BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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

INITIAL BRIEF OF COMMISSION STAFF

April 13, 2007

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Statutes

Rules

Cases

Other Authorities

I. INTRODUCTION

Qwest is currently subject to traditional rate of return, rate-base regulation in Washington. The Legislature, however, has specifically authorized the Commission to approve an alternative form of regulation ("AFOR"), upon petition, where doing so will better achieve the public policy goals set forth in RCW 80.36.135 and RCW 80.36.300, and is consistent with the public interest. The parties to this docket, except for Public Counsel, have reached a settlement agreement that presents to the Commission a modified version of Qwest's AFOR proposal which addresses all of these goals. It provides a measured, moderate, and precise tool for adjusting regulation in response to changes in technology, competition, and the structure of the telecommunications industry. It retains the Commission's regulation of Qwest's service quality, improves the customer service guarantee program, and provides for a reasonable cap on the price of Qwest's residential service. The modified AFOR proposal leaves essential programs and public service offerings in tariff, but allows the company pricing flexibility and streamlined reporting similar to competitive companies. It preserves and protects the public interest, and should be approved by the Commission.

II. THE LEGISLATURE HAS AUTHORIZED THE COMMISSION TO APPROVE ALTERNATIVE FORMS OF REGULATION WHERE THIS WILL BETTER ACHIEVE THE TELECOMMUNICATIONS PUBLIC POLICY GOALS SET FORTH IN RCW 80.36.135 AND RCW 80.36.300.

The Legislature has set forth criteria for the Commission to consider in determining whether to approve a petition for an AFOR. In addition to the policy goals declared in RCW 80.36.300, the Commission shall consider whether the proposed AFOR will:

> (a) Facilitate the broad deployment of technological improvements and advanced telecommunications services to underserved areas or underserved customer classes;

(b) Improve the efficiency of the regulatory process;

(c) Preserve or enhance the development of effective competition and protect against the exercise of market power during its development;

(d) Preserve or enhance service quality and protect against the degradation of the quality or availability of efficient telecommunications services;

(e) Provide for rates and charges that are fair, just, reasonable, sufficient, and not unduly discriminatory or preferential; and

(f) Not unduly or unreasonably prejudice or disadvantage any particular customer class.

RCW 80.36.135(2). The statute does not require that the Commission make an affirmative finding as to each of these criteria. Rather, RCW 80.36.135(3) states, in part, "The Commission shall order implementation of the alternative plan of regulation unless it finds that, on balance, an alternative plan as proposed or modified fails to meet the considerations stated in subsection (2) of this section." Staff believes, however, for the reasons set forth below, that the modified AFOR proposal does meet each of the statutory criteria in RCW 80.36.135(2), as well as the (often overlapping) policy goals of RCW 80.36.300.

III. THE MODIFIED AFOR PROPOSAL FACILITATES THE BROAD DEPLOYMENT OF ADVANCED TELECOMMUNICATIONS SERVICES TO UNDERSERVED AREAS.

The first factor set forth in RCW 80.36.135(2)(a) for the Commission to consider in reviewing a proposed AFOR is whether the plan will "facilitate the broad deployment of technological improvements and advanced telecommunications services to underserved areas or underserved customer classes." The modified AFOR proposal specifically does so, in two ways.

First, the plan mandates that Qwest implement a plan for broadband infrastructure development, commencing during the first quarter of 2008 and completed within 30 months, in which Qwest will deploy high-speed Internet (DSL) services in the seven Washington wire centers where it currently does not offer such services: namely, Easton, Elk, Northport, Pateros, Roy, Springdale, and Waitsburg. This is a significant commitment, because Qwest would not ordinarily extend DSL service to these wire centers. As Mr. Reynolds noted:

> [F]rom an economics perspective, our [Qwest's] ability to recover our investment in those seven wire centers just isn't there. That's why we have not deployed DSL to those wire centers to date. And so that is a commitment on our part, this was not part of a company plan, and it does, I think it does achieve a milestone in completing DSL deployment to 100% of our wire centers[.]

