Exhibit No. ___-TC (PMS-1TC)
Docket No. UT-061625
Witness: Paula M. Strain
REDACTED VERSION

BEFORE THE WASHINGTON
UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Petition of **QWEST CORPORATION** **To be Regulated Under an Alternative Form of Regulation Pursuant to RCW 80.36.135**	**DOCKET NO. UT-061625**

TESTIMONY OF

PAULA M. STRAIN

STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

RE: ACCOUNTING AND RECORDKEEPING
PROPOSALS and
QWEST'S FINANCIAL CONDITION

January 29, 2007

REDACTED PER PROTECTIVE ORDERS IN DOCKET NO. UT-061625

TABLE OF CONTENTS

I. INTRODUCTION 1

II. SCOPE OF TESTIMONY 2

III. SUMMARY OF TESTIMONY 2

IV. DISCUSSION 6

A. Qwest Proposal for Accounting and Financial Reporting 6

B. Qwest's Current Financial Condition 10

C. Transition Period Review and Report 16

LIST OF EXHIBITS

Exhibit No. ___ (PMS-2):	Qualifications and Experience
Exhibit No. ___ C (PMS-3C):	Summary of Qwest Rate of Return - 1998 to 2005
Exhibit No. ___ C (PMS-4C):	Qwest Adjusted Results of Operations as of 12/31/05
Exhibit No. ___ (PMS-5):	Table of Current and Proposed Accounting and Reporting Requirements
Exhibit No. ___ C (PMS-6C):	Summary of Qwest Regulatory Adjustments to Results of Operations, 1998 - 2005

I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Paula M. Strain. My business address is 1300 S. Evergreen Park Drive S.W., P.O. Box 47250, Olympia, WA 98504. My email address is pstrain@wutc.wa.gov.

Q. By whom are you employed and in what capacity?

A. I am employed by the Washington Utilities and Transportation Commission (Commission) as a Telecommunications Expert. My participation in this case is on behalf of the Commission's staff (Staff).

Q. How long have you been employed by the Commission?

A. I have been employed by the Commission for over 13 years.

Q. Have you prepared an exhibit that states your educational and professional background?

A. Exhibit No. ___ (PMS-2) describes my educational background and professional experience.

II. SCOPE OF TESTIMONY

Q. What is the scope of your testimony?

A. I am presenting testimony on behalf of Commission Staff on the financial aspects of Qwest's AFOR proposal. I also evaluate and provide recommendations about Qwest's AFOR proposals regarding accounting records and financial reporting requirements.

III. SUMMARY OF TESTIMONY

Q. Please summarize your testimony.

A. In its AFOR, Qwest proposes that it be relieved of certain regulatory accounting and financial reporting requirements. Under its AFOR, it would maintain its accounting records consistent with its FCC accounting records ("MR books"[1]), and it would file an annual report form, as required of competitively-classified companies pursuant to WAC 480-120-382. During the AFOR transition period, Qwest commits to keeping its books of account in accordance with the Uniform System of Accounts (FCC Part 32), and it would file an annual report and a report on its results of operations in accordance with standard FCC reporting, which would include several adjustments for Washington regulatory items (*e.g.*, the amortization of the DEX sale).

[1] "MR" stands for "Management Reporting" and is the term used by Qwest to describe its books of account kept for FCC reporting purposes (*see* Exhibit MSR-1T, page 9).

This AFOR proposal bears the potential for automatic rate increases for services that are not classified as competitive under RCW 80.36.350. Therefore, Staff believes it important to determine, at the onset of this AFOR, whether Qwest's rates are fair, just, reasonable, and sufficient. This does not mean Staff would always recommend having a rate case before granting such an AFOR. In order to address statutory consideration of whether the AFOR will provide for rates that are fair, just, reasonable, and sufficient, staff performed an analysis of Qwest's intrastate results of operations for the year ended December 2005. Staff incorporated the regulatory ("JR")[2] adjustments included by Qwest in its financial reports to the commission, and also included several additional adjustments Staff believes are necessary to present a more accurate picture of Qwest's intrastate results of operations. Based on Staff's analysis, Qwest is earning a [redacted] percent rate of return on its intrastate rate base. This is [redacted] its authorized rate of return of 9.367 percent. As an improvement to Qwest's proposal, Staff recommends that Qwest be required to file a similar report for the six-month transition period review, including all of the regulatory adjustments it files now, and updates to the adjustments Staff has developed in this proceeding, so that the Commission can use the information to assist it in evaluating the AFOR.

In order for this to occur, Staff recommends the following improvements to Qwest's accounting, recordkeeping and reporting proposals:

[2] "JR" stands for Jurisdictional Reporting and is the term that Qwest uses to describe accounting and reporting that follows Washington rules and orders.

