staff witness Mathew Rowell discusses the price regulation plan in his direct testimony.

Q. With regard to the traditional revenue requirement elements of Qwest's filing, has the Company proposed a year-end or average approach in quantifying overall revenue requirement?

A. Generally, Qwest has proposed end-of-period investment, revenues and wage rates. However, certain elements of the ratemaking formula are based on average test year levels in areas such as: employee levels and general non-labor operating expenses.

Q. How does the Company's general test year approach compare to that employed by the Staff?

A. In quantifying its revenue requirement recommendation, the Staff concurs with the use of 2003 historical test year, with fixed, known and measurable changes through December 2003.

Q. Why is the selection and balanced adjustment of a test year important in the determination of just and reasonable utility rates?

A. The ratemaking equation commonly employed by this Commission, and other regulatory agencies, compares a required return on rate base to the investment return generated by adjusted test year operating results. If the return indicated by the adjusted operating results (i.e., adjusted test year operating income and rate base) is deficient, an increase in revenues is required to provide the utility an opportunity to earn a "reasonable" return on its investment. Conversely, an excessive return would support a reduction in utility revenues and rates.

For the ratemaking equation to function properly, the components comprising the equation (i.e., rate base, revenues, expenses and rate of return) must be reasonably representative of ongoing levels, internally consistent and comparable – within the context of test period parameters. To the extent that these components are not properly synchronized, a utility may not have the opportunity to earn its authorized return or, alternatively, may have the opportunity to earn in excess of the return authorized. By synchronizing or maintaining the comparability of revenues, expenses and investment, the integrity of the test year can be maintained with the reasonable expectation that the resulting rates will not significantly misstate the ongoing cost of providing utility service.

Consequently, it is critical that the ratemaking process properly synchronize only those known and measurable changes which occur during the test year or within a reasonably defined period subsequent thereto, rather than establish utility rates on inappropriate factors or inconsistent post-test year events. In this manner, regulators can best be assured that rates are reasonably based on ongoing cost levels.

Q. Could you explain the concept of "known and measurable" changes, as commonly used in the ratemaking process?

A. Yes. In general terms, regulatory agencies often recognize "known and measurable changes" to operating revenues, expenses and operating income that occur within a predefined period following the test year. In my opinion, the following definition or explanation of the "known and measurable" concept is commonly applied in utility ratemaking, consistent with past Arizona practice:

> **Known and measurable changes** -- transactions or events that are:
> (a) Fixed in time. A qualifying transaction or event must occur or be reasonably certain to occur within or immediately following the test year – synchronized with other material elements of the ratemaking equation.
> (b) Known or reasonably certain to occur. The transaction or event must be "known" to exist or be highly probable to occur, in contrast with possible, uncertain or speculative changes.

(c) Measurable in amount. The financial effect of the transaction or event can be "measured" or accurately quantified.

In this context, a transaction or event should only be considered "known and measurable" if it has been agreed to by contract or commitment, can be verified to have occurred within the specified time period, and can be quantified employing actual data or reasonable estimates. However, the events giving rise to the qualifying transaction must occur within a specified and consistent period.

It is not uncommon for regulatory commissions to recognize or annualize transactions occurring within, or subsequent to, the historical test period for verifiable, yet balanced, changes which will impact a utility's future earnings. However, it is also true that parties often differ on whether offsetting factors have been appropriately considered (i.e., properly matched) and how far outside the test year it may be appropriate to reach for changes. In the absence of a reasonable balance or matching, a distorted view of the cost of service will lead to improper rate adjustments. A consistent matching of material price and quantity changes is necessary to achieve this balance, particularly when volume changes, during or subsequent to the test year, offset price level changes.

Q. How should the Company proposed adjustments that reach beyond test year-end for price or quantity changes be handled?

A. The test year cut-off should be consistently applied to all material changes in rate base, revenues, expenses and other operating income items. For example, an announced 1¢ postal rate increase effective September 1, 2003, would fall within the test year. Presuming the availability of the data required to accurately quantify the annual pro forma impact of such an increase on test year postage expense, an adjustment to annualize this "known" price change would meet the known and measurable criteria, all else remaining equal.

Instead of a postal rate increase, assume that the utility announced a 1% wage increase effective June 1, 2004. While this increase might be known and might be measurable, the specified change falls well outside the test year. Absent a wholesale update of the test year for all material known and measurable changes through June 2004, the June 2004 wage increase would not be eligible for annualization purposes.

Q. Based on your regulatory experience, is it reasonable to expect that changes occurring subsequent to a rate case test year will automatically put upward pressure on the cost of providing utility service?

A. No. It may be anticipated that the passage of time may result in increasing expenses and plant investments, during periods of even modest inflation. As a result, the use of an end-of-period, or post-test year, rate base and the recognition of various revenue/ expense annualization and/ or normalization adjustments might be expected to consistently yield higher revenue requirements. However, the rate of depreciation reserve growth may materially mitigate growth in plant investment, while revenue trends, productivity gains from technology and reductions in certain operating expenses may offset the presumption of a generally increasing cost of service. These favorable and unfavorable revenue requirement influences can offset one another for many years, explaining how many utilities have avoided base rate increases for extended periods of time.

<u>All</u> components of the ratemaking equation change over time. It is only by consistently analyzing the major cost of service components that a determination can be made as to whether the overall revenue requirement has changed materially. The key issue is whether revenues are growing faster or slower than the overall costs, including investment return, necessary to support those revenues.

QWEST UPDATE – CORRECTIONS & REVISIONS

Q. Why are Staff Adjustments B-1 and C-1 necessary?

A. During the course of Staff's review of the Company's June 21, 2004, revised R14-2-103 Filing, Qwest's responses to various Staff and RUCO discovery requests have identified various corrections or revisions the Company believes are necessary to that filing. Since Staff's revenue requirement recommendation is based on adjusting the Company's proposed values for rate base and operating income, it was necessary for Staff to post the Company's revisions to the June 2004 filed amounts, in lieu of a formal revision to

Qwest's R14-2-103 Filing. Staff Adjustments B-1 and C-1 represent composite adjustments that combine the various modifications identified by the Company.

Q. Are you sponsoring these adjustments?

A. Mr. Brosch and I jointly sponsor these corrections the Company has indicated are necessary to its June 2004 R14-2-103 filing. By posting these adjustments, we are not necessarily adopting or agreeing with those Company modifications. Rather, we are merely reflecting the changes Qwest believes are necessary to its June 2004 filing. In fact, Mr. Brosch and I specifically sponsor adjustments that further correct, modify or reverse all or portions of individual Company revisions.

Q. Could you briefly describe how Staff Adjustments B-1 and C-1 are organized?

A. Yes. The Company has identified various adjustments, which affect rate base and/ or operating income. Staff Adjustment B-1 merely compiles those portions of each of these Company revisions that impact rate base into one consolidated rate base adjustment. Staff Adjustment C-1 reflects a similar approach to operating income.

Q. What was the data source of the various Company adjustments included in Staff Adjustments B-1 and C-1?

A. In response to various Staff discovery, but more specifically Staff Data Requests UTI 1-1 and 7-2, Qwest has been providing the quantification of the revisions to its filing. This data from the Company serves as the basis for these Staff adjustments. Since late summer, we have also had several discussions with Company and Staff representatives about this revision process.

TELEPHONE PLANT UNDER CONSTRUCTION (TPUC)

Q. Please describe Staff Adjustments B-5 and C-8.

A. In assembling its R14-2-103 filing, Qwest proposed a pro forma accounting adjustment (PFA-04) to change from the "capitalization" method to the "revenue requirement offset" method of accounting for telephone plant under construction ("TPUC"). Under the revenue requirement method, Qwest originally proposed to increase intrastate rate base by $20,406,000 and increase net operating income by $101,000. Subsequent Company revisions now increase rate base by $20,148,000[7] and <u>decrease</u> net operating income by $157,000. Staff Adjustments B-5 and C-8 reverse the revised Qwest adjustments to rate base and net operating income.

Q. What is TPUC?

A. TPUC represents the original cost of construction projects not yet completed and in service – that is, an investment in projects that are not yet used and useful in providing utility service. The FCC Uniform System of Accounts ("USOA" or "Part 32") requires that all TPUC expenditures be charged to Account 2003, unless the construction project is estimated for completion within two months or the gross additions are expected to be less than $100,000. The construction cost of those projects of short duration or small amount may be charged directly to the appropriate plant account. Under the current FCC USOA, telecommunications companies are no longer required to maintain different accounts for short-term and long-term construction projects, although Qwest has continued to maintain this distinction because of intrastate regulatory accounting requirements.[8]

Q. Of the $20.1 million increase to rate base, what is the relative distribution between short-term and long-term construction projects?

A. According to the Company workpapers supporting Adjustment PFA-04, the TPUC balance included in rate base is predominantly related to short-term TPUC.[9] When the TPUC issue was last litigated in Docket No. E-1051-93-183, the Company had sought to include about $29.3 million of short-term TPUC ("STPUC") in rate base.[10]

Q. Why has Qwest proposed to include TPUC in rate base?

A. Although Mr. Grate has sponsored eleven pages of testimony discussing three methods used to account for TPUC, none of his testimony actually addresses why the Company

[7] The TPUC component of revised Qwest Adjustment PFA-04 is $21,023,000 compared to $21,448,000 in the original Company adjustment.

[8] See response to UTI 2-1, Attachment A, Technical Accounting RA-1-74, Account 2004.

[9] Original balance was comprised of short-term TPUC of $19,176,866 and long-term TPUC of $2,270,992.

[10] See Decision No. 58927, pp. 5-6 (ACC Docket No. E-1051-93-183, January 3, 1995).

has sought to include TPUC in rate base for intrastate revenue requirement purposes. However, he does offer a simplified analysis of three methods of accounting for TPUC: capitalization method, rate base method and revenue requirement method. Through this analysis, Mr. Grate attempts to show that the capitalization method, currently authorized by the ACC, "does not provide an opportunity for full recovery of the cost of construction." [Grate direct, p. 69] It appears that Mr. Grate has mistakenly focused his analysis on whether the capitalization method yields the same return to the Company as the other rate base alternatives. This analysis will be discussed in more detail later in my testimony.

Q. Why should TPUC be excluded from rate base?

A. A telecommunications provider, or other regulated enterprise, may expend funds for construction in order to modernize plant, replaced damaged or worn out facilities, or meet the demands of growth or entry into new markets. The completion of a construction project may allow the Company to realize improved efficiencies, cost savings and/ or additional revenue.

As discussed in the earlier test year section of my testimony, it is critical for the elements of a test year to be representative of ongoing levels and to be internally consistent and comparable. The TPUC projects the Company has proposed to include in rate base, were not completed or in-service as of the end of the test year (December 31, 2003). Because these projects were not used and useful during the test year, any related benefits (e.g., cost savings, new revenues, etc.) reasonably expected to arise from these uncompleted projects would, by definition, only be realized subsequent to the test year. Since no adjustments have been proposed by Company or Staff to reach out beyond the test year to capture TPUC related post-test year savings or revenues in determining revenue requirement, it would be inappropriate to include in rate base any expenditures for uncompleted plant because of the inherent mismatch such inclusion would introduce into the ratemaking process.

Q. How much of the Company's construction expenditures relate to growth or are viewed as being revenue production or likely to result in cost savings?

A. I do not know. Staff Data Request UTI 16-15 requested this information, but the response thereto indicated that Qwest does not maintain or have a breakdown of the TPUC investment between new growth or revenue producing projects, efficiency or cost savings projects, replacement projects, and non-revenue producing or non-cost savings projects. Apparently, the Company has no need for this information. Further, this response also states: "The Company's revenue requirement calculation does not include any additional revenues, cost savings or efficiencies that may be expected to be realized by plant under construction." Curiously, the response observes that the recognition of such amounts, if known, "would violate the proper construction of the test year" – even though such revenues, savings or efficiencies would result from the very uncompleted projects Qwest proposed to include in rate base. Finally, the response to Staff Data Request UTI 16-15 indicates that the FCC did not require these offsets when the revenue requirement offset method was adopted. So, it is not possible to assess what proportion of TPUC may reasonably be expected to result in new sources of revenues or other cost savings.

Q. Has it been uncommon for State regulatory commissions to exclude TPUC from rate base?

A. No. I have not seen a national survey of this type of data since the mid-1990's. However, in ACC Docket No. E-1051-93-183, Qwest reported that ten of the thirteen other States in which the Company operates excluded short-term TPUC from rate base.[11] The disallowance of TPUC from rate base is not unique to Qwest. Over the years, I have been involved in a number of regulatory proceedings in various jurisdictions. In my experience, the discussion of including TPUC (or CWIP for energy companies) in rate base has addressed a variety of issues, such as test year matching concerns and requirements to demonstrate that rate base inclusion is needed to maintain the regulated entity's financial integrity.

---

[11] Company response to Staff Data Request No. UTI-108 in Docket No. E-1051-93-183.

Q. Would the exclusion of TPUC from rate base jeopardize Qwest financial integrity in Arizona?

A. No, I do not believe so. Based on historical information set forth on Schedule E-3, Comparative Statement of Cash Flows, from Qwest's June 2004 revised R14-2-103 filing, the Company's Arizona construction expenditures have been more than met by internally generated funds over the last three years.

Q. Will your proposal to exclude TPUC from rate base deny the Company the opportunity to earn a return on those construction expenditures?

A. No. In Decision No. 58927, the Commission adopted Staff's recommendations and excluded short-term TPUC from rate base. Furthermore, all TPUC has and will continue to accrue an allowance for funds used during construction ("AFUDC") at the approved capital cost authorized herein until the project is completed and ready for service.

Arizona: Historical Treatment of TPUC

Q. When did the Company last present the rate base inclusion of TPUC to the Commission?

A. In the Company's last rate case, the Company did not seek rate base inclusion of TPUC. To the best of my knowledge, the Company's 1993 rate case (Docket No. E-1051-93-183) was the last rate proceeding in which Qwest sought rate base treatment. In Docket No. T-1051B-99-105, the Company's rate filing did not propose inclusion of TPUC in rate base.

Q. Were you involved in the Company's 1993 Arizona rate case?

A. Yes. I was the Staff witness who sponsored the testimony excluding TPUC from rate base, which was adopted by the Commission. The basis for the Commission's decision on this issue is clearly set forth in the following excerpt from Decision No. 58927:

> The Company included $29,282,000 of short-term plant under construction ("STPUC") in its original application. The Company included the STPUC since it was expected to be in service before new rates were approved in this case.
>
> Staff recommended removal of STPUC because of the inherent mismatch that would result from its inclusion. According to Staff, there will be benefits from the completion of the plant which will not be

> recognized until a subsequent rate proceeding. In place of STPUC, Staff recommended the Company be authorized to continue the capitalization of an allowance for funds used during construction ("AFUDC") until the project is completed and ready for service. At that point, the Company would prepare an off-book computation of monthly depreciation expense on the capitalized AFUDC accumulated with STPUC, and maintain an accumulated depreciation reserve. According to Staff, this procedure should provide the amount of AFUDC to be included in plant-in-service and the depreciation reserve in future rate cases.
>
> In response, the Company indicated it would still prefer inclusion of STPUC in rate base. However, the Company agreed either method would be acceptable.
>
> Under the circumstances presented herein, we will adopt Staff's position and remove STPUC from rate base. Furthermore, all STPUC will continue to accrue AFUDC at the approved capital cost authorized herein until the project is completed and ready for service.
>
> [Decision No. 58927, pp. 5-6]

To my knowledge, this is the only litigated rate case in which the Commission considered and affirmatively addressed how TPUC should be handled for ratemaking purposes.

Q. At pages 66 and 67 of his direct testimony, Mr. Grate discusses the history of the ACC on the ratemaking treatment of TPUC, indicating that the Commission has switched from the capitalization method prior to 1982 to the rate base method in 1983 and reverting to the capitalization method in 1993. Do you agree with that characterization?

A. No. The Commission's findings in Decision No. 53040 (Docket No. 9981-E-1051-406) were based on a negotiated settlement. The following language appears in that order concerning short-term TPUC:

> Mountain Bell also seeks to have the Corporation Commission adopt and apply for intrastate ratemaking purposes changes to the Uniform System of Accounts relating to the treatment of the telephone plant under construction and interest during construction made by the Federal Communications Commission effective January 1, 1979. Under the stipulated settlement, the Corporation Commission will adopt and apply the directives of the Federal Communications Commission for intrastate ratemaking purposes. This will result in interest during construction no longer being accrued on short term plant under construction. Instead, short term plant under construction shall be included in the rate base.
>
> [Decision No. 53040, p.5]

However, it is important to recognize that Decision 53040 was indeed based on a stipulated settlement, the nature of which is further discussed in the following excerpt from that same order:

> This stipulation is entered into with the express understanding and agreement that all negotiations and offers of settlement and discussions relating thereto and this stipulation, itself, are the result of an attempt to resolve and compromise disputed and controverted positions. Accordingly, this stipulation and all negotiations and settlement conferences leading up to this agreement are made without prejudice to any party and are not admissible in evidence or deemed to be an admission against interest by any party hereto of any matter considered or discussed or contained herein, directly or indirectly. Furthermore, this stipulation, any order of this Commission entered pursuant to this stipulation, and the settlement offers leading thereto shall not be used in any manner by the parties hereto or any other party whatsoever, in any litigation, proceeding or docket pending, existing or to be tried in the future, it being expressly and clearly recognized that this stipulation is considered a nonprejudicial compromise of the parties' positions in this proceeding only.
>
> ...
>
> This stipulation shall not be binding on any party in any subsequent proceeding, docket or litigation.
>
> [Decision No. 53040, p.12; Emphasis Added]

In my opinion, the above language means exactly what it says. Decision No. 53040 was based on a negotiated, nonbinding settlement. Consequently, I do not concur with any implication that this order represents a careful and deliberate consideration of detailed evidence presented in that proceeding with a conclusion by the Commission that TPUC was properly includable in rate base.

Q. In this same portion of his direct testimony, Mr. Grate also states that the Commission used the rate base method on short-term TPUC in its 1983 and 1986 rate decisions. Did the Commission issue any rate orders subsequent to Decision No. 53040 which included short-term TPUC in rate base?

A. Yes. In February 1983, the Company filed an application (Docket No. E-1051-83-035) seeking an overall rate increase. This docket was a contested case proceeding, resolved by Decision No. 53849. Although a review of this decision does indicate that TPUC was included in rate base[12] net of a minor disallowance, the policy issue of whether short-term TPUC should be included or excluded from rate base was not presented to nor addressed by the Commission – rather the parties agreed on rate base inclusion. While it was the regulatory intent of the parties to include TPUC in rate base, this order does not present a conclusive determination by the Commission, as the rate base method was not presented as a litigated issue.

A similar factual situation arose in Docket No. E-1051-84-100, pursuant to a rate increase application filed by the Company in October 1984. In Decision 54843, the Commission again included short-term TPUC in rate base, after accepting certain adjustments proposed by Staff decreasing the amount requested by the Company.[13] Again, TPUC was included in rate base by agreement of the parties, but the Commission was not presented with the policy issue of whether such inclusion was appropriate.

Docket No. E-1051-88-146 arose from a Commission initiated investigation of the Company's rates and charges, which resulted in the issuance of a complaint against a predecessor company, US West, directing the Company to show cause why its rates should not be reduced. In interim Decision No. 56363 (issued February 22, 1989), the Commission concluded that Staff had met its burden that a $33.4 million interim rate decrease was warranted. Although Decision No. 56363 (page 7) referenced the issue as uncontroverted, the Commission adopted a Staff adjustment removing short-term TPUC from rate base in quantifying the amount of the interim rate decrease. Subsequent to that interim order, the Commission issued Decision No. 56471 making the interim decrease permanent, with an additional $3.9 million reduction to touch tone rates, and rescinded Decision No. 56363 pursuant to an agreement between the Company and Staff.

In Docket No. E-1051-91-004, the Commission issued Decision No. 57462 adopting a global settlement between the Company and Staff, authorizing a $78.8 million rate

[12] Decision No.53849 (December 22, 1983), pp. 16-17 & 21.
[13] Decision No.54843 (January 10, 1986), pp. 26 & 28.

increase. This order resolved all rate case issues without addressing the disposition of any particular issue, including short-term TPUC.

Q. What is your view of this history of the Commission's rate base treatment of TPUC?

A. In my opinion, the Commission had not clearly articulated a policy position regarding the rate base treatment of TPUC until Docket No. T-1051B-99-105. While the regulatory intent of the parties may be clear, the Commission did not reach an affirmative disposition of this issue as the matter was either included in a settlement or not presented as an issue in the other proceedings identified by Mr. Grate. I believe that any implications otherwise would mischaracterize the facts and circumstances surrounding those individual proceedings.