Tr. 293:23-294:4.

Second, Qwest must also file a report with the Commission at the end of the AFOR on broadband infrastructure development, informing the Commission of Qwest's progress towards the goal of ensuring that wireline high-speed Internet service is available to over 83% of customers in its Washington service area. This also represents a significant increase from the number of customers that can currently receive DSL service. As indicated in the Supplemental Response to Bench Request No. 3, and by Mr. Reynolds at the hearing, as of December 2006, Qwest can provide approximately 78% of households with DSL service without having to do any additional network rearrangement. Ex. 3C**.** However, some of Qwest's loops are encumbered with load coils or bridge taps (i.e., they are "loaded loops), which prevents Qwest from providing DSL on these lines. Qwest can, through line rearrangement, raise the percentage of customers that will be able to receive DSL to 84%. Achieving this level of DSL availability would clearly be beneficial to Washington customers. This percentage would be exceeded in only four out of the fourteen states in which Qwest operates, assuming that similar line rearrangement was carried out in each of Qwest's other states. *Id.*

Staff is aware that other measurements concerning DSL have been suggested, such as the total amount of DSL investment, or the amount of investment per-line, in Washington. Staff believes, however, that establishing a goal whereby Qwest will actually make DSL available to a definite percentage of households in Washington is a better indicator of Qwest's commitment to expand DSL availability as a part of an AFOR. It will give the Commission a clear barometer, at the end of the AFOR's four-year term, on whether Qwest has met its DSL commitment; the Commission can then take this into account in deciding whether to extend or modify the AFOR in the future.

Moreover, DSL is an area in which the Commission's jurisdictional reach is somewhat problematic, as the FCC has classified DSL as an "information service" at the federal level. FCC 05-150, *In the Matters of Appropriate Framework for Broadband Access to the Internet over Wireline Facilities*, ¶¶ 12-17 (August 5, 2005). In the recent Verizon-MCI merger docket, the Commission required Verizon to provide stand-alone DSL service, but did so only to the extent that this was required by a prior FCC order. The Commission noted, "We acknowledge that if our jurisdiction to act independently were clear, we might take a more expansive view." Docket No. UT-050814, *In the Matter of the Joint Application of Verizon Communications, Inc. and MCI, Inc. for Approval of Agreement and Plan of Merger*, Order No. 07, ¶¶ 144-150 and n. 92 (December 23, 2005). Here, Qwest has made an important and beneficial commitment to expand its DSL service to Washington customers as a part of the multiparty settlement agreement. In addition, the Commission may monitor Qwest's performance towards achieving overall DSL availability to 83%

during the term of the AFOR. Qwest clearly has an incentive to meet this goal, as the failure to do so may well be considered as reason either not to extend, or to substantially modify, the AFOR after its 4-year term expires.

IV. THE MODIFIED AFOR PROPOSAL WILL HELP IMPROVE THE EFFICIENCY OF THE REGULATORY PROCESS.

RCW 80.36.135(2)(b) directs the Commission to consider whether a proposed AFOR plan will "improve the efficiency of the regulatory process." The modified AFOR proposal does so in several respects, while at the same time not sacrificing the ability of Staff and the Commission to sufficiently monitor Qwest's performance and financial situation under the AFOR. As staff witness Paula Strain indicated in her prefiled testimony, the Commission is required to consider whether an AFOR will provide for rates that are fair, just, reasonable, and sufficient. It is thus important, while streamlining Qwest's reporting requirements, to ensure that sufficient information is provided to evaluate the success of the AFOR. Ex. 127 (Strain) at 9, 10, and 16-17. The settlement proposal before the Commission addresses both of these interests.