- Qwest should be permitted to maintain its accounting records using FCC Part 32 accounting rules during the transition period. However, Qwest's proposal to use whatever version of the FCC rules is in effect at the time raises the issue of whether the Commission would be delegating its authority over accounting records to the FCC. The safer course is to have the effective date of the FCC Part 32 rules be a fixed date, rather than whatever version of the FCC rules is in effect at any one time during the transition period. Qwest could still seek a waiver of the Commission's accounting rule during the transition period. For example, the Commission could authorize the use of the version of FCC Part 32 rules that is in effect on the date Qwest transitions from JR to MR books;
- Qwest should be allowed to discontinue filing the quarterly financial reports required by WAC 480-120-385(2);
- During the AFOR term, Qwest should be allowed to file its annual reports as proposed, with a results of operations report that includes regulatory adjustments for Dex, sharing, rural sales, and the transition from JR to MR books;
- Qwest should be required to maintain the ability to produce updated amounts for its regulatory adjustments, if requested. The adjustments could be very different if changes in tax law or accounting law, or FCC decisions on jurisdiction of revenues, expenses or plant take place during the transition period, and the ability to quantify those

adjustments that fluctuate is key. Qwest must also be able to develop any other adjustments that stem from changes in law or policy during the transition period;

- Qwest should be required to file comprehensive information on its financial condition for the transition review contemplated in the AFOR. In that filing, Qwest must include its current regulatory adjustments in the analysis, and current versions of those developed by Staff in this case, as well as any other adjustments needed to account for changes in law or policy during the transition period.

Q. Can you please summarize how your recommendations affect the waivers from rules that Qwest asked for?

A. The following table presents this information:

Statute or rule to be waived per Qwest's proposal	Staff Recommendation	Staff Conditions
Accounting		
WAC 480-120-359(1)(a), requiring accounting records to comply with Part 32 as of 10/1/98	Grant in part	Use FCC Part 32 as of a fixed date (Transition from JR to MR books)
WAC 480-120-359(2)(b), requiring modification to Part 32 for Washington intrastate differences for commission accounting and ratemaking decisions and maintenance of subsidiary revenue records	Grant in part	Maintain certain adjustments, calculate all for transition report and if requested
Reporting		
WAC 480-120-385(1), requiring annual report including jurisdictional results of operations	Grant	Continue filing results of operations report with certain regulatory adjustments; report all for transition report
WAC 480-120-385(2), requiring quarterly reports	Grant	

IV. DISCUSSION

A. QWEST PROPOSAL FOR ACCOUNTING AND FINANCIAL REPORTING

Q. What does Qwest's AFOR propose in the way of accounting and financial reporting?

A. As discussed in Mr. Reynolds' amended testimony, Qwest proposes to maintain its accounts consistent with FCC requirements. It proposes to submit an annual report to the Commission in compliance with WAC 480-120-382 (Annual report for competitively classified companies). That report must include an income statement, a balance sheet, a statement of revenues for Washington and Washington intrastate operations subject to Commission jurisdiction, number of access lines, and a regulatory fee form.

Q. What does Qwest propose for the four-year transition period?

A. During the transition period, Qwest proposes to keep its books of account in accordance with the Uniform System of Accounts (USOA) required by the FCC – the "MR" books. It also proposes to file an annual report, in accordance with WAC 480-120-385(1), based on its books of account but would include the effects of so-called regulatory adjustments required by the Commission – the "JR" adjustments.

Q. Can you summarize the changes in accounting and reporting that Qwest proposes?

A. Exhibit No. ___ (PMS-5) compares the reports that Qwest files currently as well as Qwest's proposal for the transition period and post-transition period. It also includes a column showing Staff's recommended improvements.

Q. What are the primary differences between what Qwest reports now and what it would file during and after the transition period?

A. Under Qwest's proposal, quarterly results of operations reports would be discontinued. During transition, results of operations would be filed annually, but Qwest would eliminate five of the 12 regulatory adjustments it currently makes to its results of operations. It would freeze the level of four others ("MR Transition" adjustments) and include their effect on rate base accounts in Qwest's rate base. The effect of the "MR Transition" adjustments on net operating income would be discontinued. The three remaining adjustments (DEX sale amortization, previous AFOR sharing, and rural exchange sale), which are essentially fixed amounts, would be continued. After transition, Qwest would continue reporting results of operations, including the "MR Transition" rate base adjustments and the three remaining "JR" adjustments.

Q. What are the amounts of the adjustments, and how significant are they in relation to Qwest's results of operations?

A. Exhibit No. ___C (PMS-6C) summarizes the amounts of Qwest's "JR" adjustments from 1998 through 2005. It also shows the effect of the Qwest-proposed treatment of the adjustments on rate base and net operating income. As the exhibit shows, the Qwest proposal would retain recognition of the largest adjustments. However, even though the discontinued adjustments are smaller than the ones retained, they still have a considerable effect on Qwest's results of operations.