Q. At page 72 of his direct testimony on the TPUC issue, Company witness Grate indicates that Qwest should not be required to substantiate the existence of ratepayer benefits before the Commission can approve adoption of the "revenue requirement offset" method, stating:

> Whether an accounting method favors ratepayers over investors or investors over ratepayers is not an appropriate criterion for determining the desirability of one accounting method over another. No one could reasonably assert that ratepayers should be subjected to an accounting method solely because it produces a higher revenue requirement than another method. It is no less true that investors should not be subjected to accounting method solely because it yields a lower revenue requirement than another method. The choice of accounting methods should turn on which method yields the most accurate reflection of actual costs and actual results of operations.

In deciding to adopt the capitalization method for short-term TPUC in Decision No. 58927,[14] did the Commission adopt Staff's recommendation on the basis that the capitalization method favors ratepayers over shareholders?

A. No. As indicated by the earlier excerpt from Decision No. 58927, the Commission's adoption of the capitalization method was not based on whether the method favored ratepayers or investors – instead focusing on the inherent mismatch that would result.

[14] ACC Docket No. E-1051-93-183, January 3, 1995.

FCC Accounting Requirements

Q. At page 63 through 68 of his direct testimony, Mr. Grate discusses the FCC's accounting for TPUC including a discussion of its Report and Order in CC Docket No. 93-50. At page 65, Mr. Grate states:

> Then, in 1995, the FCC released an order that adopted the revenue requirement offset method for both long-term and short-term construction projects. [footnote omitted] Attached as Exhibit PEG-D3 is a copy of the order. The order explains why the FCC concluded the revenue requirement offset method is superior to the rate base and capitalization methods and is the best approach.

Have you reviewed the FCC order discussed by Mr. Grate?

A. Yes. I have carefully reviewed the FCC Report and Order ("FCC R&O")[15] attached as Exhibit PEG-D3 to Mr. Grate's direct testimony.

> In the Notice, we proposed the revenue requirement offset method for both short-term and long-term construction projects because we believed that this method would allow us to adopt accounting that is both consistent with GAAP and fair and reasonable for ratemaking purposes. Of the thirteen commenting parties, three support the proposal, [footnote omitted] and ten oppose it in varying degrees. [footnote omitted]
> [FCC R&O, par. 7]

In general, the FCC concluded that the revenue requirement offset method was the best approach for several reasons, including:[16]

- Consistency with GAAP for both long-term and short-term TPUC;
- Provides carriers with incentive to invest in new plant, because TPUC and AFUDC would be included in rate base;
- Allows carriers to earn a rate of return on total investment;
- AFUDC is included in determination of both rate base and current income for ratemaking purposes;
- Recognition of AFUDC in current income mitigates the increase in revenue requirement resulting from including all TPUC in rate base;
- Because other methods lack these advantages, the revenue requirement offset method is superior to the alternatives.

---

15 Report and Order FCC 95-56, CC Docket No. 93-50, released February 28, 1995.
16 FCC R&O, par. 10.

The FCC also cited as an advantage the fact that the revenue requirement offset method would allow carriers to earn the authorized rate of return on all investments in the telecommunications network as a result of rate base inclusion. Because of the revenue offset unique to this method, the FCC concluded that interstate ratepayers would pay very little for any new plant until the plant is placed in service.[17]

Q. Do you concur with the FCC's findings on this issue?

A. No. At paragraph 13 of the FCC R&O, the FCC observed, in part:

> We acknowledge that in our new policy with regard to all TPUC, as in our prior policy [footnote omitted] with regard to short-term TPUC, we depart from the used and useful standard by allowing carriers to place plant in the rate base prior to its being placed in service. We believe, however, that this limited additional departure from the used and useful standard will not harm the ratepayers because for carriers as a group during each of the first few years, the revenue offset will exceed the additional revenue requirement associated with the inclusion of long-term TPUC in the rate base. The ratepayers receive the benefits of reduced rates in the initial years of implementation. In future years, the increased return and depreciation expense resulting from the inclusion of plant under construction in the rate base could exceed the amount of interest capitalized. Then the total revenue requirement for carriers as a group would exceed the level that would occur under our present requirements. Although excluding all TPUC from the rate base, as MCI suggests, would avoid this effect, we believe that such an exclusion would be unfair to carriers and that the method we are adopting best balances ratepayer and carrier interests.

I disagree with the FCC's rationale on several key points for intrastate regulatory purposes. First, the used and useful standard is "key" to the matching concept often applied for ratemaking purposes, as discussed earlier, to avoid inherent distortions introduced into the revenue requirement formula. If for no other reason, the Commission should reject the Company's proposed rate base inclusion of TPUC, consistent with its past findings.

Second, the FCC relied on its assessment of the revenue requirement impact of the change to this method, which was believed to actually "reduce rates in the initial years of

[17] FCC R&O, par. 11.

implementation." Unfortunately for the Company's Arizona intrastate customers, the FCC's assessment does not portray the realities of Qwest's proposed adoption of this method. One must look no further than the Company's own quantification of the revenue requirement effect of its Adjustment PFA-04 to see that an immaterial amount of AFUDC revenues are dwarfed by the current return realized on the TPUC balance included in rate base – resulting in an increase to revenue requirement of about $4.1 million.[18] This result is contrary to the cited expectation of the FCC of reduced revenue requirements for carriers as a group.

Q. At the time the FCC was considering adoption of the revenue requirement method, did the Company expect reduced revenue requirements in the early years of adoption?

A. Apparently not. At paragraph 12 of the FCC R&O, the FCC expressed their disagreement with the assertions of the Florida PSC, BellSouth and Qwest (then US West) that the revenue offset method "should not be used because AFUDC accruals are immaterial." The FCC went on to address its view that "we would expect AFUDC accruals under our proposal to amount to nearly $400 million or approximately 3 percent of their total return." Further, the FCC stated that carriers would be encouraged to transfer investment from the TPUC account to plant in service, as "the revenue requirement offset method gives carriers the incentive to transfer plant from construction into service as promptly as possible to avoid AFUDC revenue requirement offsets."

In earlier reply comments filed by U S West Communications, Inc. (CC Docket No. 93-50) on May 28, 1993, the Company made several references to AFUDC materiality concerns and the need for flexibility, as noted in the following excerpts:

> U S WEST believes that carriers should be accorded the flexibility to decide whether to account for AFUDC under the revenue requirement offset method or not, depending on whether the accounting carrier makes a company-specific determination that AFUDC is immaterial. Such flexibility becomes increasingly more appropriate in light of the advent of new entrants and burgeoning competition in telecommunications. In such an environment, regulated carriers should be permitted to report their results of operations on a basis that is consistent with other companies operating in similar technological and competitive environments.

[18] Qwest spreadsheet "az1203_Revised 11-05-04.xls".

> It is not clear from the NPRM the extent to which the Commission would make mandatory the revenue requirement offset method of accounting, regardless of whether or not the amounts to be capitalized are material. [footnote omitted] U S WEST urges the Commission not to make the use of such method mandatory in all circumstances.
> [U S WEST Reply Comments, May 28, 1993, p.3]
>
> ...
>
> U S WEST supports the Commission's proposal to move to the revenue requirement offset method of accounting for AFUDC, with the caveat that the full significance of SFAS 34 be accorded Commission support. Thus, if a carrier deemed AFUDC not material enough to be accounted for under the revenue requirement offset method, it would be free to utilize a different accounting methodology, such as the rate base method.
> [U S WEST Reply Comments, May 28, 1993, pp.4-5; Original Emphasis]

Although I do not concur with the suggestion that the rate base method is a reasonable alternative, it is important to observe the Company's materiality concerns and its expressed interest in flexibility. In the pending Arizona docket, the Company is heavily relying on the FCC's final decision in CC Docket No. 93-50 as the principal basis for adopting the revenue requirement offset method.

Company Analysis of AFUDC Alternatives

Q. What AFUDC cost rate does Mr. Grate's simplified analysis use for the capitalization method?

A. Referring to Exhibit PEG-D4, Mr. Grate's analysis uses an authorized rate of return of 10% (debt & equity) and an AFUDC rate of 8% (average debt cost). Unfortunately, these assumed cost rates are inconsistent with the Company's proposed weighted cost of capital, do not reflect the actual AFUDC rates recently employed by Qwest in Arizona, and fail to recognize the gross-up for income taxes that result from rate base inclusion.

Q. What weighted cost of capital is Qwest proposing in the current proceeding?

A. Referring to Staff Schedule D, Qwest is proposing a weighted cost of capital of 11.18%, not 10%.

Q. What AFUDC rate has the Company been recently using in the capitalization of AFUDC for Arizona accounting purposes?

A. Qwest's response to Staff Data Request UTI 16-14(c) indicates that the AFUDC rate employed by the Company has been 9.75% -- the return authorized by the Commission in Docket No. E-1051-93-183.

Q. Why is the gross-up for income tax expense at all important in assessing the impact of these alternative methods?

A. In assessing alternative approaches, attention should be focused on the net present value of the change in overall revenue requirement attributable to the accounting alternatives proposed by the Company. Such analyses normally focus on life cycle assessments, which Mr. Grate's Exhibit PEG-D4 assumes to be a five-year period. Unfortunately, the cost to ratepayers of either rate base method (revenue requirement offset method or rate base method) is significantly understated from a revenue requirement perspective, as the equity component of the weighted cost of capital is materially understated. Referring to Staff Schedule E, page 2, the effective return (i.e., gross of tax return) proposed by Qwest in quantifying overall revenue requirement is about 14.8%, not the 11.18% weighted cost rate nor the 10% rate assumed in Qwest's analysis.

Q. Do you agree with Mr. Grate that his analysis is useful and instructive?

A. No. His analysis only demonstrates the obvious. Rate base inclusion of TPUC, or any asset, yields a current return and cash earnings to the Company – by definition. AFUDC, on the other hand, is intended to provide a mechanism for the Company to recover the cost of financing the construction of the asset while the assets are under construction. Once construction is complete and the asset is placed in service (i.e., used and useful), the capitalization of AFUDC ceases. Such capitalized costs are included in the cost of the asset included in rate base and recovered through the depreciation of the book basis of that asset. AFUDC is not and has never been intended to compensate the utility for the full return on investment during and after construction is complete.

In other words, Qwest appears to argue that any method of capitalizing AFUDC is deficient if it does not result in equivalent value to the Company as would inclusion of TPUC in rate base – which is the key element of both the rate base method and the revenue requirement offset method. In spite of this fundament deficiency, the analysis prepared by Mr. Grate quantifies a difference in the AFUDC methodologies that is not due to a deficiency in the capitalization method, but is an intended result of the capitalization method.

Other Considerations

Q. Do any other jurisdictions in which Qwest operates have TPUC regulatory policies that differ from the FCC?

A. Yes. According to Qwest's response to Staff Data Request UTI 16-13S1, the State jurisdictions of Colorado, Minnesota and Washington require a different TPUC methodology than the FCC. It appears that Colorado and Washington allow AFUDC to be capitalized on both long-term and short-term TPUC, but exclude TPUC from rate base – similar to Arizona. Minnesota does not allow AFUDC to be capitalized on short-term TPUC, but includes short-term TPUC in rate base.

Q. When did Qwest first adopt the revenue offset method for interstate accounting and regulatory purposes?

A. For FCC regulatory purposes, Qwest adopted this method in September 1995.[19]

Q. Did the Company propose the revenue requirement offset method in the last Arizona rate case, Docket No. T-1051B-99-105?

A. No. Even though the test year in the last rate case was based on calendar year 1999, the Company did not seek rate base inclusion of TPUC or the adoption of the revenue requirement offset method.

Q. At page 66 of his direct testimony, Mr. Grate describes carrier incentives in the context of the revenue requirement offset method, allowing carriers to earn a current return on

[19] Qwest response to Staff Data Request UTI 16-10.

TPUC expenditures. Has Qwest declined to invest in new plant in Arizona specifically due to the fact that TPUC has not historically been included in rate base for intrastate ratemaking purposes?

A. No.[20]

PRO FORMA DEPRECIATION & RESERVE ADJUSTMENTS

Q. Please describe Staff Adjustments C-22, C-23 and B-7.

A. Staff Adjustment C-22 represents the annualization of depreciation expense based on the depreciable plant included in rate base and book depreciation rates adjusted to recognize the depreciation reserve balance at test year-end. Staff Adjustment C-22 is similar to Company Adjustment PFA-01, except Qwest's adjustment is based on depreciation rates that recognize depreciation reserve balances at the start of the test year. Staff Adjustment C-23 recognizes the pro forma effect of new depreciation accrual rates, based on Staff's revised "projection lives" and "future net salvage" recommendations. Collectively, these Staff adjustments represent the incremental change to the pro forma level of book depreciation expense included in Qwest's update filing of June 21, 2004, as proposed and sponsored by Staff witness Dunkel.

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

Q. How were Staff Adjustments C-22 and C-23 quantified?

A. Book depreciation was annualized by multiplying the intrastate investment in depreciable plant included in rate base as of December 31, 2003, by the proposed accrual rates (i.e., by plant account) sponsored by Staff witness Dunkel. The aggregate amount of the pro

[20] Qwest response to Staff Data Request UTI 16-12.

forma depreciation was then compared to the sum of Qwest's annualization adjustments (Company Adjustments PFA-01 and PFN-11) and the amount of depreciation expense recorded in Account 6561 during the test year.[21]

Q. Why did you quantify the Staff Adjustments C-22 and C-23 in this manner?

A. In order to accurately quantify Staff's adjustment to the Company's June 21, 2004, updated filing, it was necessary to properly determine the amount of pro forma depreciation expense Qwest has included in its proposed operating results. Further, Staff's annualization of depreciation expense is based on the amount of intrastate depreciable plant included in rate base, as multiplied by the proposed depreciation rates recommended by Mr. Dunkel.

Q. How does the value of the Staff's proposed change in book depreciation rates compare to the change recommended by the Company?

A. Referring to the combination of Staff Adjustments C-22 and C-23, Staff's depreciation rate recommendation reduces intrastate depreciation expense (i.e., using the Staff's proposed depreciation accrual rates as applied to year-end 2003 depreciable plant) by approximately $140 million in addition to the Company's proposed reduction of about $104 million (Qwest Adjustments PFA-1 and PFN-11).

Q. Is the entire $244 million change in depreciation expense proposed by Company and Staff related solely to the change in book depreciation rates?

A. No. During 2003, the amount of book depreciation expense actually recorded by the Company is based on average depreciable investment. As the Company's investment in depreciable plant increases, so does the amount of related depreciation expense. Since Qwest has increased the level of depreciable investment during the test year (i.e., approximately $158 million according to Company workpapers underlying Adjustment PFA-01 and PFN-11), the annualization of depreciation expense on year-end investment

[21] In quantifying Staff Adjustment C-22 and C-23, special consideration was given to the recommended adjustments proposed by Mr. Dunkel for DSL assignment to interstate (Staff Adjustments B-3 & C-6) and the elimination of BSI related construction charges (Staff Adjustments B-4 & C-7) in order to ensure that the depreciation expense related to these items was not inadvertently eliminated twice or otherwise double-counted.

would be higher than recorded amounts – even if the Commission does not authorize any change in book rates. So, the $244 million decrease in depreciation has been offset, in part, by additional depreciation related to the test year growth in depreciable plant.

Q. Why do you believe that it would not be appropriate to reflect the annual effect of the proposed depreciation rate decrease in the quantification of rate base?

A. While the annualization of depreciation expense for ratemaking purposes should synchronize the new depreciation rates with the level of depreciable plant included in rate base, the depreciation reserve used as an offset to rate base should be determined consistent with the balance of plant in service included in rate base. In other words, the balance of both of these rate base components in Staff's filing should be valued at December 31, 2003 – as appropriately adjusted for eliminations, corrections or other valuation issues. In my opinion, the Commission should <u>not</u> reach out beyond test year-end to capture, in isolation, the full pro forma annual effect of the change in depreciation rates on the December 31, 2003, year-end balances for the accumulated depreciation reserve and the accumulated deferred income tax reserve. Otherwise, test year distortions and mismatched components of the ratemaking equation would yield improper results.

Q. As a result of reversing Qwest's pro forma effect on the accumulated depreciation reserve and the accumulated deferred income tax reserve, did Staff Adjustment B-7 have the effect of increasing or decreasing overall revenue requirement?

A. As indicated on Staff Schedule E, Staff Adjustment B-7 decreases intrastate rate base, thereby decreasing revenue requirement by about $7.6 million, based on Staff's proposed capital structure and cost rates.

Q. Have you proposed similar adjustments to rate base in past cases, reversing Company's rate base adjustments tied to pro forma changes in book depreciation expense?

A. Yes. I have sponsored testimony and a similar rate base reversal adjustment in the Company's last rate case (Docket No. T-1051B-99-0105), even though that Staff adjustment had the effect of increasing both rate base and overall revenue requirement.

DSL – REMOVED FROM INTRASTATE

Q. Please describe Staff Adjustments B-3 and C-6.

A. Staff Adjustments B-3 and C-6 represent the removal of DSL[22] net investment and related operating expenses from the intrastate jurisdiction. These adjustments are based on the corrections set forth on confidential Schedule WDA-15, sponsored by Staff witness Dunkel, and incorporate those recommendations into Staff's overall revenue requirement recommendation.

Q. Are any other Staff adjustments affected by Staff Adjustments B-3 or C-6?

A. Yes. One component of Staff Adjustment C-6 removes DSL related book depreciation from the intrastate jurisdiction. Since Staff has separately annualized book depreciation expense based on the intrastate depreciable plant included in rate base (i.e., net of the DSL assignment) using the proposed depreciation accrual rates sponsored by Staff witness Dunkel,[23] it is necessary to integrate Staff's DSL recommendations with that annualization of book depreciation so as to avoid any double counting of the depreciation and plant assignment.

Referring to Staff Adjustments C-22 and C-23, DSL investment has been excluded from the balance of intrastate depreciable plant for purposes of quantifying the pro forma depreciation effect of Staff's recommended accrual rates. In order to avoid removing DSL depreciation from the intrastate jurisdiction twice, the depreciation expense component of Staff Adjustment C-6 is added back on line 34 of Schedule C-22.

Q. Why did you quantify Staff Adjustments C-6 and C-22 in this manner?

A. This format accomplishes two purposes. First, Staff Adjustment C-6, in conjunction with Staff Adjustment B-3, represents a stand-alone quantification of the DSL removal recommended by Mr. Dunkel. Second, Staff Adjustment C-22 recognizes the interrelationship that exists between the two DSL adjustments and the annualization of

---

22 As discussed in the direct testimony of Staff witness Dunkel, DSL is a broadband/wideband Internet transport service used for internet access and provided by Qwest.

23 Staff Adjustments C-22 and C-23.

book depreciation expense, using Staff's proposed accrual rates that are different from those in effect during the test year.

BSI – CONSTRUCTION RELATED CHARGES

Q. Please describe Staff Adjustments B-4 and C-7.

A. Staff Adjustments B-4 and C-7 represent the proposed elimination of certain net investment and related depreciation expenses attributable to BSI construction related charges.[24] These adjustments are based on the proposed adjustments summarized on confidential Schedule WDA-18, sponsored by Staff witness Dunkel, and incorporate those recommendations into Staff's overall revenue requirement recommendation.

Q. Are any other Staff adjustments affected by Staff Adjustments B-4 or C-7?

A. Yes. Staff Adjustment C-7 removes test year book depreciation related to the construction charges that should have been paid for by BSI, as discussed by Mr. Dunkel. Since Staff has separately annualized book depreciation expense based on the intrastate depreciable plant included in rate base (i.e., net of the BSI elimination) using the proposed depreciation accrual rates also sponsored by Staff witness Dunkel,[25] it is necessary to integrate Mr. Dunkel's BSI recommendations with the annualization of book depreciation so as to avoid any double counting of the depreciation and plant assignment.

Referring to Staff Adjustments C-22 and C-23, BSI investment has been excluded from the balance of intrastate depreciable plant for purposes of quantifying the pro forma depreciation effect of Staff's recommended accrual rates. In order to avoid removing the BSI construction related depreciation twice, the depreciation expense component of Staff Adjustment C-7 is added back on line 34 of Schedule C-22.

[24] As discussed in the direct testimony of Staff witness Dunkel, BSI (a Qwest affiliate) uses certain Qwest facilities to provide ADSL TV and other services, including certain cabinet locations built specifically to serve the needs of BSI.

[25] Staff Adjustments C-22 and C-23.

Q. Why did you quantify Staff Adjustments C-7 and C-22 in this manner?

A. This format accomplishes two purposes. First, Staff Adjustment C-7, in conjunction with Staff Adjustment B-4, represents a stand-alone quantification of the BSI construction charge issue addressed by Mr. Dunkel. Second, Staff Adjustment C-22 recognizes the interrelationship that exists between the two BSI adjustments and the annualization of book depreciation expense, using the Staff's proposed book rates that are different from those in effect during the test year.

YEAR-END WAGE & SALARY ANNUALIZATION

Q. Please describe Staff Adjustment C-16.

A. Staff Adjustment C-16 revises test year basic wages and salaries by consistently recognizing, or matching, ongoing Arizona employee counts with the effective salary levels and wage rates at test year-end.