The reporting requirements in the AFOR closely parallel those recommended by Ms. Strain. Qwest will be permitted to keep its books in accordance with WAC 480-120-355. Qwest will also use the same accounting method that it uses to maintain its books for FCC reporting purposes ("MR," or Management Reporting books), with the possibility of adopting revised accounting standards if acceptable to the FCC and the Commission. Ex. 4, Transition ¶ 3; Ex. 127C (Strain) at 4. Qwest will file an annual report in accordance with WAC 480-120-385(1), rather than in accordance with WAC 480-120-382 (the format used by competitive companies), but quarterly reports of operations would be discontinued. Ex. 4, Transition ¶ 4, Ex. 127C (Strain) at 7.

Significantly, as recommended by Ms. Strain, the modified AFOR proposal requires Qwest to include adjustments to its MR books to account for the directory revenue credit in the Qwest Dex sale case (Docket No. UT-021120), a credit to depreciation reserve for a prior sale of rural exchanges, and a credit to depreciation reserve for sharing under Qwest's prior AFOR. Qwest also must maintain the ability to calculate five specific Commission basis adjustments, and file with the Commission, six months before the four-year anniversary of the AFOR, an annual report containing these adjustments. Ex. 4, Transition ¶¶ 5-6 and Appendix B; Ex. 127C (Strain) at 7-10. These adjustments will allow the Commission to monitor Qwest's financial condition during the period of the AFOR, and at the same time, streamline the regulatory process.

Qwest will also be permitted to modify its service quality reporting requirements under the modified AFOR proposal. Qwest claimed in its initial testimony that it was required to file a 40-page monthly service quality report, in contrast to other Class A companies whose monthly report was 8-12 pages. As staff witness Ms. Russell explained, much of this additional detail had previously been required because of the Service Quality Performance Program (SQPP) that Qwest had been required to implement since 2001, but which ended on December 31, 2005. Ms. Russell further noted that Staff has worked with Qwest since September 2006 to streamline the Company's service quality report and eliminate information that is not required on a monthly basis. Ex. 134 (Russell) at 11-12.

The modified AFOR proposal further simplifies the process, and permits Qwest to provide service quality reporting consistent with the requirements in WAC 480-120-439(1) that are followed by other Class A companies. It does not allow Qwest to abandon service quality reporting altogether, as Qwest's original AFOR proposal would have done. It also continues to require Qwest to file Customer Service Guarantee Program reports in accordance with the Seventeenth Supplemental Order in Docket No. UT-991358, but the requirement is streamlined to permit semiannual rather than monthly reports.

Affiliated interest reporting is streamlined to continue to require Qwest to file annual reports under WAC 480-120-395, but discontinue the requirement to file individual transactions pursuant to RCW 80.16.020. Ex. 4**,** Exceptions ¶ 4. Staff has concluded that the information in the annual reports will be sufficient to monitor the volume and character of affiliated interest transactions. Ex.152C (Reynolds) at 20. Qwest is permitted to discontinue securities filings, although Qwest is required to continue to comply with RCW 80.08.030 regarding use of funds. Staff has noted that securities information is publicly available, and thus available to the Commission during review of the AFOR. *Id.* at 9. Finally, transfer of property filings are limited to those that exceed greater than five percent of rate base ($78 million), involve the sale of one or more entire exchanges, or involve the merger or acquisition of Qwest Corporation. This five-percent threshold, while greater than the one percent threshold originally recommended by Staff as its litigation position, still ensures that major transactions will continue to be filed with the Commission.

All of these reporting aspects of the modified AFOR proposal serve to improve the efficiency of the regulatory process as set forth in RCW 80.35.135(2)(a). Staff witness Thomas L. Wilson estimated that the number of filings that Qwest would make with the Commission during the first year of the AFOR would be 43 percent lower than the number of filings in 2006—a significant reduction and corresponding increase in regulatory efficiency. Ex. 142C (Wilson) at 72-73.