Q. What is the rationale for eliminating the NOI effect of the four "MR Transition" adjustments?

A. According to Qwest, these four adjustments are made to recognize differences in accounting requirements between the FCC and the commission. For example, one adjustment is made to recognize the difference between the depreciation methods allowed by the FCC, and those ordered by the Commission. Another results from an accounting change affecting software capitalization that occurred after the effective date of the Part 32 system of accounts adopted by the Commission. Qwest implemented the change for FCC purposes but not for its Commission reports.

Qwest is proposing to convert its accounting to be consistent with FCC requirements, if the AFOR is approved. If that happens, these four adjustments will no longer need to be calculated. Qwest's proposal to continue recording a rate base adjustment would be appropriate, since it would recognize the effect on the balance sheet of the adjustments made in previous years.

Q. Do Qwest's accounting, recordkeeping and reporting proposals in its AFOR address the public policy goals and AFOR considerations listed by Staff witness Thomas L. Wilson?

A. Yes. The streamlined and reduced frequency of financial reporting proposed by Qwest would promote regulatory efficiency, as would Qwest's proposal to maintain its books of account consistent with the requirements of the FCC, as allowed in WAC 480-120-355, and to file an annual report in accordance with WAC 480-120-382.

Q. Does Staff propose improvements to the Company's proposal?

A. Yes. Staff believes maintaining the annual reports in the current format, including the current regulatory adjustments, will make it easier for the Commission to evaluate how Qwest's results of operations compare to those of pre-AFOR years.

After reviewing Qwest's proposed reporting proposals, Staff believes they will be acceptable during the AFOR term. As discussed below, Staff recommends that Qwest be required to maintain the ability to update any of the current regulatory adjustments during the term of the AFOR.

For purposes of the six-month review at the end of the AFOR transition period, it would be appropriate to review Qwest data, including financial data, and to compare the most current data available at the six-month mark against the data reviewed prior to commission approval of the AFOR. Staff is aware that Qwest has committed to maintaining the ability to update any of the adjustments, if need be, in the future. However, experience has taught Staff that when reporting or accounting requirements are discontinued, the affected entities are hard-pressed to justify maintaining the expertise on their staffs, just in case the requirements are reimposed in the future.

Q. How can this concern be addressed?

A. Staff recommends the Commission make it a requirement that Qwest maintain the ability to update any of the JR adjustments. Staff believes this improvement to the AFOR accounting and reporting proposals strikes a proper balance between regulatory efficiency on the one hand and maintaining the ability to evaluate the success of the AFOR on the other.

B. QWEST'S CURRENT FINANCIAL CONDITION

Q. How is financial information germane to a review of Qwest's AFOR proposal?

A. Qwest's testimony in this case generally presents a picture of a company besieged by competition and losing customers. It contends that the AFOR will help ensure its survival, thus presenting customers with more choice. It argues that streamlining its reporting and accounting requirements will promote efficiency gains.

One way of understanding the effect of Qwest's AFOR proposal is to look at financial information. How will the AFOR result in fair, just, reasonable, and sufficient rates, if it allows annual increases in local rates? Will the efficiency gains Qwest anticipates translate to financial savings? If Qwest decides to charge higher rates for UNEs, how much could that increase its revenues? In order to have an idea of how Qwest is or could be affected by events, it helps to look at the Company's current financial condition. By making such an evaluation now, Qwest and others will have a benchmark in place that will assist all parties and the Commission with evaluating the financial effect of the AFOR during the four-year transition period.

Q. Has Qwest provided information about its financial condition in this proceeding?

A. Qwest has provided financial reports and results of operations data to the parties through discovery. The AFOR statute does not require such information to be filed as part of an AFOR proposal.

Q. How is a company's financial condition typically evaluated by the Commission?

A. The Commission requires companies to file annual reports. For Qwest and other Class A companies not classified as competitive, the annual report includes data in a "results of operations" format, which allows the calculation of a company's rate of return on rate base. It also includes an income statement and balance sheet, and line count information.

Q. Is return on rate base a calculation that is unique to utility regulation?

A. No. In other industries, similar calculations are made to determine return on investment, which is one of several indicators of a company's financial condition. These indicators are used by lenders, shareholders, and others in the financial community, as well as by other types of regulators (the SEC for example). The ability to determine Qwest's rate of return is relevant even as more of its operations are competitively classified or non-regulated.

Q. What is the most current annual report on file for Qwest?

A. The most recent annual report on file is for the year ended December 31, 2005.[3]

Q. What rate of return is reflected in the December 2005 report?

A. The report shows that Qwest earned an [redacted] percent return on rate base on its total Washington (interstate plus intrastate) operations and a [redacted] percent intrastate

[3] Qwest's 2006 annual report is due no later than May 1, 2007.

return. After adding the effect of intrastate JR adjustments, its intrastate return was [redacted] percent.