Q. Did the Company propose a pro forma adjustment to annualize salaries and wages to test year-end levels?

A. No. However, the Company's filing does include an adjustment (i.e., Adjustment PFN-05)[26] to annualize the effect of certain pay increases granted in the first quarter of 2003. In the Company's last rate case (Docket No. T-1051B-99-105), Qwest did present a payroll annualization adjustment that considered, in part, year-end employee or headcount levels.

Q. Did Company Adjustment PFN-05 recognize the effects of any decline in test year headcounts?

A. No. As discussed by Mr. Grate,[27] the Company "found no statistically valid trend in employee levels over time." Citing to Exhibit PEG-D6 attached to his direct testimony, Mr. Grate states:

> The R-Squared of the independent variable (time) to the dependent variable (employee count) was only 0.114 and the T-Score was 1.13, indicating an absence of any statistically meaningful and reliable

---

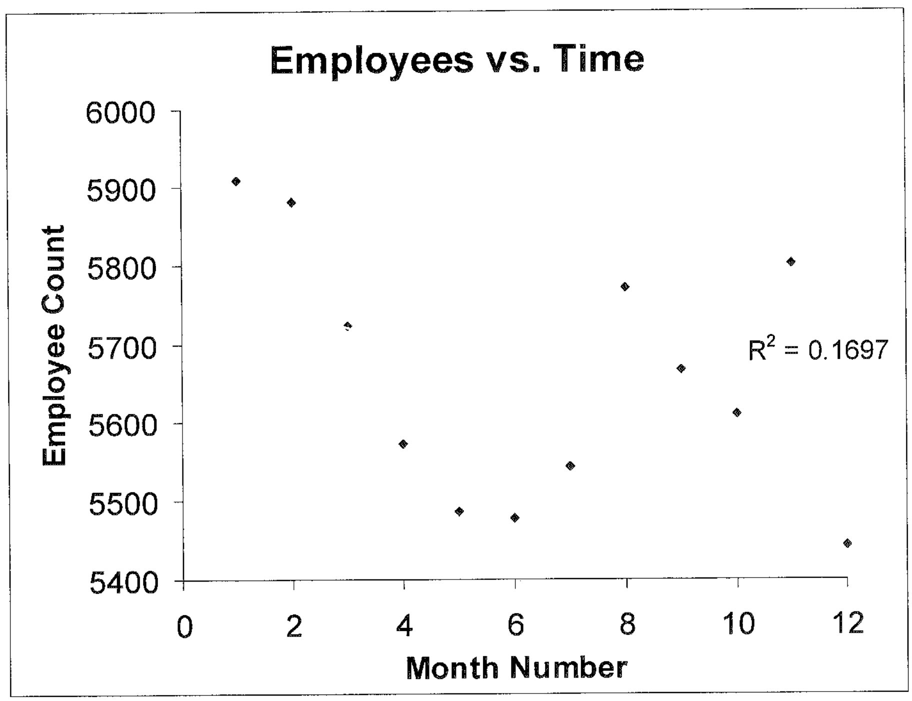
[26] Grate direct testimony, p. 92.

[27] Grate direct, p. 92.

relationship. In other words, the variability in the level of employees over the course of the test year does not support the hypothesis that the employee count at the end of the test year is more realistic or representative of ongoing conditions than the count during the test year as a whole. Accordingly, I made no adjustment for end-of-period employee levels.[28]

Mr. Grate's revised PEG-D6, provided in the non-confidential response to Staff Data Request UTI 2-2, is reproduced below for reference purposes:

Qwest Arizona
2003 Employee Levels



Q. If the test year employee trend is as poor as depicted by Mr. Grate, why should pro forma wage expense recognize employee counts at test year-end?

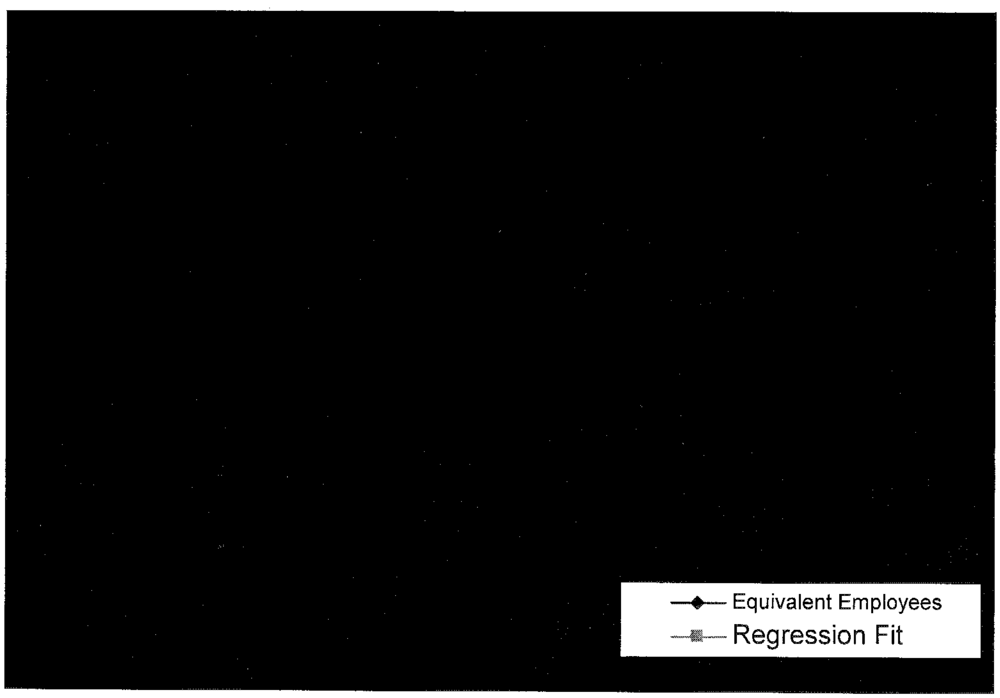
A. On first impression, it would appear that test year equivalent headcount levels, as set forth on revised PEG D-6, were sporadic and would not support the need for any significant employee annualization adjustment. However, after reviewing employee

[28] In response to Staff Data Request UTI 2-22, PEG-D6 was revised to reflect minor revisions in equivalent headcounts for October-December 2003, increasing the coefficient of determination (R-Square) from 0.114 to 0.1697.

trends prior to and subsequent to the test year, the data indicates that the "uptick" in headcounts shown on PEG D-6 for months of August - December 2003 was aberrational.

Q. Could you describe the recent historical trend in employee levels, continuing through and subsequent to the test year?

A. Yes. The following chart represents the historical trend in Qwest's actual equivalent headcounts from January 2001 through December 2003, including post-test year levels for comparative purposes. While equivalent headcounts can and do vary from month to month, like the increase in late 2003 that contributed to the Company's calculation of a poor 0.1697 R-Squared statistic, Qwest has exhibited a decidedly downward trend in headcounts since January 2001. In addition to actual monthly equivalent headcounts, the following chart also depicts the smoothed headcount trend resulting from a 36-month regression analysis (January 2001 through December 2003), using the linear regression technique employed in the Company's test year headcount analysis as well as in analyzing and annualizing test year revenues and expenses:



Although the "uptick" in late 2003 is clearly observable on this chart, the 36-month linear regression yields a statistically significant 0.8661 R-Squared, showing a strong correlation between time and equivalent headcounts – unlike the 0.1697 (revised) R-

Squared resulting from the twelve test-year data points. The "regression fit" line on the chart represents the 36-month regression results, which smooth the month-to-month data variations. The headcount estimate for the terminal month (i.e., December 2003) was used in quantifying Staff Adjustment C-16 so as to remove the aberration in employee levels in late 2003. Clearly, the regression fit trend line better reflects the historical trend in observed levels and fits relatively well with actual post-test year equivalent headcounts.

Q. Did you rely on the regression results to determine year-end headcounts for purposes of annualizing basic payroll?

A. Yes, in part. Consistent with the annualization adjustment I proposed in Qwest's last rate case (Docket No. T-1051B-99-105), Staff Adjustment C-16 is based on average regular pay (basic pay plus paid absences) per equivalent employee (i.e., both management and occupational employees) for the months of October through December 2003. Because of the aberration in December 2003 employee levels, the "regression fit" employee count for December 2003 was multiplied by the three-month average pay per employee and then multiplied by an annualization factor of twelve (12). This methodology consistently recognizes the annual effect of any wage and salary changes implemented during the test year with a reasonable valuation of year-end employee levels.[29]

Q. Since Company Adjustment PFN-05 has a negligible impact on test year wage and salary costs, how does Staff's proposed level of basic wages and salaries compare with recent actual levels?

A. The following table compares the basic wage and salary costs[30] incurred in 2001, 2002 and 2003 with Staff's pro forma level:

[29] This Staff annualization technique is comparable to the methodology used in the last rate case, but for the reliance on linear regression results.

[30] Sum of basic wages and salaries plus paid absences on a Total Arizona basis, before distribution between expense and capital accounts.

(millions)	Qwest – Arizona Basic Wages & Salaries[31]		
	Total State	Change	% Change
2001	[redacted]		
2002	[redacted]	[redacted]	[redacted]
2003	[redacted]	[redacted]	[redacted]
Staff Pro Forma	[redacted]	[redacted]	[redacted]

Source: Qwest confidential response to Staff Data Request UTI 9-4 & Staff Adjustment C-16.

As indicated by this table, Staff's proposed level of basic salaries and wages compares favorably with recent experience – in terms of both dollar and percentage reductions. In spite of continued headcount declines and reduced basic wage and salary levels, Qwest has essentially presumed that actual test year expense reasonably represents ongoing levels.

Q. Could you briefly explain the reference to "equivalent" employees or headcounts?

A. Yes. Qwest's employee workforce is distributed at work locations throughout a fourteen state region. Due to the nature of the work an individual employee might perform, the payroll and benefit costs of that employee could be assigned directly to the Company's operations in the State in which the employee is physically located or could be allocated between multiple State operations. Headcounts based on the geographic location (e.g., Arizona) of the employee are referred to as "situs" employees. If 100% of a particular employee's time was directly assigned to the State in which he/she was physically located, this employee would be counted as one "situs" employee as well as one "equivalent" employee.

The difference between "situs" and "equivalent" employees comes into play when the payroll and benefit costs of certain employees are allocated to or distributed between the operations of more than one State. Since payroll costs are typically allocated between

[31] Source: Qwest confidential response to Staff Data Request UTI 9-4, basic wages and salaries plus paid absences.

multiple States, the Company determines Arizona's "equivalent" employee count based on the relationship of Arizona's salaries and wages to Total Qwest Corporation salaries and wages to allocate Total Qwest Corporation "situs" employee levels. So, an employee located in Arizona and partially allocated to other States would be viewed as one "situs" employee in Arizona, but less than one Arizona "equivalent" employee.

INCENTIVE COMPENSATION

Q. Is Staff proposing an adjustment to the test year amount of incentive compensation expense Qwest has included in revenue requirement?

A. Yes. In quantifying overall revenue requirement, Qwest Adjustment PFN-08 decreased the amount of incentive compensation accrued during the test year to reflect the actual bonus amounts paid in 2004 for the 2003 plan year.[32] Staff Adjustment C-17 represents a partial disallowance of test period incentive compensation expense Qwest has recognized in quantifying overall revenue requirement. Staff proposes to eliminate the incentive costs associated with the financial components of Qwest's incentive compensation plan, while allowing ratemaking recovery of test period expense associated with the customer satisfaction components. After Staff's proposed adjustment, the test period will include approximately [redacted] of incentive compensation expense (intrastate).

Q. Please describe the incentive program offered by the Company.

A. In prior Arizona proceedings, the Company had maintained various long-term and short-term incentive plans, which are no longer offered. During 2003, Qwest had only one incentive compensation plan (the "Bonus Plan" or "Bonus Award") for eligible employees. The Bonus Plan was offered to employees of Qwest Corporation, Qwest Services Corporation and Qwest Communications International Inc. ("QCII").[33] As presented to the Board of Directors, the philosophy of Qwest's Bonus Plan was stated as follows:[34]

---

[32] Qwest response to Staff Data Request UTI 2-29S1.
[33] Qwest response to Staff Data Request UTI 8-36.
[34] Qwest response to Staff Data Request UTI 1-31S1, Confidential Attachment C.

[redacted]

Q. Please briefly describe the various components of the incentive compensation program.

A. The Bonus Plan is based on three components: [redacted]

	Weighting Factor	% Payout	Weighted Payout
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]

[redacted]

Source: Qwest confidential response to Staff Data Request UTI 1-31.

[redacted].[35]

Q. How did you quantify Staff Adjustment C-17?

A. As shown by the above table, the Bonus Plan is heavily weighted to [redacted] targets and objectives. For example, [redacted]. Conservatively, Staff Adjustment C-17 allows [redacted]% of test year incentive compensation payments charged to operating expense.

Q. How does the amount of incentive compensation Qwest has proposed to recover in this proceeding compare to the amounts incurred in recent years?

A. Recognizing that Company witness Grate proposes to adjust the Bonus Plan accruals recorded during the test year to the actual amount paid in 2004 for the 2003 plan year, the actual test year expense level is higher than the amount Qwest has included in overall revenue requirement. The following table compares the historical level of incentive compensation costs with the levels proposed by both Qwest and Staff.

---

[35] Qwest response to Staff Data Request UTI 1-31, Confidential Attachment D.

Intrastate **Year**	**Paid**	**Accrued** (d)
2001 – Plan Year (a)	[redacted]	[redacted]
2002 – Plan Year (b)	[redacted]	[redacted]
2003 – Plan Year (c)	[redacted]	[redacted]
2003 – Qwest Proposed		[redacted]
2003 – Staff Proposed		[redacted]

Source: Qwest confidential response to Staff Data Request UTI 20-4 & confidential Staff Adjustment C-17.

[redacted]

Q. Why have you proposed to disallow a significant portion of the test year incentive plan cost?

A. There are several reasons why this adjustment is appropriate. First, a significant portion of the Bonus Plan focuses on the corporate-wide financial results of Qwest Communications International, Inc. ("QCII"). Those Company employees directly or indirectly supporting the provision of telecommunications service in the State of Arizona have limited ability or opportunity to materially affect the consolidated financial results of QCII. Efforts to enhance consolidated financial results may not be consistent with the interests of Qwest's Arizona customers or reasonable pricing of regulated service offerings, recognizing that any revenue requirement finding in this proceeding may not translate into revised rates charged Arizona customers.

Second, the consolidated <u>financial</u> targets are not linked to customer service, employee safety, cost reductions or operational achievements or efficiencies in Qwest's Arizona service territory.

Third, to the extent that the inclusion of financial targets in the Bonus Plan assists Qwest in achieving improved financial results, the cost of the Company's discretionary bonus plan should be funded by the increased levels of net income, cash flow and other financial resources, rather than through the revenue requirement that could be used to support prices charged to Qwest's Arizona customers.

Obviously, a decision by management to incur incentive compensation costs is an indication that such costs were viewed as reasonable by the Company, but regulators need not allow above-the-line accounting for all discretionary costs incurred by management absent a showing that such costs provide direct, tangible benefits to ratepayers. With this in mind, Staff proposes recovery of the test year Bonus Plan costs reasonably allocable to service quality measures.

Q. Please explain the focus of the financial components of Qwest's 2003 Bonus Plan.

A. The financial targets of the 2003 Bonus Plan are based on consolidated results for Qwest Communications International, Inc. The following response to Staff Data Request UTI 12-4 provides the rationale for the linkage to the consolidated financials:

> Qwest does not budget at the entity level. Qwest's financial objectives are at a total Company (or QCII) level and/or Business Unit level (i.e., Consumer Markets, Business Markets). Compensation targets are tied to these objectives regardless of to what entity an employee's labor costs are allocated. The effect of tying incentive compensation costs to QCII level and Business Unit level performance cuts both ways: employees whose costs are charged to regulated operations are compensated based on QCII results (which include non-regulated operations) and employees whose labor is not charged to regulated operations are also compensated based on QCII's total operations (which also include regulated operations). The effect is that all employees are compensated in part based on the performance of regulated operations (regardless of where their time is charged) and all employees are compensated in part based on the performance of non-regulated operations (again regardless of where their time is charged).
> [Qwest response to Staff Data Request UTI 12-4]

Q. How do the consolidated financial results of QCII compare over the past several years?

A. The QCII 2003 Form 10-K filed with the Securities and Exchange Commission for calendar 2003 contains detailed financial information, including the following historical income information:

Qwest Communications International, Inc.
Consolidated Financials

Millions	Net Income (Loss)	Loss from Continuing Operations
2001	$ (5,603)	$ (6,117)
2002	(38,468)	(17,618)
2003	1,512	(1,313)

Source: QCII 2003 SEC Form 10-K, pp. 34 & 75.

During each of these three calendar years, QCII recorded asset impairment charges pursuant to FAS144, Accounting for the Impairment or Disposal of Long-Lived Assets. According to notes accompanying the QCII consolidated financial statements, the magnitude of the loss reported in 2002 is attributable to the recording of significantly larger asset impairment charges, as compared to 2001 and 2003.[36]

Q. In 2003, the reported loss from continuing operations is negative, while QCII reported positive net income for the year. What caused this difference?

A. In 2002 and 2003, QCII recorded significant gains on the sale of its directory publishing business as well as income from those discontinued operations. Although QCII reported a $2.6 billion gain related to this sale in 2002 (before income taxes), the 2002 gain was overshadowed by much larger impairment charges. But for the gain from the directory sale, QCII would have also reported a net loss in 2003, as indicated by the $1.3 billion loss from continuing operations.

Q. Did the 2003 Bonus Plan use the consolidated net income as one of the financial components to determine payouts under the plan?

A. Yes.

Q. Since continuing operations reported a net loss for 2003 absent the sale of the directory publishing business, why would any incentive payments for the 2003 plan year?

[36] Source: QCII 2003 SEC Form 10-K, pp. 42, 62, 88 & 91-92.

A. That very question was posed to Qwest as Staff Data Request UTI 13-1(a). The Company responded as follows:

> The financial targets established for the 2003 Bonus Plan anticipated the close of DEX West and its effect on revenues, net income and cash flow. Had the sale not closed, it is likely the compensation committee would have approved revising the targets to remove the anticipated sale because whether or not it closed was not a matter upon which the employees could have any substantial effect.
> [Staff Data Request UTI 13-1(a)]

Absent the Dex West sale, it would seem somewhat of a challenge to fashion incentive payouts around QCII's consolidated financials that reported a rather large net loss for the year. In response to Staff Data Request UTI 13-1(b), the Company addressed, in part, why employees should receive a bonus for 2003 even if net income had been negative absent the Dex West sale:

> ...The bonus plan is not a profit sharing plan were employees receive a portion of net income. Instead, it is an incentive plan where the targets must be established in a way that helps to encourage desired behaviors and financial results. Setting unrealistic targets that require positive net income in the current economic and competitive environment would not prove useful for motivating positive behavior and might, instead, contribute to employee dissatisfaction.
> [Staff Data Request UTI 13-1(b)]

This line of thought seems to indicate that incentive targets or objectives should be established based on parameters that employee actions or inactions could have a substantial effect in attaining or missing. As designed, it is difficult to envision how the employees supporting Qwest's Arizona operations could have a substantial influence on achieving the consolidated financial results of QCII.

Q. Earlier, you stated that "regulators need not allow above-the-line accounting for all discretionary costs incurred by management absent a showing that such costs provide direct, tangible benefits to ratepayers." Could you further elaborate on this statement?

A. Yes. In considering amendments to Part 65 of the FCC rules prescribing the components of rate base and net income for dominant carriers, the FCC discussed the framework surrounding its proposed changes.

> 7. In developing our proposal, we were guided by two historically applied principles – the "used and useful" standard and the benefit-burden test.

> The "used and useful" standard denotes property dedicated to the efficient conduct of a utility's business, presently or within a reasonable period. That standard reflects the principles that owners of public utilities must receive an opportunity to be compensated for the use of their property in providing a public service and that ratepayers must not be forced to pay a return on investment that does not benefit them directly. The benefit-burden test is based on the principle that the party who bears the financial burden of a particular utility activity should also reap the benefits resulting therefrom. We proposed to apply these two general principles to specific assets and asset categories established in Part 32 of our Rules, which will become effective January 1, 1988. [footnote omitted][37]

Although incentive compensation is only partially allocable between capital and expense accounts, Staff's approach follows the conceptual framework of the "benefit-burden" test. In other words, the party who benefits from a particular transaction or activity should bear the related financial burden. If ratepayers have not benefited from the achievement of the Bonus Plan incentive targets (consolidated financial results) or Arizona allocable employees can not substancially contribute to achieving those results, ratepayers should not be responsible for that portion of the cost of the Bonus Plan (incentive costs related to consolidated financial results).