V. THE MODIFIED AFOR PROPOSAL WILL PRESERVE OR ENHANCE THE DEVELOPMENT OF EFFECTIVE COMPETITION AND PROTECT AGAINST THE EXERCISE OF MARKET POWER DURING ITS DEVELOPMENT.

RCW 80.36.135(2)(c) directs the Commission to consider whether a proposed AFOR plan will "preserve or enhance the development of effective competition and protect against the exercise of market power during its development." The modified AFOR proposal does so in several ways. First, it provides that Qwest will generally be treated as if it were a competitively classified company under RCW 80.36.320. Staff believes that such treatment is appropriate, given the changing competitive landscape under which Qwest presently operates. As staff witness Thomas Wilson has elaborated upon in detail, Qwest's regulated telecommunications services are subject to increasing levels of competition in a market where customers choose from a broad array of regulated and unregulated services, offered over a variety of intermodal technologies. Qwest's competitors are not simply competitive local exchange companies (CLECs), but also wireless, cable, and voice over Internet protocol (VOIP) providers. There are now, in fact, more wireless subscribers than wireline subscribers. Ex. 142C (Wilson) at 32-36.

While Qwest should be afforded treatment that is comparable to other competitive companies—subject to several exceptions, discussed below, under which several Qwest services would be subject to tariffs or price caps—the proposal for RCW 80.36.320 treatment will have a relatively small incremental effect on the regulatory status of the company as a whole. The change will amount to competitive flexibility only for a relatively small number of additional customers, since Qwest has already received competitive classification for many of its services including toll, Centrex, and many business services. *Id.* at 31-32. One significant area in which Qwest would have additional pricing flexibility concerns its packages or bundles. This is a market, however, in which Public Counsel witness Dr. Loube agreed that prices are at competitive levels. Tr. 462:15-23.

The modified AFOR proposal will maintain the status quo for all of the market-opening and wholesale provisions under the Telecommunications Act of 1996, thus preserving competition. Ex. 4, Exception ¶ 1. Such competition is the best discipline to constrain Qwest from exercising market power. Ex. 142C (Wilson) at 53-54, 73. Moreover, the AFOR plan prevents Qwest from geographically deaveraging its nonrecurring and monthly recurring rates for digital business services, analog private line services, and residential exchange service features and packages. This will provide protection against the local exercise of market power in isolated areas, and ensure that rural, high-cost, low-demand customers receive the benefits of competition in urban areas. *Id.* at 61, 63. Qwest also will remain subject to the provisions of RCW 80.36.330(3), and the Commission's implementing regulations, in connection with below-cost pricing. Ex. 4, Exceptions ¶ 7.

Finally, Qwest's stand-alone residential service will be price-capped at no more that $13.50, and must remain in Qwest's tariff for the duration of the AFOR. Several other critical services will also be subject to tariffing requirements as well. Ex. 4, Exceptions ¶ 3. This will further constrain the exercise of market power and benefit the customers of Qwest.

VI. THE MODIFIED AFOR PROPOSAL WILL PRESERVE AND ENHANCE SERVICE QUALITY AND PROTECT AGAINST THE DEGRADATION OF THE QUALITY OR AVAILABILITY OF EFFICIENT TELECOMMUNICATIONS SERVICES.

RCW 80.36.135(2)(d) directs the Commission to consider whether a proposed AFOR plan will "preserve or enhance service quality and protect against the degradation of the quality or availability of efficient telecommunications services." The modified AFOR proposal fulfills these statutory objectives. Qwest will remain subject to the Commission's service quality rules, will be subject to reporting requirements that will permit Staff and the Commission to monitor its performance, and will be subject to an improved Customer Guarantee Program for the duration of the AFOR. Qwest will also be subject to the increasing level of competition that has occurred for telecommunications services, and has a significant incentive to provide quality service to its customers.