Q. How do these returns compare to Qwest's authorized rate of return?

A. Both of the returns above are [redacted] than Qwest's authorized rate of return of 9.367 percent, which was established in 1996 in Docket UT-950200, a U S WEST rate case.

Q. What has been the trend in Qwest's rate of return over the last several years?

A. Based on the annual reports Qwest has filed with the Commission, its return has fluctuated over the years but has declined overall. Exhibit No. ___ C (PMS-3C) is a schedule summarizing Qwest's (or U S WEST's) total state, interstate and intrastate results of operations and rates of return for the years 1998 through 2005. The exhibit shows an overall decline in rate of return, a sharp decline in intrastate return and a sharp increase in interstate return.

Q. What line item components of the results of operations are causing the difference in the interstate and intrastate returns?

A. The difference is caused by shifts in revenue between the two jurisdictions, while the operating expense and rate base assignments have stayed largely the same. As shown on page 2 of Exhibit No. ___ C (PMS-3C), Qwest's 1998 intrastate operations produced 71 percent of the state operating revenues, and were assigned 73 percent of the state operating expenses and rate base. In 2005, intrastate revenues had declined to 61 percent of the total; intrastate operating expenses were 70 percent of total state; and 73 percent of rate base was assigned to intrastate.

Q. What is causing the shift in revenues between the jurisdictions?

A. One cause is that the FCC has determined that several services are interstate in nature and that revenues derived from them should be assigned to the interstate jurisdiction. The services affected include DSL (Digital Subscriber Line) service and special access facilities.

Q. Why aren't operating expenses and rate base for these services shifted along with revenues?

A. The separations freeze ordered by the FCC requires Qwest to assign plant and expenses based on the jurisdictional allocations and category relationships as of December 2000. Because of the freeze, plant costs and expenses for services that have since been determined to be interstate are still assigned to the intrastate jurisdiction.

Q. If the plant costs and expenses are adjusted so that the costs of interstate services are removed from the intrastate operating expenses and rate base, what happens to the return on rate base?

A. As indicated in Exhibit No. ____C (PMS-4C), I developed two adjustments to remove operating expenses and investment for DSL and special access from the intrastate results of operations. These two adjustments increase the intrastate rate of return by [redacted] basis points, or approximately [redacted].

Q. Are there other factors affecting Qwest's results of operations that the commission should consider in evaluating Qwest's financial condition during the AFOR process?

A. Yes. Two other events should be accounted for when evaluating Qwest's financial condition during the AFOR.

One is the effect of the Commission's interpretive statement in Docket UT-053025, a proceeding opened to consider the impact of the FCC's Triennial Review Remand Order (TRRO) on Washington telephone companies. In that docket, the Commission determined Qwest was no longer required to provide DS1s and DS3s and unbundled dark fiber, at wholesale (UNE) rates in certain wire centers. Therefore, Qwest will be allowed to charge retail access rates for those facilities in those wire centers, subject to what the market will bear. Staff has calculated the maximum potential additional revenues Qwest could receive if it charges the higher special access rates for the DS1s and DS3s, and commercial rates for dark fiber, in the affected wire centers. The adjustment is in column (h) of Exhibit No. ___ C (PMS-4C).

Staff has also calculated the effect of the $0.50 per year increase in the $12.50 monthly residential rate that Qwest proposes in its AFOR. Staff's calculation assumes that Qwest implements the entire $2.00 increase over the transition period.

As shown on Exhibit No. ___ C (PMS-4C), the effect of the Staff-proposed adjustments, when added to those already reported by Qwest, result in a return on rate base of [redacted] percent, which is [redacted] the 9.367 percent return the Commission has authorized for Qwest.

C. Transition Period Review and Report

Q. What does Staff recommend be required in the report Qwest would file six months before the end of the four-year transition period?

A. Qwest should update all the adjustments in preparation for the six-month review at the end of the AFOR transition period. It should also be required to update the adjustments staff developed in this case and to include an analysis of any other changes in accounting requirements, law or policy that would affect its results of operations. The Commission will be able to more clearly see what the effect of the AFOR has been if the effect of other events that could hamper the comparison are accounted for in the analysis.

Q. Do the Staff-proposed improvements to Qwest's AFOR comport with the public policy goals and policy considerations discussed in Mr. Wilson's testimony?

A. Yes. The Commission is required to consider whether an AFOR will provide for rates that are fair, just, reasonable, and sufficient. The Staff improvements to Qwest's AFOR accounting and reporting requirements as to its financial condition, and the recommendations regarding the transition period review reporting, will provide better information for the commission to use in its consideration process.

Q. Does this conclude your testimony?

A. Yes.