Q. How does the amount of test year incentive compensation expense compare to Qwest's basic wages and salaries, excluding incentive compensation?

A. According to the confidential responses to Staff Data Request 2-24, Qwest's basic wages and salaries and overtime pay for the test year is about [redacted] (Total Arizona before jurisdictional separation). In comparison, the Company's test year incentive compensation expense of about [redacted] (Total Arizona before jurisdictional separation)[38] represents additional employee compensation of about [redacted]%, on average.

Incentive compensation is a method of providing monetary awards to the work force through unguaranteed bonus, or other payment program, in addition to base wages. Incentive compensation plans are typically designed to attract, retain and motivate employees, enhance teamwork and high levels of achievement, and to facilitate the

---

[37] CC Docket No. 86-497, FCC Report and Order, released December 24, 1987, par. 7.

[38] Qwest confidential responses to Staff Data Request UTI 9-3 and RUCO 6-1 indicate net incentive compensation for the 2003 plan year of $[redacted] (accrued in 2003) and negative $[redacted] (true-up recorded in 2004.

accomplishment of specific corporate, business unit and individual goals. By linking employee compensation to predetermined targets or objectives, individual employees are theoretically incented to perform well by directly influencing their day-to-day actions and activities – because if they do not achieve the target levels, they will not receive incentive compensation pay.

Based on largely unadjusted test year data, Qwest's cost of service recognizes that employees could receive, on average, an additional [redacted]% of at-risk, ratepayer funded compensation above and beyond their base wages/ salaries and overtime pay. The potential for indirect shareholder incentives do not directly influence the day-to-day actions and activities of individual employees. Instead, it is, or should be, the risk of losing the additional [redacted]% of compensation that will sufficiently incent an employee to help the Company achieve its targets and goals.

Q. If employees fail to achieve the corporate targets or individuals goals, will shareholders be required to forego all benefits associated with the incentive plans?

A. No. Since incentive compensation is "at-risk" to the employee, the amount of such compensation from year to year is not fixed, regular nor even certain to occur. In the event that minimum targets are not met, employees do not receive incentive payments and the amount of incentive compensation included in rates (e.g., Qwest has sought recovery of about [redacted] of incentive pay, excluding affiliate allocations and before jurisdictional separation) would contribute to increasing utility profits. In other words, ratepayers would be placed at-risk to fund incentive plan costs regardless of payout while employees are at-risk because targets might not be achieved for any number of reasons. At the same time, neither the Company nor its shareholders would necessarily be at-risk with respect to the [redacted] of total incentive pay included in test year expense, because the allowed expenses would be recovered through rates, regardless of future payouts.

Q. Since Staff Adjustment C-17 proposes to reduce test year incentive compensation expense, would this same theory apply to the remaining costs?

A. Yes.

Q. Does the Bonus Plan represent a binding commitment from Qwest?

A. No, I do not believe so. With regard to the 2003 Bonus Plan, the confidential response to Staff Data Request UTI 1-31, Attachment D, states: "[redacted]."

<u>SOP 98-1 (Internal-Use Software)</u>

Q. Please describe Staff Adjustments B-6 and C-11.

A. Staff Adjustment C-11 recognizes the pro forma effect of adopting for regulatory purposes, in the 2003 test year, a 1998 change in accounting for the cost of computer software developed or obtained for internal use. This adjustment reflects a five-year amortization of test year software costs transferred from expense to capital accounts and effectively eliminates the portion of Qwest's revised Adjustment PFA-03 that seeks to amortize pre-test year software costs that have not been previously capitalized for Arizona regulatory accounting purposes.

Since the Arizona regulatory adoption of SOP 98-1 recognized by Staff Adjustment C-11 is prospective in nature, Staff Adjustment B-6 reduces rate base to eliminate all plant in service, depreciation reserve and deferred income tax reserve effects improperly imputed by Qwest's revised Adjustment PFA-03. In essence, the Company's revised adjustment would set rate base as if SOP 98-1 had been adopted for Arizona regulatory purposes in 1999. Because that presumed adoption has not and did not occur, it would be improper to include those amounts in rate base.

Q. Please describe this accounting change.

A. Beginning at page 57 of his direct testimony, Mr. Grate describes Statement of Position 98-1 ("SOP 98-1") issued by the American Institute of Certified Public Accountants on March 4, 1998. Basically, SOP 98-1 changed the accounting guidance on the cost of internal use software from expensing in the current period to the capitalization and amortization of such costs. As indicated by Mr. Grate, Qwest adopted SOP 98-1 in 1999 and has recognized such accounting in its external financial statements since that time. However, Qwest has not adopted SOP 98-1 in any State jurisdiction other than Oregon for regulatory purposes.[39]

The following discussions, which appear in Qwest's (formerly USWC's) 1998 and 1999 SEC Form 10-K Annual Reports, provide concise summaries of this accounting change and the related effects on the Company's results of operations:

> **<u>1998 SEC 10-K</u>**
> On January 1, 1999, we adopted the accounting provisions required by the American Institute of Certified Public Accountants' Statement of Position ("SOP") 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," issued in March 1998. SOP 98-1, among other things, requires that certain costs of internal use software, whether purchased or developed internally, be capitalized and amortized over the estimated useful life of the software.
>
> Based on information currently available, adoption of the SOP may result in an initial increase in net income in 1999 of approximately $100-$150 [million]. In periods of adoption, if software expenditures remain level, the impact on earnings will decline until the amortization expense related to the capitalized software equals the software costs expensed prior to the accounting change.
> [USWC 1998 SEC Form 10-K, p.16]
>
> **<u>1999 SEC 10-K</u>** [all amounts in millions]
> COMPUTER SOFTWARE. On January 1, 1999, we adopted the accounting provisions required by the American Institute of Certified Public Accountants' Statement of Position ("SOP") 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use". SOP 98-1, among other things, requires that certain costs of internal use software, whether purchased or developed internally, be capitalized and amortized over the estimated useful life of the software. Capitalized computer software costs of $544 and $180 at December 31, 1999 and 1998, respectively, are recorded in property, plant and equipment and other assets – net. Amortization of capitalized computer software costs totaled $104, $82 and $78 in 1999, 1998 and 1997, respectively.
> [USWC 1999 SEC Form 10-K, p. F-6, FreeEdgar.com]

---

[39] Grate direct, pp. 57-58.

All non-governmental entities were required to implement this accounting change for fiscal years starting after December 15, 1998. Accordingly, the Company adopted SOP 98-1 on January 1, 1999, for financial reporting purposes, but has not yet adopted this accounting method in any State jurisdiction other than Oregon for regulatory accounting purposes.

Q. Why did SOP 98-1 require the capitalization and amortization of the cost of internal use software?

A. According to the Accounting Standards Executive Committee, the SOP 98-1 project was undertaken because of inconsistent accounting for software costs. The following historical information was extracted from the Introduction and Background section of SOP 98-1:

> 1. The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed*, in 1985. At that time, the FASB considered expanding the scope of that project to include costs incurred for the development of computer software for internal use. The FASB concluded, however, that accounting for the costs of software used internally was not a significant problem and, therefore, decided not to expand the scope of the project. The FASB stated that it recognized that at that time the majority of entities expensed all costs of developing software for internal use, and it was not convinced that the predominant practice was improper.
>
> 2. Because of the absence of authoritative literature that specifically addresses accounting for the costs of computer software developed or obtained for internal use and the growing magnitude of those costs, practice became diverse. Some entities capitalize costs of internal-use computer software, whereas some entities expense costs as incurred. Still other entities capitalize costs of purchased internal-use computer software and expense costs of internally developed internal-use computer software as incurred.
>
> 3. The staff of the Securities and Exchange Commission (SEC) and other interested parties have requested that standard setters develop authoritative guidance to eliminate the inconsistencies in practice. In a November 1994 letter, the Chief Accountant of the SEC suggested that the Emerging Issues Task Force (EITF) develop that guidance. However, the EITF and the Accounting Standards Executive Committee (AcSEC) agreed that AcSEC should develop the guidance.
> [SOP 98-1, p.7]

In addition to improving the comparability of financial data between entities, AcSEC expressed the belief that:

> ...the costs of computer software developed or obtained for internal use are specifically identifiable, have determinate lives, relate to probable future economic benefits (FASB Concepts Statement No. 6), and meet the recognition criteria of definitions, measurability, relevance, and reliability (FASB Concepts Statement No.5).
> [SOP 98-1, par.64]

Q. Has the FCC adopted SOP 98-1 for interstate regulatory purposes?

A. Yes. In an order issued on June 30, 1999, the FCC adopted SOP 98-1.

Q. Why are you recommending that the ACC adopt capitalization accounting for internal use software for Arizona regulatory purposes?

A. In general terms, costs which relate solely to the current period should be expensed as incurred. Costs incurred during the current year that relate to prior years should also be expensed. However, those costs that provide identifiable benefits or otherwise relate to more than one future period should be capitalized and amortized over the expected benefit period. Internal-use software does produce identifiable benefits for multiple future periods. As such, the cost of such software should be capitalized and amortized as specified by SOP 98-1.

It merits comment, however, that the mere recognition of a cost as a current period expense does not necessarily equate to inclusion in rates. For example, the regulatory process typically eliminates operating expenses associated with prior periods. Similarly, the level of certain costs recorded as expense in a particular test year may be abnormal (i.e., too high or too low), thereby requiring normalization adjustments to reflect reasonable ongoing levels.

Q. During 1999, did Qwest account for the cost of internal-use software differently in its financial accounting records than in its regulatory accounting records?

A. Yes. For financial accounting purposes, the Company capitalized the cost of internal-use software costs, consistent with SOP 98-1 as noted in the earlier SEC 10-K excerpts. At that time, the Company continued to expense the costs of internal-use software in its regulatory books of accounts. However, following the FCC's adoption of SOP 98-1, the Company similarly modified its accounting for the interstate portion of its regulated operations to reflect this change in capitalization, but continued to expense the portion of those same costs allocated to its Arizona intrastate operations.

Q. Could you explain how the Company can use different accounting treatments for the same item in its accounting records?

A. Yes. Qwest maintains and reports its financial results using accounting methods that may treat certain transactions differently for financial reporting, FCC reporting and State regulatory reporting purposes. In fact, regulatory reporting may differ between State jurisdictions, based on individual regulatory requirements. The Company's financial reporting records are maintained on what is generally referred to as an "FR" (or financial reporting) basis, consistent with Generally Accepted Accounting Principals (or "GAAP"). The Company's regulatory financial results are initially prepared and maintained consistent with FCC accounting requirements. These results are generally identified as being presented on an "MR" basis. Any differences in accounting treatments or requirements that exist between the FCC and each State regulatory agency are accounted for in the Company's "offbook" or side records, thereby allowing for specific tracking and consideration of these differences in State regulatory proceedings. The Company's "JD" reports reflect the accounting presentation that incorporates any "jurisdictional" accounting differences with the FCC and is consistent with State accounting requirements. While it is not as complicated as it may seem, Qwest has adopted SOP 98-1 and accounts for the capitalization of internal-use software for both "FR" and "MR" accounting purposes, but continues to expense these costs for "JD" accounting purposes in Arizona, absent a Commission decision adopting SOP 98-1 for intrastate regulatory purposes.

Q. Why does the Company report its operating results to the financial community on a different basis than is reported to the FCC?

A. As indicated in USWC's 1993 annual report to the Securities and Exchange Commission (SEC 10-K), the Company incurred a non-cash, extraordinary charge of $3.0 billion, net of income taxes, in conjunction with its decision to discontinue accounting for its operations in accordance with Statement of Financial Accounting Standards No. 71 (FAS71), "Accounting for the Effects of Certain Types of Regulation." The Company's decision to discontinue the application of FAS71 "was based on the belief that competition, market conditions and the development of broadband technology, more than prices established by regulators, will determine the future revenues of the Company." As a result of this change, the operating results reported to the financial community began to diverge from the results reported for regulatory purposes, because the Company's regulatory accounting and reporting methods were not affected by this change. So, the Company began maintaining different accounting records for financial reporting purposes than for regulatory purposes.

Q. The earlier quotes from the Company's 1998 and 1999 SEC 10-Ks, indicated that the adoption of the SOP 98-1 would result in increased net income during 1999. Has the Company proposed to reflect the Arizona share of this increase in net income in its proposed revenue requirement?

A. Yes and no. In direct testimony, Mr. Grate sponsored Adjustment PFA-03, representing Qwest's first ever recommendation that SOP 98-1 be adopted for Arizona regulatory purposes.[40] However, according to the response to Data Request UTI 4-1S1, Mr. Grate has revised his position and now concludes that Qwest should have adopted SOP 98-1 in 1999. As a consequence, Mr. Grate proposes to revise Adjustment PFA-03 from recognizing the pro forma affect of adopting SOP 98-1 in the 2003 test year (decreasing revenue requirement by $12.7 million) to adoption in 1999 (increasing revenue requirement by about $19 million). This revised position, increasing overall revenue requirement by $31.7 million, is sponsored by Mr. Grate even though the Company has

---

[40] Grate direct, pages 57-62.

never previously proposed nor sought Commission approval to recognize this accounting change for intrastate regulatory purposes.[41]

Q. How do you know that Qwest has not previously sought Arizona regulatory approval to adopt SOP 98-1?

A. In the Company's 1999 rate case, I sponsored testimony and a pro forma adjustment on behalf of Staff recommending the adoption of SOP 98-1 in the 1999 test year. Qwest opposed that adjustment. Mr. George Redding, then Director-Regulatory Finance for Qwest Corporation, filed rebuttal and rejoinder testimony opposing Staff's recommendation. In my opinion, it is rather unusual and disingenuous for the Company to oppose Staff's proposed adjustment adopting SOP 98-1 in the 1999 test year and now suggest that SOP 98-1 should be recognized in the 2003 test year as if it had been adopted in 1999. This shift in position is the epitome of a "heads the Company wins, tails ratepayers loss" situation.

Q. Do you have any information which addresses why the Company has not sought ACC approval to capitalize internal-use software?

A. Yes. In the Company's last rate case, Data Request No. UTI 13-21(d) specifically requested Qwest's position regarding whether this change should be reflected in Arizona revenue requirements. The Company's response to this portion of that discovery request is reproduced below:

> The company has not petitioned the Arizona Corporation Commission to adopt the software capitalization accounting. Since the life for the capitalized software is very short, the effect of this accounting on ratemaking is to produce a first year dip in revenue requirements followed by a near term turnaround of revenue requirements and over time, higher revenue requirements. Furthermore, the change from expensing of software to capitalization is not cash affecting, while the ratemaking effect would be cash affecting. Given both the short term revenue requirement profile and the fact that software capitalization is not cash affecting the Company does not intend to petition the Arizona Corporation Commission to adopt this accounting.
>
> [Docket T-01051B-99-0105, Data Request No. UTI 13-21(d)]

41 The supplemental response to Staff Data Request UTI 7-2S1 also values the revenue requirement impact of this change from its prefiled position on this issue at $31.7 million.

Q. Do you have any comments on the Company's position, as stated in the response to Data Request No. UTI 13-21(d)?

A. Yes. As I stated in my direct testimony in that docket, the Company's "not cash affecting" position was specious.[42] Further, Mr. Grate's direct testimony in the pending proceeding originally embraced the adoption of SOP 98-1 in 2003, but he has now revised his position on the basis that it should have been adopted in 1999.

Q. Is it true that adoption of SOP 98-1 has a temporary effect by producing a first year dip in revenue requirements followed by higher revenue requirements over time?

A. Yes. That is a true statement. However, the capital to expense shift resulting from the adoption of FCC Part 32 (FCC uniform system of accounts) a number of years ago resulted in higher initial revenue requirements followed by theoretically lower revenue requirements over time. In order for the Company's regulated customers to receive the full benefit of the capital to expense shift resulting from Part 32 accounting, Qwest's intrastate rates needed to continue to be set on the basis of the Company's cost of providing service, presuming the subsequent savings were actually realized. Nevertheless, any change in accounting method has revenue requirement trade offs.

Q. Since you are recommending that internal-use software be capitalized, rather than expensed currently, how will the Company amortize that investment?

A. With limited exceptions, capital assets are either depreciated or amortized to expense over a reasonable period of time. As a result, the capitalized cost of internal-use software will be amortized to operating expense over a multi-year period. In fact, Qwest has been capitalizing and amortizing these costs for financial reporting, FCC reporting and Oregon regulatory purposes for many years.

Q. What period are you using to amortize these capitalized software costs?

---

[42] As indicated in the response to Data Request No. UTI 20-12(a) in Docket T-1051B-99-0105, the phrase "not cash affecting" simply means that the change in accounting method will not result in any change in the amount or timing of Company's cash payments to fund software development and modification efforts. Further, the response to Data Request No. UTI 20-12(b) in that same docket confirmed that changes otherwise "not cash affecting" become "cash affecting" merely by recognizing those accounting changes for ratemaking purposes.

A. Consistent with the Company's "book" accounting and Adjustment PFA-03, Staff Adjustment C-11 is based on a five (5) year amortization period.

Q. Earlier, you indicated that the Company's last rate case was resolved by negotiated settlement. How do you know that Qwest was not indirectly granted regulatory authority to adopt SOP 98-1 for Arizona intrastate purposes in that proceeding?

A. It is true that the last rate case (Docket No. T-01051B-99-105) was resolved through negotiated settlement. In support of that settlement Staff witness Brosch and Company witness George Redding, then Director-Regulatory Finance for Qwest Corporation, prefiled written testimony discussing the proposed rate increase of $42.9 million. At pages 2 - 3 of his supplemental testimony, Mr. Brosch provided the following discussion of why the $42.9 million rate increase was reasonable and in the public interest:[43]

> Staff's prefiled direct evidence supported a rate increase of $7.2 million, after making many accounting adjustments and significantly reducing the Company's requested rate of return. In contrast, the Company's filing supports a total revenue increase of $201.2 million. Schedule E within the ACC Staff Joint Accounting Exhibit is a one-page reconciliation of the many issues between Qwest and the Staff that make up the approximately $194 million in dispute between Qwest and Staff in this Docket. ... However, at lines 15 through 45, many operating income adjustments are summarized that total $153.6 million in revenue requirement value (see Line 49). Most of the major issues shown in this listing are vigorously disputed by Qwest. Several of the issues in dispute have no guiding precedent in prior ACC rate orders. If Staff were to <u>not</u> prevail on only a few of the larger operating income adjustments, the resulting approved rate increase would be much larger than the $42.9 million in the Settlement Agreement. Additionally, if the Commission were to grant a return on equity only modestly higher than Staff's 11.75 percent recommendation, the resulting rate increase could be much larger than Staff has recommended.
> [Brosch Supplement Testimony, p. 2, Docket No. T-1051B-99-105]

The testimony of Mr. Brosch also contained the following discussion of those operating income issues proposed by Staff that had no guiding precedent in prior ACC rate orders:

> Adjustment C-13 (Line 28 of Schedule E) reflects adoption of the new SOP 98-01 accounting pronouncement for computer software costs, causing certain software costs previously expensed to now be capitalized

[43] A copy of Staff Schedule E, reconciliation from Docket No. T-1051B-99-105, is appended hereto as Attachment SCC-3, for reference purposes.

> on the books. This adjustment is contested by Qwest and has the effect of reducing test period revenue requirements by $32.8 million in Staff's filing. ... While Staff believes its position is fully supported in prefiled evidence for each of these adjustments, it is entirely possible that litigation of these issues and other Staff adjustments may result in much higher revenue increases in the final rate order than have been agreed upon through settlement.
> [Brosch Supplement Testimony, p. 3, Docket No. T-1051B-99-105]

The rebuttal testimony of Company witness Redding in the last rate case was also illuminating in its description of the negotiation and settlement process, including the following excerpts:

> The settlement process was highly contentious and hard fought. The result reflects the parties' view of the strength of the arguments and voluminous testimony and evidence presented in this case, including direct, rebuttal, surrebuttal and rejoinder testimony by over a dozen witnesses representing several different parties. That testimony was developed in the light of multiple rounds of discovery that yielded answers to hundreds of questions. Both parties carefully considered the Commission's position on issues in Qwest's last rate case. The process of reaching a compromise on the many contested positions in this case was carefully considered and far from arbitrary.
> [Redding Rebuttal Testimony, p. 6, Docket No. T-1051B-99-105]
>
> ...
>
> Although many proposed adjustments were not specifically discussed, Qwest, in reaching a compromise with Staff, was fully cognizant of the fact that if this case were to continue to be litigated, the Commission would be presented with arguments and supporting evidence for each and every position taken by each and every witness sponsored by every party in this case, not just Staff's. It follows that the compromise Qwest reached reflects its assessment of all of the positions and supporting evidence of all of the parties, not just Staff's.
> [Redding Rebuttal Testimony, p. 8, Docket No. T-1051B-99-105]

Although these excerpts clearly illustrate why negotiated settlement agreements typically contain language regarding their non-precedential nature, these passages also clearly establish that major issues raised by Staff, such as SOP 98-1, were vigorously disputed by Qwest and should be considered to have no guiding precedent in future rate proceedings.

Q. If the Company has adopted SOP 98-1 for financial reporting and FCC accounting, has Qwest maintained special accounting records designed to maintain its Arizona regulatory accounting records as if SOP 98-1 has <u>not</u> been adopted?

A. Yes. As detailed in Attachment B to Staff Data Request UTI 1-3, Qwest maintains "offbook" accounting entries to separately track each significant difference between State and FCC regulatory requirements and generally accepted accounting principles ("GAAP"). The following excerpt describes how Qwest keeps track of the differences in accounting for SOP 98-1:

> **BAC 0360 J Software Capitalization – JD**
> Description: In January, 1999, U S WEST implemented the provisions of SOP 98-1, Accounting for Internal Use Software. The SOP dictates that costs for software purchased or developed for internal use be capitalized. Not all State regulatory commissions ordered implementation of the SOP effective 1/1/99. The purposes of this BAC is to reverse the intrastate effects of the capitalization entry for the period of time between 1/1/99 and the effective date of the individual state orders. The balances on this BAC will be amortized over the life of the software and retired at the end of the amortization period.
> [Qwest response to Staff Data Request UTI 1-3, Attachment B]

The facts are clear. Qwest opposed Staff's proposed adjustment to adopt SOP 98-1 in the Company's last rate case, which had a 1999 test year. Qwest adopted SOP 98-1 for both public financial and FCC reporting purposes. Qwest has stated that, among its State jurisdictions, only Oregon adopted SOP 98-1 in 1999. And, finally, Qwest established specific offbook accounting records to ensure that SOP 98-1 was not reflected in its Arizona intrastate operating results.

Referring to the response to Staff Data Request UTI 16-17, Qwest also maintained offbook records for SOP 98-1 in the follow State jurisdictions in 2003: Colorado, Iowa, Idaho, Minnesota, Montana, Nebraska, New Mexico, North Dakota, South Dakota, Utah, Washington and Wyoming. This same response indicated that the reason Qwest maintained offbook records for SOP 98-1 in all the jurisdictions was the same as Arizona: "There have been no orders in any of these jurisdictions implementing SOP 98-1." On balance, Staff believes that the evidence demonstrates that SOP 98-1 has not previously been recognized in Arizona, but should be reflected in the 2003 test and recognized in quantifying overall revenue requirement in this proceeding.

FAS106 OPEB COSTS

Q. Please describe Staff Adjustments B-8 and C-18.

A. Staff Adjustment C-18 modifies Qwest Adjustment PFA-02 and recognizes other postretirement benefits costs (OPEB costs) on an accrual basis. The primary difference between Company and Staff on this issue concerns the amortization period and amount of the transition obligation, or liability, to be amortized.

Staff Adjustment B-8 revises the Company's proposed rate base offset to reflect internal funding of OPEB accrual basis costs in excess of PAYGO, based on Staff's position that it was the regulatory intent of the parties to adopt accrual basis accounting in Qwest's last rate case.

Q. Please describe Company's proposed adjustment related to its test year accounting for OPEB costs.

A. As discussed by Company witness Grate, Qwest has proposed to adjust test year rate base and operating expense relating to its accounting for FAS106 OPEB costs.[44] Qwest's revised Adjustment PFA-02 increases test year OPEB expense by about $60.5 million and decreases rate base by $117.5 million, to recognize a "change in accounting method." The primary focus of Mr. Grate's direct testimony, at pages 54-56, is the history of OPEB accounting and regulatory treatment in Arizona.

Q. Why has the Company proposed a rate base reduction as part of this change in accounting method?

A. Qwest has proposed the rate base offset in order to recognize internal, rather than external, funding of the amounts recovered from ratepayers in excess of pay-as-you-go (PAYGO) or cash basis accounting.[45] Upon initial adoption of FAS106, some

---

44 See Grate direct testimony, pages 54-56.
45 Qwest response to Data Request RUCO 3-10.

jurisdictions have required external funding so as to ensure that the funds would be available when needed to pay retiree benefits. Given the complexity of Qwest's attempts to track regulatory accounting and fund assets among and between its fourteen State jurisdictions and the FCC, Staff does not oppose the internal funding approach. However, Staff would require the Company to maintain detailed information supporting the amounts recognized for Arizona regulatory purposes in excess of PAYGO to ensure ratepayers are not denied full credit in future proceedings.

Q. Please provide a brief overview of FAS106.

A. In December 1990, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard No. 106 ("FAS106"), Employers' Accounting for Postretirement Benefits Other Than Pensions, also known as "OPEBs" or "PBOPs". These benefits generally include health care and life insurance benefits provided outside a pension plan to retirees and their spouses, dependents and beneficiaries.

In general, FAS106 requires employers to accrue the cost of OPEBs to expense during the employees' service period, thereby recognizing a balance sheet liability for such obligations for financial reporting purposes. Since pay-as-you-go ("PAYGO") or cash basis was the predominant method of accounting for financial and regulatory accounting for OPEBs prior to the issuance of FAS106, a major component of the incremental cost of moving from the cash to accrual basis of accounting for OPEBs is the transition obligation.

Q. What is the "transition obligation"?

A. Generally, the transition benefit obligation ("TBO") represents the excess of the actuarial present value of the cumulative benefits attributed to employee service over the fair value of any plan assets, as of the date of plan adoption. In other words, the TBO is the unrecognized liability to both active and retired employees attributable to services rendered prior to the date of accrual accounting adoption. FAS106 provides two alternative methods for recognizing this previously unrecognized TBO upon adoption:

- The immediate recognition of the cumulative effect of the change as a current period charge; or

- The straight line amortization of the unrecognized obligation over the average remaining life of employees, or twenty years if longer.

For financial reporting purposes, the Company chose the immediate recognition option. However, for Arizona regulatory purposes, the Company proposed to amortize the TBO over a 17.3 year period in ACC Docket Nos. E-1051-93-183 and T-1051B-99-105.

Q. Have you previously submitted testimony before this Commission addressing the issue of OPEB cost recovery?

A. Yes. I have testified on behalf of Staff in multiple dockets on this matter opposing the adoption of FAS106 for ratemaking purposes, including Docket No. E-1051-88-146 (U S West complaint), Docket Nos. E-1551-89-102 and 103 (Southwest Gas Corporation) as well as Docket No. E-1051-93-183 (U S West rate case).

As indicated in the following excerpt from Decision No. 58927 (Docket No E-1051-93-183), the Commission essentially adopted the recommendations of Staff and RUCO and denied the Company's proposed adjustment to transition from PAYGO to accrual accounting:

> …we are still not convinced that a change from the cash method to an accrual method which includes past and current costs is appropriate at this time. We are making this decision based upon an overall comparison of the Paygo method versus an accrual method which includes the Transition Costs. We share some of the Company's concerns regarding intergenerational inequities. Ideally, each generation of customers will pay the OPEB costs that directly benefit them and not pay those costs which directly benefit other generations of customers. The existence of the Transition Costs demonstrates that the paygo method does not meet the ideal situation of matching costs and benefits. A change to the accrual method without consideration of the Transition Costs could provide a better match of costs and benefits. Even though the Company for financial purposes has written off the Transition Costs, the Company made it clear it preferred the Paygo method over a straight accrual method without Transition Costs. Based on all the above, we will not recognize for ratemaking purposes the effect of the accounting change proposed by the Company for post-retirement benefits.

...

> The Company's real concern is whether, when and if it is placed in a completely competitive, unregulated environment, it still will be able to recover all of its OPEB costs and still be competitive. In our mind, such a concern is not all bad since it forces the Company to closely monitor its OPEB costs. Accordingly, we will not adopt the Company's $28 million adjustment.
> [Decision No. 58927, pages 44-45 (Docket No E-1051-93-183)]

Q. Did you file testimony in the Company's last rate case, Docket No. T-1051B-99-105, on this issue?

A. No. Prior to the last rate case, Staff and the Commission had revised their consideration of this issue and proposed or adopted accrual accounting in other proceedings. In the last rate case, Company witness George Redding filed testimony proposing the adoption of FAS106 accrual accounting in testimony similar to that filed by Mr. Grate in the current proceeding. Recognizing that Staff and the Commission had revised their views on this accrual issue prior to the last Company rate case, my testimony was intentionally silent on Mr. Redding's OPEB recommendation. Because Staff's revenue requirement started with Qwest's proposed levels of rate base and operating income, Staff's decision to not oppose the Company's FAS106 adjustment in that rate proceeding had the effect of including the Company's higher accrual accounting costs in Staff's proposed revenue requirement.

Q. Could you briefly summarize the proceedings you referenced as signaling Arizona's revised view on the FAS106 accrual accounting issue?

A. Yes. At page 56 and in footnote 42 of his direct testimony, Mr. Grate states that the Commission previously approved accrual accounting for OPEB costs for ratemaking purposes for Paradise Water Company (Decision No. 60220) and Southwest Gas Corporation (Decision No. 60352).

The following excerpts appear in the Commission's Opinion and Order in Docket No. U-1303-96-283, involving the rate increase application of Paradise Water Company:

> Both RUCO and Staff opposed the Company's request to switch to the accrual method for PBOPs. Each cited previous decisions in

> which the Commission has denied recovery of the FAS No. 106 costs. Staff and RUCO were still concerned with problems such as retroactive ratemaking, intergenerational inequities, and the fact that the liability for future obligations to make PBOPs payments is not known and measurable. In addition, RUCO indicated that FAS No. 106 accruals include expenses based on a series of assumptions that can be expected to change. Further, there is no directive that requires the Company to fund its accrual.
> At the hearing, the Company agreed to use the cash method for PBOPs for this proceeding. However, the Company urged the Commission to adopt the accrual method for future cases...
> We concur with the parties that continuation of the cash method for PBOPs is proper for this case...However, for the reasons set forth by the Company, we find that in future cases the accrual method should be utilized by the Company. We want to make it clear that our determination is solely for this Company and other determinations will be made on a case by case basis.
> [Paradise Water Company, Decision No. 60220, pages 9-10]

Unlike the Paradise Water Company rate case, the Southwest Gas Corporation rate case was resolved by negotiated settlement. Decision No. 60352 approved the Settlement Agreement, which included the following language concerning FAS106 accrual accounting:[46]

> POST-RETIREMENT BENEFITS
> The accounting and ratemaking treatment proposed by RUCO for Post-Retirement Benefits, which is set forth on pages 59 through 62 of the pre-filed testimony of RUCO witness Marylee Diaz Cortez, is adopted.
> [Southwest Gas Corporation, Decision No. 60352, pages 5-6]

Both of these decisions were issued by the Commission in mid-1997,[47] well before Staff and Qwest filed notice of the Settlement Agreement in the Company's last rate case (Docket No. T-1051B-99-105) on October 20, 2000.

Q. Is Staff opposing Qwest's recommendation that accrual accounting be adopted for ratemaking purposes?

---

46 Southwest Gas Corporation (Decision No. 60352, pages 5-6) issued August 27, 1997.
47 Paradise Water Company (Decision No. 60220) issued May 27, 1997, and Southwest Gas Corporation (Decision No. 60352) issued August 27, 1997.

A. No. Staff is not opposing the concept of accrual accounting for OPEB costs. Instead, Staff contends that Company Adjustment PFA-02 overstates revenue requirement because it fails to recognize the regulatory intent of the parties in the Company's last case to explicitly consider the cost of transitioning to accrual accounting in revenue requirement, even though the settlement agreement in that docket was silent on the issue. Basically, Company Adjustment PFA-02 was quantified as if the amount of OPEB costs recognized in the last rate case was based on PAYGO accounting and results in an overstatement of the transition costs subject to amortization over a dramatically reduced amortization period.

Q. Does the Company discuss how this issue was handled in the last rate case?

A. Yes. In direct testimony, Mr. Grate recognizes that Mr. Redding did propose adoption of FAS106 accrual accounting in the last rate case. However, Mr. Grate also observes that neither the settlement agreement nor the Commission's order in that case (Decision No. 63487) adopted or mentioned OPEB accounting under FAS106. While Mr. Grate accurately points out that Staff and RUCO opposed accrual accounting in Docket No. E-1051-93-183, he fails to mention that neither party opposed Mr. Redding's recommendation in the last rate case. According to Mr. Grate, Qwest has continued to accounting for OPEBs using the PAYGO method for Arizona regulatory purposes.[48]

Q. Do you concur with Mr. Grate's characterization of the treatment of this issue in the last Arizona rate case proceeding?

A. Only in part. Mr. Grate is quite correct that both the settlement agreement and the Commission's order are silent concerning the transition from PAYGO to OPEB accrual accounting. Unfortunately, this observation ignores the fact that the proposed revenue requirements of both Staff and Qwest included $27.4 million for the OPEB transition in excess of PAYGO costs. In spite of the regulatory intent of Staff's acquiescense to the Company's proposed adjustment, Qwest would now pretend as if the Arizona regulatory process has consistently denied the Company any opportunity to recover the higher accrual-basis costs.

[48] Grate direct testimony, pages 55-56.

Q. Could you identify the components of the Company's proposed OPEB costs and explain the amounts at issue?

A. Yes. The primary components of the Company's pro forma OPEB costs underlying Adjustment PFA-02 are summarized below and compared to Staff's proposed treatment:

CONFIDENTIAL	Arizona Intrastate	
	Qwest Pro Forma	**Staff Pro Forma**
Service Cost	[redacted]	[redacted]
Interest Cost	[redacted]	[redacted]
Expected Return	[redacted]	[redacted]
Amort. Of Prior Service Cost	[redacted]	[redacted]
Amort. Of Actuarial Gain	[redacted]	[redacted]
Subtotal Medical & Life	[redacted]	[redacted]
APBO/TBO	[redacted]	[redacted]
Amortization Period	[redacted]	[redacted]
Subtotal TBO Amortization[49]	[redacted]	[redacted]
Pro Forma OPEB Costs (a)	[redacted]	[redacted]
	(b)	(c)

Note (a): Amounts before allocation between expense & capital accounts.
Note (b): Qwest workpapers supporting Adjustment PFA-02.
Note (c): Qwest confidential response to Staff Data Request UTI 47-11, Docket T-1051B-99-105.

Q. Referring to this table, please define the reference to both the "APBO" and "TBO", explaining why the amounts proposed by Qwest and Staff are significantly different.

A. As indicated previously, the TBO (or transition benefit obligation) basically represents the present value of the liability for OPEBs (medical and life insurance benefits) earned by active and retired employees over the fair value of any plan assets, as of the date of plan adoption. Due to the change from PAYGO (cash basis) accounting to FAS106 accrual accounting, the TBO is amortized over a finite period of time (e.g., 17.3 years) in order to transition between these accounting methodologies.[50]

---

[49] Had Qwest used the 17.3 year amortization period in quantifying Adjustment PFA-02, the [redacted] TBO amortization would have been [redacted]. Similarly, a 10-year amortization of the TBO from the 1999 rate case would increase Staff's proposed [redacted].

[50] Confidential Attachment A to the response to Staff Data Request UTI 16-2 (March 31, 1993 Accounting Standards Ruling 92-02, Accounting for adoption of SFAS No. 106) describes the TBO as follows (page 1): "[redacted]

According to FAS106, the APBO (or accumulated postretirement benefit obligation) is the present value of the cumulative benefits earned by employees at a specified date. As of the date of FAS106 adoption, the TBO and the APBO would be the same, except the TBO would be shown net of any related plan assets.

In general terms, the valuation of the APBO will change over time due to assumption revisions (e.g., discount rates, inflation rates, survivor and mortality statistics, etc.) and the mere passage of time, as the APBO is a present value of future obligations. Consequently, establishing the TBO (or APBO) in 1999 for purposes of determining the annual transition amortization will be different than a more current APBO level – such as year-end 2003. Because Staff considers that it was the intent of the parties to adopt FAS106 for Arizona regulatory purposes in the last rate case (i.e., the 1999 test year), the APBO/TBO balance subject to amortization is based on the amount proposed by Qwest in that case and adopted by Staff.

Q. Could you provide more information to explain why the APBO Qwest now proposes to amortize over a ten-year period is larger than the APBO Staff proposes to amortize over 17.3 years?

A. The APBO changes from year to year for several reasons. First, the APBO is a discounted value that should be expected to increase each year, all else remaining constant. Merely due to the passage of time, the present value of a future obligation will change each year, even if the future obligation remains constant in nominal dollars and the discount rate is unchanged. Second, the future obligation and the discounted APBO will increase each year, as participants earn additional benefits that will be payable in future years. Third, the future obligation and the discounted APBO will decrease, or be reduced each year, as retiree obligations are satisfied as the Company incurs costs to provision benefits to participants each year. Fourth, changes in assumptions (e.g., discount rate used to quantify net present value, medical cost inflation trend rate, medical

---

[redacted]."

claim cost payout rate, etc.) used to project the future obligation will result in increases or decreases to the aggregate value of the future obligation and the APBO, in relation to the assumptions embedded in earlier calculations of the obligation.[51] In the aggregate, the assumption changes and passage of time since the last rate case has resulted in a higher APBO in 2003 than in 1999.

Q. Also referring to this same table, could you explain the difference between the Company's 10-year versus Staff's 17.3-year amortization period?

A. In response to Staff Data Request UTI 3-3(c), the Company provided the following explanation of the reduction of the TBO amortization period to ten years:

> At the time the Company adopted SFAS 106 in 1992 the TBO amortization period was 17.3 years because the estimated average remaining service lives of its employees in 1992 was 17.3 years. Eleven years later, in 2003, the average remaining service life of employees stands at just slightly over 10 years. According, the TBO amortization period for adoption of SFAS 106 in 2003, instead of 1992, is 10 years.

In the Company's last Arizona rate case, the Company proposed an amortization period of 17.3 years, which was adopted by Staff.

Q. Why, then, should the Commission use the lower APBO/TBO balance and an amortization period of 17.3 years as proposed by Staff?

A. In Qwest's last Arizona rate case (Docket No. T-1051B-99-105), Company witness George Redding sponsored Adjustment P-05 to recognize accrual accounting under FAS106 for intrastate ratemaking purposes. The documentation supporting that adjustment, accepted and uncontested by Staff and RUCO, clearly shows the APBO/TBO amortization being based on a 17.3 year period. Having mutually adopted an APBO/TBO balance and an amortization period, those components should be fixed for intrastate regulatory purposes – as recognized in Staff Adjustment C-18.

Q. Earlier, you indicated that the Company's last rate case was a negotiated settlement and that the subject of OPEBs was not specifically addressed in the settlement agreement.

[51] Qwest response to Staff Data Request UTI 3-3.

Could you elaborate on your position as to why FAS106 should be considered as having been adopted in Docket No. T-1051B-99-105?

A. As discussed at some length in the section of my testimony on the SOP 98-1 issue, Qwest's last rate case (Docket No. T-01051B-99-105) was resolved by negotiated settlement. In support thereof, both Staff witness Brosch and Company witness Redding, then Director-Regulatory Finance for Qwest Corporation, prefiled written testimony discussing the proposed rate increase of $42.9 million. At the risk of being redundant, the following excerpt from pages 2 and 3 of Mr. Brosch's supplemental testimony in that proceeding contains the following discussion of the $42.9 million negotiated rate increase:[52]

> Schedule E within the ACC Staff Joint Accounting Exhibit is a one-page reconciliation of the many issues between Qwest and the Staff that make up the approximately $194 million in dispute between Qwest and Staff in this Docket. ... Most of the major issues shown in this listing are vigorously disputed by Qwest. Several of the issues in dispute have no guiding precedent in prior ACC rate orders.
> [Brosch Supplement Testimony, p. 2, Docket No. T-1051B-99-105]

Company witness Redding also filed rebuttal testimony supporting the settlement, including the following excerpts:

> Although many proposed adjustments were not specifically discussed, Qwest, in reaching a compromise with Staff, was fully cognizant of the fact that if this case were to continue to be litigated, the Commission would be presented with arguments and supporting evidence for each and every position taken by each and every witness sponsored by every party in this case, not just Staff's. It follows that the compromise Qwest reached reflects its assessment of all of the positions and supporting evidence of all of the parties, not just Staff's.
> [Redding Rebuttal Testimony, p. 8, Docket No. T-1051B-99-105]

While negotiated settlement agreements typically contain language regarding their non-precedential nature, the settlement testimony sponsored by Messrs. Brosch and Redding highlight litigation risk and describe the negotiation process. Clearly absent from this testimony is any discussion about reversion to PAYGO accounting or expressed concern that the Commission, in a litigation scenario, would not follow the path of adopting

[52] A copy of Staff Schedule E, reconciliation from Docket No. T-1051B-99-105, is appended hereto as Attachment SCC-3, for reference purposes. FAS106 OPEB does not appear as a contested issue.

FAS106 established in the 1997 rate cases involving Paradise Water Company and Southwest Gas Corporation.

Further, the overall context of the settlement in Qwest's 1999 rate case should be considered. Specifically, the focus of the settlement discussions was not limited to resolving typical rate case issues disputed by the parties. Rather, the extensive negotiations and settlement language signified the departure from traditional regulation and implemented a new regulatory framework that is under evaluation in the instant docket. As a consequence, I do not find it disturbing, dispositve or surprising that OPEB accounting (i.e., PAYGO continuation or adoption of FAS106) was not explicitly addressed in the last rate case settlement agreement, unlike the specific reference contained in the 1997 Southwest Gas Corporation settlement.

Q. Mr. Carver, are you proposing that this Commission go behind a negotiated settlement in order to resolve this issue?

A. No. I am proposing that the Commission consider all relevant information reasonably available from the last proceeding in order to assess whether Qwest Adjustment PFA-02 accurately quantifies the pro forma effect of recognizing accrual basis OPEB expense for ratemaking purposes or materially overstates overall revenue requirement. If the Commission concurs that the information available regarding the regulatory intent of the parties does not support the Company's contention that it has never recovered any accrual basis OPEB costs from Arizona ratepayers, Qwest Adjustment PFA-02 should be modified as proposed by Staff.

It should be noted that, in the 1999 rate case, only AT&T's witness opposed Mr. Redding's OPEB adjustment, as neither RUCO nor Staff opposed Qwest's proposed adoption of accrual accounting for OPEB costs. While AT&T would have certainly been allowed to present its recommendation to the Commission absent the settlement agreement, any presumption that PAYGO accounting was continued in the last case would need to conclude that the Commission was likely to adopt AT&T's recommendation and reject the regulatory policy transition to accrual accounting that commenced in 1997. Based on the information readily available, it is my opinion that the regulatory intent underlying the 1999 settlement agreement was to reflect accrual accounting for OPEB costs as presented by Company witness Redding.

Other Considerations

Q. Has the Company's historical accounting for OPEB costs been influenced by how and whether accrual accounting has been adopted by individual regulatory jurisdictions?

A. Yes. Since the early 1990's, the Company has employed a regulatory recovery, or recognition, "test" in its accounting for other postretirement benefits (OPEBs), as evidenced by the following confidential excerpt from the Company's March 31, 1993, Accounting Standards Ruling 92-02, Accounting for adoption of SFAS No. 106:[53]

> **History**
>
> [redacted]
>
> [redacted]
>
> [redacted]
>
> [Staff Data Request UTI 16-2, Confidential Attachment A, page 2]
>
> ...

[53] Staff Data Request UTI 16-2, Confidential Attachment A, pages 2 & 4.

[redacted]

[Staff Data Request UTI 16-2, Confidential Attachment A, page 4]

As indicated in response to Staff Data Request UTI 2-28, Qwest has continued to keep detailed records comparing its jurisdictional accounting for OPEB costs with the timing and method of regulatory adoption of FAS106. Since the early 1990's, the Company has maintained an "OPEB Allocation Model" ("OPEB Model") to track the timing and method of regulatory adoption of FAS106 for purposes of apportioning OPEB fund contributions and earnings on plan assets to the benefit of those jurisdictions that have adopted FAS106 and required contributions to an external fund.

This detailed OPEB Model contains links to [redacted] that are periodically updated by the Company. This detailed tracking of jurisdictional regulatory treatment and allocation of plan assets/ earnings is in stark contrast to the Company's position regarding the FAS87 Pension Asset. As will be discussed in a subsequent testimony section, Qwest argues that the pension asset should be included in rate base, in part because tracking of the regulatory treatment of pension credits is improper and constitutes retroactive ratemaking.[54]

In the context of pension credits and pension asset accounting, Mr. Grate's direct testimony (page 119) generally addresses the subject of cost recovery and ratemaking principles, including the following excerpt:

> Under the same principles that deem accrued depreciation expense to be recovered by shareholders whether or not it actually was, accrued pension expense debits are deemed to be borne by ratepayers and received by shareholders and accrued pension expense credits are deemed to deemed [sic] to be borne by shareholders and received by ratepayers.[55]

---

[54] As discussed more fully in the pension asset testimony section, Staff disputes the Company's position.
[55] Grate direct testimony, page 119.

Interestingly, Qwest does not follow this recovered as recorded theory when it comes to OPEB costs. Instead, the Company has developed an elaborate jurisdictional tracking model to measure regulatory adoption of FAS106 for purposes of apportioning OPEB contributions and earnings on plan assets to only those jurisdictions that have explicitly authorized and adopted FAS106 and required external funding.

This tracking approach has resulted in an allocation of "zero" plan assets or earnings to Arizona – a sign that at least a portion of the foundation underlying the Company's regulatory approach is comprised of shifting sand that is molded to fit individual circumstances.

Q. How does Qwest account for OPEB costs in its Arizona intrastate regulatory accounting records?

A. This question has been a matter of some confusion. As indicated in the SOP 98-1 section of my direct testimony, Qwest generally maintains its accounting records using methods that may treat certain transactions differently for financial reporting, FCC reporting and State regulatory reporting purposes. The Company's regulatory financial results are initially prepared on a basis consistent with FCC accounting requirements (i.e., an "MR" basis). Differences in accounting treatments or requirements between the FCC and individual State regulatory agencies are typically tracked in the Company's "offbook" or side records (i.e., a "JD" basis), enabling the Company to present operating results consistent with State "jurisdictional" accounting. While not necessarily a complicated concept in and of itself, Qwest's responses to several Staff discovery requests have identified what may be inconsistencies in the Arizona jurisdictional accounting for OPEB costs.

Recognizing that FCC (MR basis) accounting for OPEB costs began to diverge from PAYGO accounting in 1989 and that the Company developed an elaborate OPEB Model to track jurisdictional adoption of FAS106, Qwest's responses to several Staff data requests[56] indicate that the Company has continued to follow accrual methods, not

---

56 Qwest responses to Staff Data Requests UTI 3-1, UTI 3-14, UTI 18-7, and UTI 18-8.

PAYGO, for the Arizona intrastate regulatory accounting of OPEB costs – contrary to Mr. Grate's assertion that Arizona has not deviated from PAYGO accounting.

Q. Please summarize those Qwest discovery responses.

A. The following outline briefly summarizes those responses to Staff data requests:[57]

- UTI 3-1(b): Qwest identified two offbook jurisdictional accounting differences between MR and JD accounting. For Arizona intrastate accounting purposes, the Company reverses the 17.3-year TBO amortization recognized for MR basis accounting. The Company also removes the amortization effect of OPEB costs capitalized prior to 1992 associated with the FCC's early adoption of FAS106 current service costs, but not recognized by Arizona. This response does not indicate that Qwest fully reverses all other accrual accounting entries and recognizes PAYGO costs for Arizona intrastate regulatory reporting.
- UTI 3-14(a) & (c): In describing the unadjusted test year expense allocated to intrastate operations, Qwest stated that all OPEB expense included in its unadjusted test year expense is on an accrual accounting basis – not a PAYGO basis.
- UTI 18-7(a): Referring to the response to UTI 3-14 and Qwest's rate filing, the Company is asked to clarify and explain whether the Arizona intrastate test year starting point on Company Schedule C-1 includes OPEB costs on a PAYGO or accrual accounting basis. The response clearly states: "The Arizona intrastate test year starting point includes OPEB costs on an accrual accounting basis."
- UTI 18-8: Again referring to UTI 3-14, the Company was requested to provide the amount of APBO/TBO amortization expense included in the OPEB accrual basis accounting used for Arizona intrastate regulatory accounting purposes. The response stated: "The Company has not been recording OPEB costs on an accrual basis for Arizona intrastate regulatory purposes. On an Arizona intrastate regulatory basis no TBO (or APBO) amortization has been recorded during the test year."

Based on this information, Qwest has not followed PAYGO accounting for Arizona intrastate regulatory accounting purposes – as would be expected, given the Company's position that Arizona has not adopted accrual basis accounting for OPEB costs. Instead, the Company reversed the APBO/TBO amortization, but largely followed accrual accounting consistent with FAS106. This accounting treatment raises interesting questions in the context of the following testimony section concerning the basis of Qwest's proposed rate base inclusion of the pension asset.

[57] Attachment SCC-6 contains copies of Qwest's complete responses to Staff Data Requests UTI 3-1, UTI 3-14, UTI 18-7 and UTI 18-8.

Q. Please briefly summarize the key elements underlying Staff's proposed TBO amortization.

A. As discussed previously, the adoption of accrual accounting was not disputed by Staff or RUCO in Qwest's last rate case. It is my belief that it was the regulatory intent of the parties in Qwest's last rate case to explicitly recognize the TBO amortization as an added cost of transitioning from PAYGO to accrual accounting, even though the settlement agreement in that docket was silent on the issue. In addition, Qwest has not maintained its Arizona intrastate regulatory accounting records in strict compliance with the PAYGO accounting method adopted by the Commission in Docket No. E-1051-93-183 (Decision No. 58927). Based on this information and history, Staff has recognized accrual accounting for OPEB costs in developing overall revenue requirement, including the amount of the TBO amortization requested by Qwest and not opposed by Staff in Docket No. T-1051B-99-105.

FAS87 PENSION ASSET

Q. Is Staff proposing an adjustment to the Company's proposed inclusion of the pension asset in rate base?

A. No.

Q. If Staff is not opposing the Company's proposed treatment of the pension asset, why is Staff presenting testimony on this issue?

A. Since Staff has opposed similar recommendations in prior Qwest rate proceedings, the basis for Staff's non-opposition should be clearly communicated. As discussed previously, I believe the Company has misconstrued and misinterpreted Staff's non-opposition to the regulatory recognition of accrual accounting for OPEB costs in Qwest's last rate proceeding (Docket No. T-1051B-99-105) – a problem Staff desires to avoid in future proceedings concerning either OPEB costs or the pension asset.

Q. Why is Staff not opposing inclusion of the pension asset in rate base?

A. Updated Staff analyses of pension credits presumably recognized in the ratemaking process now indicate that Qwest's Arizona intrastate customers have substantially participated in cumulative pension credits, supporting rate base inclusion .

Q. Have you addressed this issue in past rate proceedings involving Qwest?

A. Yes. The following table identifies the Qwest proceedings in various jurisdictions in which I have sponsored testimony opposing the inclusion of a pension asset in rate base:

Jurisdiction	Case / Docket	
Arizona Corporation Commission	E-1051-93-183	(a)
	T-1051B-99-105	(a)
Utah Public Service Commission	97-049-08	(a)
Washington Utilities and Transportation Commission	UT-930074	(b)

Note (a): Rate case proceedings. Note (b): AFOR – sharing proceeding.

Q. In the proceedings identified in this table, did you recommend the complete elimination of the pension asset from rate base?

A. Yes. In those proceedings, my pension asset analyses were similar to those prepared in the current proceeding and resulted in recommendations excluding the pension asset from rate base. Absent a demonstration that ratepayers had materially participated in the cumulative pension credits comprising the pension asset, my analyses fairly consistently questioned whether the alleged benefits were instead enjoyed by investors, not ratepayers.

<u>Pension Cost Accounting</u>

Q. Please describe the events or circumstances giving rise to the pension asset.

A. In December 1985, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 87 ("FAS87"), concerning employers' accounting for pension costs. Qwest adopted FAS87 for financial accounting purposes effective January 1, 1987. Prior to FAS87, the amount of pension costs distributed to expense and capital accounts was equal to the level of contributions actually made to the pension fund. After the adoption of FAS87, pension costs expensed/ capitalized and pension contributions began to diverge. Since the adoption of FAS87, Qwest began recording <u>negative</u> pension costs (a pension credit) instead of positive pension costs. The pension asset balance represents the accumulation of those pension "credits".

<u>Staff Approach</u>

Q. Could you briefly outline the rate base concept?

A. Rate base is commonly viewed as being comprised of net utility asset investments used and useful in providing service to customers. When investors provide the funds necessary to support these company investments, those amounts are generally included in rate base, allowing investors an opportunity to earn a return on invested capital. Similarly, funds advanced, reimbursed, or otherwise paid for by customers are properly excluded from rate base. The direct testimony of Company witness Grate (page 116) discusses various reasons supporting rate base recognition of the pension asset, including:

- The pension asset is a capital asset.
- Investors have contributed the capital for the pension asset.
- There is no sound reason for denying investors a return on the pension asset.

Q. Does the mere existence of pension credits result in an automatic and substantial decrease to the cost of service benefiting ratepayers?

A. No. Under traditional utility regulation, utility rates are based on a test year cost of service, theoretically designed to balance the various components of the ratemaking equation. Once determined, those rates are generally considered just and reasonable until a moving party presents evidence that the utility is materially under, or over, earning the authorized return in support of revised rates. In general terms, the utility is considered to have recovered all costs recorded between rate cases and achieved a reasonable return on its rate base investment.

However, it is not uncommon for regulators to be presented with issues associated with accounting changes (e.g., transition from pay-as-you-go to FAS106 accrual accounting for OPEB costs, adoption of FCC Part 32 capital to expense shifts), cost deferrals (e.g., storm damage, demand-side management costs), amortization requests (e.g., depreciation reserve deficiency, workforce reduction program costs) or tracking mechanisms (fuel cost trackers) that deviate from this general framework. If the mere recording of a transaction meant that ratepayers symmetrically funded increases and benefited from decreases in expense, there would seem to be no need for the deferral, cost tracker or amortization issues that arise in utility regulation. The fact is that such issues do arise and have existed for many years. Rather than dismissively reject these requests, regulators typically review the facts and circumstances unique to each situation and determine whether the regulatory treatment requested by the utility should be accepted, rejected or modified.

The pension asset is no different. While negative pension credits have been recorded since the late 1980's, the question is whether Arizona ratepayers have adequately participated in the reduced expense to support rate base inclusion of the pension asset. In other words, have negative pension costs been included in the cost of service or somehow separately flowed through to customers "as recorded" each year since the adoption of FAS87? If the ratepayers are not the beneficiaries of those pension credits, then the Company and its investors are the only remaining parties that could have benefited from the cost reductions through higher earnings than would have otherwise been achieved.

While Mr. Grate has alleged that investors have "supplied capital to fund the pension asset," he has provided no factual support for the $97 million pension asset Qwest proposes to include in intrastate rate base, gross of ADIT reserves. Such treatment is appropriate only if it is reasonably demonstrated that a comparable level of cumulative pension credits have been flowed through to the benefit of Qwest's Arizona ratepayers.

Q. Do you believe that ratepayers receive the benefit of pension credits merely as a result of recording the negative pension costs?

A. No. The mere act of recording costs or credits does not conclusively demonstrate "who" may have funded, or benefited from, the pension credits. Since Qwest has sought rate base treatment of the pension asset, Qwest should bear some burden to demonstrate that such inclusion is proper. When rate base inclusion is premised on the "as recorded" concept (i.e., the company recorded credits so ratepayers have benefited), I disagree with reliance only on that premise for determining ratepayer <u>benefit</u> and rate base inclusion. Absent some attempt to assess ratepayer participation in those cumulative pension credits, Qwest's rate base proposal would charge ratepayers with a rate base return on funds they may have never received – unnecessarily benefiting Qwest and its investors.

Q. Are you suggesting that the Commission engage in retroactive ratemaking?

A. No, absolutely not. I do not propose or suggest that Qwest should pay back past excessive profits or recoup past operating losses, as implied by Mr. Grate.[58] Instead, the retrospective review would solely be used to gauge the extent of benefits received by ratepayers or retained by investors in determining the amount of the pension asset balance includable in rate base.

Q. Please explain.

A. Prior to FAS87, the pension costs charged to expense/capital accounts and contributed to the pension fund were equal. Subsequent to FAS87, the Company has recorded negative pension costs and made no further pension fund contributions. In order to establish whether ratepayers have inappropriately benefited to the investors' detriment, neither the act of recording costs nor making contributions necessarily establish the pension cost amount ratepayers have "invested" in or "benefited" from through cost of service.

In assessing whether these pension credits have inured to the benefit of ratepayers to the detriment of investors, Qwest would need to demonstrate that the cumulative pension credits reasonably flowed through to its Arizona intrastate customers equal or exceed the pension asset it proposes to include in rate base. In past Qwest proceedings, I have stated that, based on the results of my analyses, Qwest could not demonstrate substantial ratepayer benefits to support inclusion of the pension asset in rate base. While my prior testimonies were accurate, updated analyses now indicate that Arizona ratepayers have received sufficient pension credit benefits to support rate base inclusion.

Q. At page 117 of his direct testimony, Mr. Grate contends that your approach "was not used for any other element of rate base." How do you respond?

---

[58] See Grate direct testimony, page 118, footnote 67.

A. I agree that this approach is generally not used for other elements of rate base. However, that criticism fails to address the key points of concern relative to this issue:

- Have ratepayers benefited from the pension credits?
- If so, by how much?
- Is the cumulative extent of those benefits enjoyed by ratepayers sufficient to include the pension asset in rate base?

The implementation of FAS87 resulted in a significant shift in accounting method from a cash basis to an accrual basis – a shift implemented by the Company for accounting purposes outside the context of a rate proceeding. This shift resulted in Qwest recording negative expenses (i.e., pension credits) for fifteen of the past seventeen years. Because the existence of these pension credits are the sole cause of a pension asset being recorded, I believe that it is responsible and reasonable for regulators to question the extent to which ratepayers, not the Company and its investors, have enjoyed the benefits of those annual pension credits.[59]

In this context, Mr. Grate (direct testimony, p. 119) discusses the subject of cost recovery and general ratemaking principles, including the following excerpt:

> Under widely accepted ratemaking principles, the recorded balances for accumulated deprecation [sic] are included in rate base without imposition of any test to prove that shareholders actually recovered the depreciation expense accruals that created the accumulated depreciation balances. There is no rational basis in regulatory accounting or law for asserting that the pension asset should be subject to a recovery test (especially one that is impossible to satisfy) before it too is included in rate base.[60]

It is rather curious that Mr. Grate would suggest that it is improper and irrational to subject any cost of service item to a "recovery test." Although Staff's recommendations on the regulatory treatment of other postretirement benefits (OPEBs) are more fully addressed in another section of my direct testimony, Qwest's own accounting for this item has used just such a "recovery test" since the early 1990's resulting in the Qwest denying Arizona ratepayers any participation in external OPEB fund assets or earnings on

[59] A benefit-burden test.
[60] Grate direct testimony, page 119.

plan assets – because this Commission continued pay-as-you-go ("PAYGO") regulatory accounting for OPEB costs, rather than adopt accrual accounting in the early 1990's.

As indicated in the "Test Year" section of my testimony, all components of the ratemaking equation change over time – revenues, expenses and investment. As each component changes, a utility should have a reasonable opportunity to achieve its authorized return (i.e., not materially over or under earn), so long as the components remain in relative balance or changes to one component are mitigated or offset by changes to the other. I generally agree with Mr. Grate that the prohibition against retroactive ratemaking presumes that recorded costs are assumed to be recovered, regardless of explicit inclusion in cost of service.[61] This presumption holds the utility accountable for incurred costs and prevents a potentially abusive process of collecting past earnings deficiencies from current and future ratepayers.

Since adoption of FAS87, the amount of pension credits recorded by Qwest has varied significantly from year to year.[62] In the absence of rate case activity or some mechanism to flow the volatile annual pension credits through to benefit ratepayers, FAS87 pension accounting may have resulted in large pension credits increasing utility income and investor returns. Contrary to implications otherwise, Staff's evaluation of this issue is <u>not</u> designed, intended nor does it result in a retrospective inquiry of past earnings to impose a surcharge for past under-recoveries or a refund for past over-recoveries. Instead, Staff's approach is designed to evaluate, based on available information, whether it is reasonable to assume that ratepayers have sufficiently enjoyed the benefits of the ever fluctuating pension credits (supporting rate base inclusion of some portion of the pension asset) or whether the resulting earnings benefits have been retained by investors (supporting the rate base exclusion).

[61] Qwest Adjustment PFA-02 (OPEB pro forma) values the APBO and selects an amortization period assuming adoption of accrual accounting in 2003, contrary to this very presumption.

[62] The amount of annual pension costs recorded since 1987 have ranged from a positive [redacted] to a negative (credit) of [redacted].

Q. Since Qwest's adoption of FAS87, how does the amount of pension costs included in cost of service compare to the pension credits recorded by the Company?

A. Although it is not possible to precisely quantify the amount of accumulated net pension recoveries from or benefits provided to ratepayers over the decades predating or following the adoption of FAS87, I have prepared a series of calculations which attempt to estimate the level of pension credit benefits ratepayers might have received since the adoption of FAS87. Relying on Company responses to discovery in Docket Nos. E-1051-93-183[63] and T-1051B-99-105,[64] the following table attempts to show the amount of pension credits that might have been flowed through to ratepayers in each proceeding immediately preceding or following the adoption of FAS87.

Arizona Intrastate – Net Pension Expense
(000's)

ACC Docket	Order Date		Ratemaking Pension Expense
84-100	1/10/86		$12,200
88-146	3/01/89	(a)	(600)
91-004	7/15/91	(a)	(9,900)
93-183	1/03/95		(9,000)
99-105	4/1/01	(a)	(13,719)

Source: Qwest response to Staff Data Request UTI 3-10.
Note (a): Resolved by negotiated settlement.

Using this information, I have prepared two analyses of the net pension credits that might have been flowed through to ratepayers. Both analyses cover the same time period, starting in 1987 and continuing through 2003. While similar in appearance, Appendices SCC-4 and SCC-5 are different in one material respect – how the amount of pension credits flowed through to ratepayers are determined when a rate proceeding is resolved by negotiated settlement, rather than by a regulatory decision in a litigated proceeding.

Appendix SCC-4 recognizes that three of Qwest's Arizona proceedings since the late 1980's (i.e., Docket Nos. E-1051-88-146, E-1051-91-004 and T-1051B-99-105) were

[63] Company responses to Staff Data Request Nos. 191, 386-388 (Docket No. E-1051-93-183).
[64] Company responses to Data Request Nos. UTI 3-12, UTI 20-5 & RUCO 28-3 (Docket No. T1051B-99-105).

resolved by negotiated settlement. Because of these settlements, Appendix SCC-4 assumes that the positive or negative pension costs included in the preceding litigated rate case would continue to be reflected in rates until the next litigated proceeding. Such an assumption would indicate that ratepayers may have provided Qwest with cumulative positive pension expense of $16.6 million, as compared to the negative $97.3 million of cumulative pension credits Qwest proposes to include in rate base.

In contrast, the analysis set forth in Appendix SCC-5 assumes that it is reasonable to consider all relevant information available to assess regulatory intent and estimate the amount of pension credits underlying negotiated settlements, in order to identify amounts included in rates and flowed through to the benefit of ratepayers. Under this approach, in spite of typical non-precedential language contained in settlement agreements, Appendix SCC-5 indicates that ratepayers may have participated in cumulative negative pension expenses exceeding $100 million, supporting rate base inclusion of the pension asset .

Q. Since these two analyses yield significantly different results, why are you recommending that Qwest be allowed to include the pension asset in rate base?

A. It may not be possible to accurately or precisely quantify the exact amount of cumulative net pension recoveries from or benefits provided to ratepayers, particularly over the decades predating the adoption of FAS87. Admittedly, these two analyses produce dramatically different Arizona-specific estimates of the pension credit benefits ratepayers might have received since the adoption of FAS87, due to the valuation treatment of settled rate proceedings. However, in past Arizona rate cases, both analyses consistently indicated that ratepayers had not yet received substantial cumulative benefits from the pension credits to support rate base inclusion of the pension asset. For the first time, the Arizona analysis depicted on Appendix SCC-5 shows that the situation has changed, at least when test year pension credits involving settled proceedings are considered.

Q. In describing Appendices SCC-4 and SCC-5, you indicated that three of the rate cases were resolved by negotiated settlement. Have you previously filed testimony that you were unable to determine what amount of pension credits may have been flowed through to ratepayers as a result of the settlement process?

A. Yes. I have taken the position that, in assessing the amount of pension credits flowed through to ratepayers, only those orders which specifically address the various components of cost of service be considered. Settlements are typically non-specific, by design, and entail any number of compromises in the interest of reaching an acceptable resolution. By its very nature, a settlement agreement reflects a compromise that can often be valued in various ways, not necessarily reflecting the filed positions of any particular party.

However, on further reflection, the amount of pension credits recognized in the three Arizona proceedings resolved by negotiated settlement appear to have been uncontested, at least by Staff. As such, the amount of pension costs recognized in those proceedings would not have necessarily changed, even if each case been litigated. As a result, Appendix SCC-5 appears to better reflect ratepayer participation in the Arizona pension credits.

Q. Do you believe that all elements of the cost of service included in past rates should be reconciled with current cost levels to determine prospective rate treatment for each item?

A. No. As a matter of ratemaking policy, I do not recommend that the Commission rely solely on or otherwise reconcile past decisions in establishing cost of service for future periods. However, the consideration of past rate orders is indeed relevant in assessing whether investors have some claim to inclusion of the pension asset in rate base. As discussed above, Staff is recommending the inclusion of the pension in rate base.

VOICE MESSAGING – STATE DEREGULATED SERVICE

Q. What is the purpose of Staff Adjustments B-8 and C-24?

A. In direct testimony, Staff witness Rowell recommends Commission approval of Qwest's pending requests to deregulate both Voice Messaging Services and Intrastate Billing and Collection Services for Arizona intrastate regulatory purposes. Because of Staff's recommendation, Staff Adjustments B-8 and C-24 remove the effects of Voice

Messaging Service from the determination of test year rate base and operating income used in the quantification of overall revenue requirement. These adjustments, which Qwest did not propose, have the affect of increasing overall revenue requirement.

Q. Since Staff is also recommending the Arizona deregulation of Intrastate Billing and Collection Services, do these adjustments also remove this service from rate base and operating income?

A. No. According to the response to Staff Data Request UTI 7-15, Qwest has included intrastate billing and collection in the Arizona test year revenue requirement, but cannot separately identify the expenses and investment attributable to this intrastate service. Absent a reasonable quantification offered by Qwest in rebuttal testimony or as a supplemental response to Staff Data Request UTI 7-15, Staff is unable to remove this service from Arizona revenue requirement.

FCC DEREGULATED SERVICES IMPUTATION

Q. Please describe Staff Adjustment C-19.

A. In quantifying overall revenue requirement, the Company has included above-the-line (or imputed for intrastate ratemaking purposes) all revenues, expenses and investment associated with the provision of FCC deregulated services (except for Public Pay Phone) in the State of Arizona. Staff Adjustment C-19 imputes additional revenues above-the-line for intrastate regulatory purposes in order to ensure that the earnings deficiency associated with these FCC deregulated services are not fully borne (or cross-subsidized) by the customers subscribing to Qwest's Arizona intrastate regulated products and services.[65]

Q. Has Staff recommended that any of Qwest's FCC deregulated services also be explicitly deregulated in the Arizona intrastate jurisdiction?

A. Yes. Staff witness Rowell is sponsoring testimony that recommends approval of the Company's pending application to deregulate Voice Messaging Service in the intrastate

65 Staff Adjustment C-19 limits the imputed revenues to 50% of the amount required to recognize full revenue imputation, consistent with the findings of the Commission in Decision No. 58927 (Docket No. E-1051-92-183).

jurisdiction.[66] Separate adjustments (Staff Adjustments B-9 and C20) remove the rate base and operating income effects of Voice Messaging Service from cost of service, consistent with this Staff recommendation.

Q. Please describe the reference to FCC deregulated services.

A. In general, Qwest provides a variety of services in Arizona that fall into one of four "jurisdictional" categories: interstate FCC regulated services; intrastate ACC regulated services; services that have been either deregulated or never regulated by the FCC; and services that have been either deregulated or never regulated by the ACC.

Qwest maintains its Arizona accounting records pursuant to FCC Part 32 (the uniform system of accounts or "USOA") on a "total" State basis. FCC Part 36 governs the jurisdictional separation (i.e., allocation or assignment) of the "total" State amounts between interstate and intrastate operations. However, the Part 36 separations rules require that nonregulated results be determined (for the FCC deregulated services) pursuant to FCC Part 64 rules and be removed before the jurisdictional separation process allocates the remaining costs between the interstate and intrastate spheres of Qwest's Arizona operations. FCC deregulated services are specifically excluded from <u>interstate</u> regulated operating results.

Q. In the aggregate, does the inclusion of the FCC deregulated services above-the-line for intrastate ratemaking purposes have the effect of increasing or decreasing the Company's overall revenue requirement?

A. As set forth on Staff Adjustment C-19, the effect of Qwest's proposed treatment increases rate base by approximately [redacted] and decreases net operating income by about [redacted]. Overall, the Company's proposed above-the-line inclusion of the FCC deregulated services increases revenue requirement by about $13.2 million, based on Staff's proposed capital structure and cost rates. However, Staff Adjustment C-19 only recognizes, or imputes, 50% of this revenue requirement impact.

---

[66] Although the ACC has not yet deregulated any of the FCC deregulated products, the only pending deregulation application filed by Qwest concerns Voice Messaging Service and Intrastate Billing and Collection (Docket No. T-1051B-98-0575). See Qwest's response to Staff Data Request UTI 1-13.

Q. How does Staff Adjustment C-19 protect Qwest's Arizona intrastate customers from bearing, or cross-subsidizing, the earnings deficiency attributable to the FCC deregulated services?

A. Qwest's R14-2-103 Filing supports a higher revenue requirement due to the imputed revenue deficiency (i.e., above-the-line inclusion of the net operating loss and rate base investment) associated with the FCC deregulated services. Full imputation would recognize the amount of additional revenues required for these FCC deregulated services to generate an above-the-line return on investment, or net operating income, equivalent to the weighted cost of capital proposed by Staff for the Arizona regulated services. However, Staff Adjustment C-19 recognizes that the Commission did not adopt Staff's full revenue imputation proposal in Docket No. E-1051-93-183. While not eliminating the entire revenue deficiency resulting from the Company's proposed above-the-line treatment, Staff Adjustment C-19 mitigates the loss otherwise attributed to the remaining Arizona intrastate customers.

In addition, those FCC deregulated services that are provided pursuant to Commission approved tariff (i.e., Premises Services, E911 and National Directory Assistance) have been excluded from the calculation of the 50% imputation adjustment.

Q. If the Commission's final order adopts a weighted cost of capital different than that proposed by Staff, would it be necessary to recalculate Staff Adjustment C-19 to reflect such change?

A. Yes. If the Commission were to adopt different values for the FCC deregulated services (rate base, revenues, or expenses) than proposed by Staff or a different capital structure or cost rates than recommended by Staff, it would be necessary to recalculate the effect of Staff Adjustment C-19, unless such changes had an immaterial effect on the calculation of imputed revenues.

Q. Are you recommending that the Company not continue to provide these services?

A. No. The purpose underlying the Staff's recommendation is to ensure that the earnings deficiency associated with the Company's provision of FCC deregulated services is not borne by regulated ratepayers. If Qwest desires to provide these various services in such a manner that produces marginal or negative margins, Staff is not seeking to interfere with that management discretion.

FCC Deregulated Services – Unadjusted Financial Results

Q. Earlier, you indicated that Qwest's FCC deregulated services produce marginal or negative margins. Since Staff and Company have previously addressed this issue in prior rate cases, did Staff attempt to determine whether Qwest viewed those marginal results to be acceptable?

A. Yes. Staff Data Request UTI 9-9 specifically inquired whether Qwest viewed as acceptable the test year operating results of those FCC deregulated services, which operated at a loss or produced small positive earnings. In its confidential response, Qwest pointed to the 2003 unadjusted loss on its Arizona intrastate <u>regulated</u> operations (citing to Rule R14-2-103 Filing, Schedule A-2 "Summary Results of Operations"), which shows a return on investment of a negative 9.09%. In this context, Qwest replied to the discovery question, as set forth in the following confidential excerpt:

[redacted]

[redacted]

[redacted]

Q. Do you concur with the Company's apparent view that the test year operating results achieved by the FCC deregulated services are superior to and more acceptable than Arizona's regulated intrastate jurisdiction as a whole?

A. No. There are certain deficiencies in the Company's response that should be addressed. First, citing to Schedule A-2 of the Company's R14-2-103 filing, Qwest fails to recognize that the unadjusted intrastate regulated return on investment of a negative 9.09% includes an unadjusted net loss of about [redacted] for the very FCC deregulated services the Company proposes to include above-the-line in quantifying Arizona intrastate revenue requirement. Although the exact amount of the average net investment of the FCC deregulated services also included in the calculation of the negative 9.09% intrastate regulated return is not readily available, Qwest's confidential response to Staff Data Request UTI 1-13 supports an average investment of about [redacted]. Contrary to the Company's assertion that the FCC deregulated services generated a "corrected" [redacted] return on average net investment during 2003, those very same FCC deregulated services contributed a [redacted] on average investment (excluding payphone) that is embedded in the cited 9.09% negative intrastate regulated return on investment.

Second, these returns on average investment are based on net income before interest expense. On a net income basis, the FCC deregulated services generated a return on average investment during 2003 in excess of a [redacted] (excluding payphone).

Third, it should be noted that the need to present "corrected" financial results now attributed to FCC deregulated services (excluding payphone) was the result of Qwest compiling the response to Staff Data Request UTI 9-8.[67] According to that response, the Company's review of the expenses assigned to "Planning for Enhanced Services" ("Planning") determined that "a majority of these amounts should have been assigned to deregulated payphone" product code, not the Planning category. This "correction" had the effect of shifting about $9.9[68] million of expense from Planning to Payphone. Although the "correction" has been quantified by Qwest and accepted by Staff, the recognition of that correction for revenue requirement purposes does not correct the "error" embedded in the unadjusted operating results cited by Qwest.

Finally, the unadjusted returns on average investment cited by the Company fail to conform with the realities of Qwest's recommendations in this proceeding and the pro forma adjustments included in its revenue requirement calculations. For example, overall revenue requirement is based on end-of-period, not average, rate base. Further, Qwest Adjustment PFN-03 is based on a series of regression analyses, resulting in a significant decrease in test year revenues attributable to the very FCC deregulated services that the Company has included above-the-line for Arizona intrastate revenue requirement purposes. In the aggregate, Qwest's adjustments reduce test year revenues for these services by about $14 million, causing a significant deterioration in the otherwise [redacted] ([redacted] "corrected") return on investment Qwest claims to have been generated during the test year.

Products and Services

Q. Could you briefly identify the various products and services which are included in the category of FCC deregulated services that Qwest has proposed to recognize above-the-line?

A. Yes. The following table lists the eleven FCC deregulated product categories that Qwest has included above-the-line, indicates whether the services are offered pursuant to tariffs

---

67 Staff Data Request UTI 9-8 sought information regarding the specific planning, development, research, marketing and deployment activities undertaken during 2003 that contributed to the operating results associated with the FCC deregulated service category "Planning for Enhanced Services."

68 Qwest non-confidential response to Staff Data Request UTI 9-8 quantifies the effect of reclassifying the Planning charges to Payphone.

approved by the ACC and identifies which "basket" of the Arizona Price Cap Plan the various products are included:

Product	ACC Tariff?/ Basket	Pricing Flexibility
1. Protocol Conversion	No	Unregulated
2. Premises Services	Yes/3	May increase rates; price changes limited to Basket 3 revenue cap.
3. Customer Dial Account Recording	No	Unregulated
4. Voice Messaging	No/3	Detariffed since introduced in late 1980's; price changes limited to Basket 3 revenue cap.
5. E911 Nonregulated	Yes/1	May increase rates; price changes limited to Basket 1 revenue cap.
6. Information Services	No	Unregulated
7. National Directory Assistance	Yes/3	May increase rates; price changes limited to Basket 3 revenue cap.
8. Joint Marketing	No	Marketing for unregulated Direct TV & Affiliate Billing; not offered to AZ customers. Priced per FCC affiliate transaction rules.
9. Unregulated Wholesale	No	Unregulated
10. Unregulated Alarm	No	Unregulated
11. Planning for Enhanced Services	No	Unregulated

Source: Qwest (non-confidential) response to Staff Data Request UTI 9-16.

Of these eleven services, three (3) are provided pursuant to ACC approved tariffs and four (4) are included in Arizona Price Cap Plan Baskets (one in Basket 1 and three in Basket 3). Only Voice Messaging has been detariffed since its introduction in Arizona, but has been included in Basket 3. Staff is recommending the intrastate deregulation of this service.

Q. Is Qwest losing money on these FCC deregulated services?

A. Based on the response to Staff Data Request UTI 9-9, these eleven (11) FCC deregulated service categories produced [redacted] "corrected" net operating income during the test year.. Attachment SCC-7, page 1, shows the "corrected" test year operating results and end-of-period rate base investment, before recognizing Qwest's pro forma ratemaking adjustments, for these eleven FCC deregulated service categories.[69]

[redacted] were the only FCC deregulated service categories that generated relatively significant [redacted] income during the test year, thereby minimizing the net loss from all other FCC deregulatedsServices. With regard to Voice Messaging, the Company previously filed a petition with the ACC to deregulate this service, which Staff witness Rowell is now recommending be adopted – along with intrastate billing and collection services. Absent the earnings generated by this service, the net operating income summarized on Appendix SCC-7 becomes a net loss, before recognizing Qwest's pro forma ratemaking adjustments.

Q. In quantifying the imputed revenues, does Staff Adjustment C-19 recognize the Company's pro forma ratemaking adjustments that impact these FCC deregulated services?

A. Yes. Staff Adjustment C-19 does incorporate the reduction in FCC deregulated revenues proposed by Qwest via Company Adjustments PFN-01, Out-of-Period, and PFN-03, Revenue Trending as well as the elimination of the NOI and rate base amounts attributable to Voice Messaging.

Q. Over the past several years, has the Company revised the prices charged for its individual FCC deregulated service offerings?

A. Yes. Confidential Attachment SCC-7, page 2, summarizes the price changes for the FCC deregulated services identified by the Company in response to Staff Data Requests UTI

[69] Staff Adjustment C-19 incorporates the additional nonregulated revenue reductions contained in Qwests Adjustments PFN-01, Out-of-Period, and PFN-03, Revenue Trending (regression analyses).

9-6 and UTI 9-7.[70] According to the referenced responses, the pro forma affect of the 2003 price changes are already reflected in the test year, but no quantification of the pro forma impact of price changes in other calendar years was provided, as a special study would be required.

Above-the-Line vs. Below-the-Line Recognition

Q. Why has Qwest included the earnings deficiency associated with these FCC deregulated services above-the-line for Arizona intrastate revenue requirement purposes?

A. Generally, Qwest has taken the position that all FCC deregulated services (except Payphone) should be considered as intrastate regulated services and included above-the-line for intrastate regulatory purposes, absent specific ACC decisions or orders deregulating such services.[71] Referring to the earlier table, only three of the eleven FCC deregulated services are provisioned under Commission approved tariffs, with Qwest describing its pricing flexibility in Arizona as "unregulated" for the remaining eight FCC deregulated services. Contrary to any assertions otherwise, Qwest has provided no clear and convincing evidence establishing that all of the FCC deregulated services are properly recognized above-the-line for intrastate revenue requirement purposes, absent imputing additional revenues as proposed by Staff.

Q. Do you believe that the Company's proposed above-the-line recognition of the FCC deregulated services protects intrastate customers from cross-subsidizing those services?

A. No. In my opinion, the inclusion of the FCC deregulated service above-the-line in calculating intrastate revenue requirement does not protect intrastate customers from potential cross-subsidies, as envisioned by the FCC's Part 64 accounting rules. By including the FCC deregulated services above-the-line, the Company has ignored protections addressed in the Part 64 rules, by reflecting the aggregate pro forma losses experienced by these services and related net investments above-the-line without any revenue imputation – contrary to the ACC's order in Qwest's last Arizona rate case (Docket No. E-1051-93-183).

---

[70] Qwest considers all pricing information for all FCC deregulated services, other than joint marketing, to be confidential.

[71] Direct testimony of Qwest witness Grate, pp. 130-131.

Q. Why do you believe that revenue imputation is the appropriate response to the Company's request to include the FCC deregulated services above-the-line?

A. There are several reasons why revenue imputation is an appropriate remedy for this issue.

First, Staff's proposed revenue imputation only applies to the seven (7) FCC deregulated services that are not provided pursuant to Qwest tariffs approved by this Commission.[72] Consequently, Qwest has complete discretion over the pricing of the services included in these product categories. If the Company believes that deregulated product revenues are unacceptably insufficient to cover the recorded cost of a service or group of services, the appropriate response would be for the Company to decrease costs and/or increase the price charged – not attempt to attribute any losses to the Company's intrastate customers taking regulated, tariffed services. To the extent that Qwest exercises discretion over the pricing of its FCC deregulated services, it should be shareholders, not ratepayers, who are accountable for any losses from such operations.

Second, Qwest can (and has) increased the prices charged for certain FCC deregulated services subsequent to the test year. In doing so, the pro forma operating loss attributed to the test year has and could further change, resulting in the above-the-line test year losses no longer being representative of ongoing conditions. The combination of post-test year price changes <u>and</u> Commission adoption of Qwest's above-the-line recommendation could result in the double-recovery of a portion of the pro forma losses attributed to Qwest's FCC deregulated services.

Third, Qwest could choose to provision financially promising FCC deregulated services through a separate affiliate, rather than by Qwest Corporation pursuant to Part 64 rules. This could result in all FCC deregulated services that are "losing" money being provisioned by Qwest and theoretically includable above-the-line for Arizona regulatory purposes, while potentially profitable FCC deregulated services could be provisioned by

[72] Of the eleven FCC deregulated services, three are provided pursuant to ACC approved tariffs and one is detarriffed. The remaining seven services are considered in the quantification of Staff Adjustment C-19.

a separate affiliate and insulated from offsetting less successful above-the-line services. Under such a scenario, adoption of the above-the-line recommendation without at least partial revenue imputation could result in the Company's regulated customers providing direct subsidies to the FCC deregulated services, depending on the structure of any revisions to the Arizona Price Cap Plan and whether regulated rates are revised.

Fourth, FCC Part 64 [47 CFR 64.901] requires carriers, such as Qwest, to separate their regulated and nonregulated costs using the attributable method of cost allocation. Part 64, which resulted from FCC orders in CC Docket No. 86-111, established procedures intended to protect interstate regulated operations from cross-subsidizing the nonregulated activities of the telecommunications industry. All nonregulated revenues and costs, consistent with Part 64, are removed from a carrier's operating results prior to the jurisdictional separation of the remaining regulated costs between interstate and intrastate operations. The Company's above-the-line treatment has the effect of shifting 100% of the potential cross-subsidy to those customers subscribing to Qwest's Arizona <u>intrastate</u> regulated services. I do not believe that such a shift in cost responsibility is the appropriate or intended result of the FCC's actions to protect <u>interstate</u> regulated services. Rather than impute additional revenues to offset the entire revenue requirement shortfall for the seven FCC deregulated services, Staff has proposed only a 50% imputation consistent with Commission Decision No. 58927.

Q. Would it be possible to achieve a result comparable to above-the-line imputation by simply moving the FCC deregulated services below-the-line?

A. Yes. Under full revenue imputation, which Staff is not currently recommending, the revenue requirement impact of these two alternatives would be identical. However, I have not proposed an adjustment moving the FCC deregulated services below-the-line out of concern whether Commission adoption of such treatment could be construed by Qwest as the intrastate deregulation of those individual services, even though no detailed investigation of the individual services has been presented or conducted.

ACC Decision 58927, Docket No. E-1051-93-183

Q. At pages 128-132 of his direct testimony, Mr. Grate discusses certain adjustments Qwest has not recognized in its R14-2-103 Filing, even though the Commission had addressed these areas in prior Arizona rate case orders. Did Qwest propose any ratemaking adjustments relating to the FCC deregulated services?

A. Yes. Qwest has presented several proposals in this regard:

- Qwest included its FCC deregulated services above-the-line for Arizona intrastate ratemaking purposes;
- Qwest proposed pro forma revenue adjustments that reduced test year FCC deregulated service revenues; and
- Qwest quantified and applied higher composite Arizona intrastate separation factors, recognizing the FCC deregulated services as intrastate services, resulting in a larger portion of each Company accounting, normalizing and pro forma adjustment (requiring jurisdictional separation) being attributed to intrastate operations for revenue requirement purposes.

What Qwest has not done is to recognize any imputed revenues to offset any portion of the pro forma revenue requirement related to the inclusion of these FCC deregulated services above-the-line for intrastate purposes. With regard to the imputation of revenues for FCC deregulated services, Staff Data Request UTI 1-11 identified the absence of such an imputation adjustment in the Company's R14-2-103 filing and sought the calculation of the adjustment that would be required if the Commission's ruling in the Company's 1993 rate case was implemented without re-litigation. Qwest's response observed, in part, that the Commission only approved 50% of Staff's adjustment and declined to provide the requested calculation.

Q. Are you familiar with that portion of ACC Decision 58927 which addresses the issue identified as FCC Deregulated Services?

A. Yes. I sponsored testimony on behalf of the Staff on that issue. In general terms, Qwest has accurately paraphrased the Commission's actions as set forth in Decision No. 58927, Docket No. E-1051-93-183. The Commission discussed the FCC deregulated services issue at pages 21-23 of ACC Decision 58927, including the following excerpts:

> ...Prior to FCC deregulation, these services were subject to the separation process. As a result of deregulation, the FCC has ruled that the services must be excluded from interstate costs and ratemaking. In this case, U S West has proposed to include all of the revenues, expenses and investment associated with its FCC deregulated services above-the-line for intrastate ratemaking purposes. According to the Company, the prices for these services are market based but do not cover their fully distributed costs.
>
> According to Staff, interstate deregulation should not by itself increase expenses to the intrastate jurisdiction. The services in question have expenses of approximately $7 million more than the associated revenues. Hence, the Company's proposal will result in other Arizona customers bearing the burden of the $7 million deficiency....As part of its case, the Company requested a $5,356,330 increase in revenues for inside wire charges. Staff concurred with the Company's proposed increase as part of its overall rate design in the case. Staff then imputed additional revenues of $1,662,000 to offset the remaining deficiency for the FCC deregulated services.
> [ACC Decision 58927, p. 21-22]

Qwest's recommendation in the current proceeding has not changed from its position in its last two rate cases (Docket Nos. E-1051-93-183 and T-1051B-99-105). The Company has once again proposed to include the pro forma net loss and rate base investment associated with the FCC deregulated services above-the-line for intrastate ratemaking purposes. Except for changes in the dollar values contained in the above excerpts, the summary of this issue from that Arizona rate case continues to apply today.

Q. Did ACC Decision 58927 adopt the Staff's revenue imputation proposal?

A. The Commission did adopt the concept of revenue imputation, but not the full amount recommended by the Staff. The following discussion appears at page 22 of Decision 58927:

> ...As to the remaining revenue deficiency for the FCC deregulated services in the amount of $1,662,000 we concur with Staff that interstate deregulation should not by itself increase expenses to the intrastate jurisdiction. On the other hand, we don't find Staff's method of simply imputing revenues to offset the entire deficiency provides an overall just result either. ... In addition, in order to recognize that neither the interstate nor intrastate jurisdictions should bear the entire deficiency of the deregulated services, we will approve 50 percent of the Staff's recommended imputed revenues or $831,000.
> [ACC Decision 58927, p. 22-23]

In the current proceeding, the Company has not contested the Commission's past inclusion of the FCC deregulated services above-the-line, but continues to argue against the imputation of any additional revenues – even though the Commission adopted 50% of the imputation adjustment I sponsored on Staff's behalf. In the current proceeding, Staff Adjustment C-19 conforms to the Commission's 50% treatment.

Q. In light of the differing regulatory treatment of these FCC deregulated services, does the Company use the same cost allocation methodology for both interstate and Arizona intrastate accounting purposes?

A. In response to RUCO Data Request 2-74, Qwest indicated that although the FCC and ACC requirements have somewhat different purposes and apply to different products/services, the regulated/nonregulated cost accounting segregation principles are consistent. Qwest's Arizona intrastate cost accounting procedures closely follow FCC Part 32 (USOA) and Part 64 rules and other cost accounting principles.

Q. Has Staff proposed to limit the revenue imputation adjustment to only 50% of the deficiency, as adopted by the Commission in the last rate case?

A. Yes. Consistent with Decision 58927, I continue to believe that interstate deregulation should not, by itself, increase costs to the intrastate jurisdiction.

Revenue Imputation

Q. Please describe the phrase "revenue imputation" as it applies to FCC deregulated services.

A. Qwest has proposed to include the pro forma net operating loss and the related rate base investment for the FCC deregulated services above-the-line for intrastate revenue requirement purposes. In this context, "revenue imputation" refers to the recognition of sufficient additional revenues for intrastate regulatory purposes so that, in the aggregate, the FCC deregulated services will earn the same overall return on investment that the ACC ultimately adopts for Qwest's intrastate regulated services. By imputing additional revenues, the Company's Arizona regulated customers will not be required to subsidize the earnings deficiency experienced by the Company's FCC deregulated services and will be indifferent as to whether these services are included above-the-line or moved below-the-line.

If the Commission were to determine that, for example, Qwest should be allowed to earn a return on investment of 10% (i.e., the weighted cost of capital), full imputation would recognize additional revenues sufficient to result in the FCC deregulated services achieving that same 10% return on investment. Staff's proposed 50% imputation would not result in those services achieving a 10% return on investment.

Q. By proposing a "revenue imputation" adjustment, are you suggesting that Qwest should increase the prices charged for its FCC deregulated services to collect those additional revenues from the customers subscribing to those services?

A. No. I am not suggesting that Qwest should change the method or approach it uses to price its FCC deregulated services. Instead, the imputation of additional revenues suggests that those customers subscribing to Qwest's intrastate regulated services should not be required to subsidize the Company's FCC deregulated offerings.

Q. In ACC Decision 58927, the Commission adopted 50% of the Staff's revenue imputation adjustment. Could you please summarize the revenue requirement effect of the Company's above-the-line proposal in the current proceeding and compare that effect with the issue presented to the Commission in Docket No. E-1051-93-183 as well as the last Arizona rate case, Docket No. T-1051B-99-105?

A. Yes. During the test year in the 1993 rate case, the Company's FCC deregulated services experienced a revenue deficiency of approximately $7 million. Because the Company proposed to increase its inside wire charges by $5.4 million as part of its overall rate design in that case, the Staff proposed to impute additional revenue of $1,662,000 to offset the remaining deficiency for the FCC deregulated services. However, the ACC only adopted 50% of the imputation, or $831,000. [ACC Decision 58927, p. 21-23]

In the last settled rate case (Docket No. T-1051B-99-105), Staff Adjustment No. C-17 imputed additional revenues of approximately $3.5 million – more than twice the value of the imputation adjustment Staff proposed in the 1993 proceeding.

In the current proceeding, Staff Adjustment C-19 proposes to impute additional revenues of about $6.6 million,[73] after recognizing the pro forma affect of other Company sponsored adjustments. In assessing Qwest's overall revenue requirement, I believe that any imputation less than Staff;s proposed revenue adjustment would be a disservice to those Arizona customers subscribing to the Company's intrastate regulated services.

The FCC Cost Allocation Manual ("CAM") resulting from Part 64 emphasizes direct cost assignment and "...allocates common cost to the nonregulated sector but leaves it wholly to the business judgment of the company and to the market place to determine how the company recovers (or fails to recover) those costs." [Report and Order CC Docket No. 86-111 (or R&O 86-111), par. 115] Discretionary pricing flexibility, dependent on market conditions, provides little certainty of the ongoing losses (or profits) of the FCC deregulated services that Qwest has proposed be absorbed by regulated ratepayers.

Voice Messaging Service

Q. When did Qwest seek the explicit deregulation of Voice Messaging Service in Arizona?

A. On September 25, 1998, the Company filed a petition with the ACC requesting the deregulation of its voice messaging service (VMS). Qwest has also sought State deregulation of its Arizona Intrastate Billing and Collection service, which is not classified as an FCC deregulated service.

Q. What is the status of Qwest's petition to deregulate VMS?

A. As indicated previously, the direct testimony of Staff witness Rowell is recommending State deregulation of this service.

[73] Represents 50% of the full revenue decificiency for the seven remaining FCC deregulated services.

Q. Is it correct that, in spite of the Company's proposed deregulation of VMS in Arizona, Qwest is recommending above-the-line treatment of VMS for intrastate ratemaking purposes?

A. Yes. The Company's confidential response to Staff Data Request UTI 9-9 indicated that, during the test year, VMS experienced [redacted], representing a [redacted] return on year-end investment, using the "corrected" data supplied by Qwest. Consequently, the Company's proposed inclusion of VMS above-the-line for ratemaking purposes has the effect of [redacted] overall revenue requirement otherwise generated by the remaining FCC deregulated services. The State deregulation of this service, as proposed by Staff, will result in the [redacted] the revenue requirement effect of Qwest's proposed above-the-line treatment.

Accounting for FCC Deregulated Services

Q. You previously referred to the FCC's accounting for these deregulated services. Could you briefly explain the background of this accounting?

A. Yes. In a REPORT AND ORDER issued in CC Docket No. 86-111 [released February 6, 1987], the FCC adopted a fully distributed costing method which emphasized direct assignment based on cost causation, required the development of Cost Allocation Manuals by the Bell operating companies, and segregated the costs of nonregulated services from the regulated costs subject to jurisdictional separations. The following excerpt appears in the introduction section of this FCC decision:

> We proposed to develop a system of accounting separation that would inhibit carriers from imposing on ratepayers for regulated interstate services the costs and risks of nonregulated ventures. Our ultimate, statutory goal was to promote just and reasonable rates for services in the interstate jurisdiction. [footnote omitted] We tentatively concluded that, to achieve our purposes, it would be necessary to deter cost shifting both in the form of misallocation of joint and common costs and in the form of improper intracorporate transfer pricing.
> [REPORT AND ORDER CC Docket No. 86-111, par. 1]

In the introduction to the Qwest's Cost Allocation Manual provided in response to Data Request UTI 1-9, the Company recognizes the FCC's concern of "guarding against cross-subsidy of Nonregulated ventures by Regulated services, and that cross-subsidy can result either from the misallocation of common costs or from improper intracorporate transfer pricing."

Q. Could you explain what is meant by a service being "subsidized" by other services?

A. In my opinion, a subsidy or cross-subsidy occurs in situations in which one or more services derive benefits from other services without assuming adequate responsibility for the associated costs. The failure of a service to assume adequate cost responsibility can result in the shifting of any unrecovered costs to other services which, in turn, could inappropriately be required to assume responsibility for providing a subsidy, absent specific regulatory treatment providing otherwise.

Q. Would the above-the-line recognition of the FCC deregulated services, as proposed by the Company, constitute a cross-subsidy of such services by the balance of the Company's Arizona intrastate regulated services?

A. Yes. In my opinion, the imputation of additional revenues as proposed by the Staff will help mitigate cross-subsidy concerns.

FCC DEREG – SEPARATIONS ADJUSTMENT

Q. Please describe Staff Adjustments B-10 and C-20.

A. Because of the Company's proposal to include the FCC deregulated services above-the-line for ratemaking purposes, Qwest calculated higher composite, intrastate separation factors for use in allocating its accounting, normalizing and pro forma ratemaking adjustments. The higher separation factors have been used by the Company and Staff to compute the intrastate share of the individual adjustments posted to rate base and operating income. Staff Adjustments B-10 and C-20 correct the intrastate separation of those various adjustments to reflect lower separation factors resulting from the exclusion of the FCC deregulated operations from the development of jurisdictional separations.

Q. Why are these adjustments necessary?

A. Because Qwest chose to directly assign 100% of the revenues, expenses and net investment of certain FCC deregulated services to its Arizona intrastate operations, the composite separations factors computed and applied by the Company have the effect of over-allocating individual ratemaking adjustments to intrastate operations. These Staff adjustments correct this over-allocation.

Ultimately, the Commission will decide how to treat the FCC deregulated services for revenue requirement purposes. If the Commission agrees with Staff's revenue imputation approach or simply moves such services below-the-line, Staff Adjustments B-10 and C-20 are necessary to remove the incremental separations affect on all other revenue requirement adjustments.

However, Staff Adjustments B-10 and C-20 assume that the Commission will adopt all adjustments proposed by Company <u>and</u> Staff. Should the Commission reject or revise individual adjustments proposed by Company or Staff, Staff Adjustments B-10 and/or C-20 should be recalculated for consistency with the Commission findings.

Q. Did the Company also revise its separation factors as a result of the "correction" that shifted additional costs from Planning for Enhanced Services to Public Payphones?

A. Yes. Because of the manner Qwest quantified the composite intrastate separation factors applied for Arizona revenue requirement purposes, this "correction" also caused the Company to similarly modify its jurisdictional allocation factors and resulted in an new pro forma adjustment [Qwest Adjustment PFN-14], also included in Staff Adjustments B-1 and C-1. Qwest Adjustment PFN-14 revises the composite intrastate separation factors in a manner similar to Staff Adjustments B-10 and C-20.

INTEREST SYNCHRONIZATION

Q. Please describe Staff Adjustment C-21.

A. Staff Adjustment C-21 synchronizes the interest deduction for income tax purposes with Staff's weighted cost of debt and rate base recommendations. This method of annualizing interest expense is commonly referred to as interest synchronization.

Q. Please define interest synchronization.

A. Interest synchronization is a method which provides for the allocation of an interest expense deduction for income tax purposes to ratepayers equal to the ratepayers' contribution to the Company for interest expense, regardless of the Company's actual or estimated interest payments to its creditors. Since revenue requirement is partially driven by the application of a rate of return to the rate base investment, the Company will recover from its ratepayers an amount of interest expense equal to the effective weighted cost of debt embedded in that rate of return. Thus, ratemaking interest can be quite different from the actual interest expense which might otherwise be deductible on a company's consolidated or stand-alone corporate tax return. Interest synchronization merely "synchronizes" the ratemaking tax deduction for interest with the interest expense ratepayers are required to provide the Company in utility rates.

Q. Did the Company propose the use of interest synchronization in quantifying its proforma level of income tax expense?

A. Yes. Company witness Grate briefly discusses Qwest's approach to quantifying pro forma income tax expense at page 104 of his direct testimony, specifically referring to Company Adjustment PFR-03 as using this interest synchronization methodology.

Q. If Qwest employed interest synchronization, why is it necessary for the Staff to separately quantify an adjustment for interest synchronization?

A. Had the Staff concurred in the Company's valuation of both rate base and cost of capital, a separate adjustment for interest synchronization would not have been necessary. However, when Staff proposes, or the Commission ultimately orders, a different valuation of rate base or the weighted cost of debt, it is necessary to quantify a separate incremental adjustment to recognize the impact of such changes on the ratemaking deduction for interest expense. In the event that the Commission ultimately adopts rate base and/or capital cost valuations other than those presented by either the Staff or the Company, interest synchronization should be recalculated using the Commission's findings, thereby appropriately synchronizing these revenue requirement elements. Consequently, the amount of pro forma interest expense ultimately recognized for ratemaking purposes should simply "roll out" from the Commission's ultimate decisions on allowable values of jurisdictional rate base and weighted cost of debt.

INCOME TAXES & REVENUE CONVERSION FACTOR

Q. What is the purpose of this portion of your testimony?

A. During the review of the Company's proposed adjustment to net operating income, Staff determined that Qwest had employed incorrect effective Federal and State income tax rates in quantifying the income tax effect of certain adjustments. In response to Staff Data Request UTI 18-10, Qwest concurred and indicated that the tax effect of each Company adjustment should reflect an effective Federal income tax rate of 32.5612% and an effective State income tax rate of 6.968%. In addition, the Company indicated that the revised effective income tax rates will change its Revenue Multiplier to 1.695858, instead of the factor applied in the Company's June 21, 2004 update filing. In supplemental responses to Staff Data Requests UTI 1-1 and 7-2, Qwest provided revised adjustments and schedules to quantify the revenue requirement impact of these revisions. The Company's adjustment to correct income tax expense has been included in Staff Adjustment C-1.

Q. In quantifying overall revenue requirement, Qwest Schedules A-1 and C-3 support a "gross revenue conversion factor" of 1.6876 in translating the operating income deficiency into the gross revenue requirement proposed by the Company. Do the corrections to the effective Federal and State income tax rates also affect the gross revenue conversion factor?

A. Yes. As indicated in the response to Staff Data Requests UTI 15-18 and 18-10, the Company has revised the calculation of the revenue conversion factor from 1.6876 to 1.6958. The effect of this change is to increase overall revenue requirement.

Q. Referring to Staff Schedules A and A-1, has Staff used the 1.6876 or 1.6958 revenue conversion factor in quantifying overall revenue requirement?

A. In presenting the Company's proposed rate changes, Staff's starting point is based on the Company's revised revenue requirement filing of June 21, 2004, as discussed previously herein. Because of Staff's approach of adjusting the Company's filing in this manner, Staff Schedules A and A-1 show the lower 1.6876 revenue conversion factor in presenting the Company's filed amounts. However, in developing Staff's proposed revenue requirement, the correct effective Federal and State income tax rates have been used in quantifying overall revenue requirement and a further correction to the uncollectible rate, discussed by Mr. Brosch, results in Staff's proposed revenue conversion factor of 1.690976.

Q. Was the correction to the effective income tax rates brought to Staff's attention by the Company or was this information obtained as a result of Staff discovery?

A. During the review of the Company's June 2004 filing and cross-checking the effective tax rate calculations with the Arizona corporate tax return information (i.e., Form 120 and related instructions) at www.revenue.state.az.us, I identified this error which was confirmed via Staff Data Request UTI 15-18.

CAPITAL STRUCTURE

Q. Could you identify the capital structure and cost rates proposed by Qwest in this proceeding?

A. Yes. Staff Schedule D sets forth the capital structure and cost rates recommended by both Staff and Qwest, which recognizes the recommendations of Staff witnesses Joel Reiker and Alejandro Ramirez.

Q. Is Staff's proposed weighted cost of capital consistent with the test year approach used in quantifying the other components of the ratemaking formula?

A. Yes, I believe so. It is my understanding that Staff's direct testimony discusses the consideration of financial data (e.g., debt issues and cost rates) involving changes that occurred subsequent to the 2003 test year.

Q. Does this conclude your direct testimony?

A. Yes.