Furthermore, as staff witness Kristen M. Russell explains in detail, Qwest's service quality has been superior to that of most other telecommunications companies in recent years, and there is nothing in this record to suggest—contrary to the contentions of Public Counsel—that this situation will deteriorate in the future. Public Counsel argues that a punitive Service Quality Incentive Program (SQIP) must be put in place to ensure that it does not. Staff disagrees. A similar program expired in 2005, and Qwest's service quality remains quite satisfactory. There is no basis to conclude that the approval of an AFOR will alter this fact.

Staff witness Wilford Saunders explained, in response to an inquiry from Commissioner Jones, that there are three significant factors to help ensure that Qwest's service quality remains high during the period of an AFOR: (1) the presence of competition, (2) the Commission's service quality rules, and (3) the enhanced Customer Service Guarantee Program. Tr. 676:19-677:11. The most important incentive, as Mr. Saunders explained, is competition:

> The most significant incentive for the Company to maintain and preserve its service quality under the AFOR is competition. As has been recognized by Staff and the company and the intervening parties, the regulatory environment or the telecommunications environment has changed. Good customer service is an essential part of retaining a market position in this state, and we believe that competition provides the primary incentive for the company to maintain and improve its customer service.

Tr. 675:20-676:4. This is a crucial point, because it markedly distinguishes the current competitive landscape from that of fifteen years ago (1990-1994), when US West, the predecessor of Qwest, was regulated under a previous AFOR.

Public Counsel witness Ms. Kimball devotes a significant portion of her testimony to US West's performance under its previous earnings-sharing AFOR plan. As she points out—and Staff does not dispute this—US West suffered a deterioration of service quality during the previous AFOR that led the Commission to implement customer service protections during the Company's 1995 rate case (Docket UT-950200). Ex. 118C (Kimball) at 7-10. Ms. Kimball then observes, "Certainly we want to avoid that happening again." *Id.* at 12. Staff agrees. But it simply does *not* follow that an AFOR plan, devoid of punitive service quality measures, will inevitably lead to a deterioration of service quality.

Most significantly, as Mr. Wilson pointed out, the Company's position in the market has changed dramatically. In the early 1990's, there was very little opportunity for competition to benefit US West ratepayers. Local exchange competition had not even been ratified until the State Supreme Court decision in *In Re Electric Lightwave, Inc.,* 123 Wn.2d 2d 530, 869 P.2d 1045 (1994) (WUTC lacks power to grant exclusive local exchange franchises); interconnection issues had not been addressed by this Commission; the market-opening reforms of the 1996 Telecommunications Act had not been passed. Today, by contrast, Qwest is operating within a viable competitive environment that will provide the company with the behavioral discipline necessary to ensure the continuance of quality service. Ex. 142C (Wilson) at 25-27.

Second, as Mr. Saunders noted, Qwest will remain subject to all of the Commission's service quality rules, and, as noted previously, will be subject to Class A reporting requirements. In this regard, Qwest will not be afforded treatment more favorable than that given to any other regulated company. Qwest will be subject to all of the rules governing missed appointments, installation of basic service, trouble reports, switching, out-of-service interruptions or impairments, and complaints. *See* Ex. 134 (Russell) at 7. It will be subject to statutory penalties under RCW 80.04.380-.400, just like any other regulated company, for violations of these rules.

The impact of the Commission's rules is not insignificant. Staff noted that Qwest has made vast improvements to its service quality in recent years. Most notably, Qwest's performance remained high during 2006, a period during which the SQPP (enacted as a condition of the Qwest/US West merger)[1] was no longer in place, having expired on December 31, 2005. Ms. Russell's Exhibit 138C demonstrates that in three areas—the five-day standard for installations, and the 48-hour and 72-hour standard for repairs—Qwest's performance in 2006 compares highly favorably to that of other Class A ILECs. During many months, Qwest outperformed all of the other companies measured. This indicates that the Commission's rules do have a salutary effect on Qwest's behavior.

Finally, under the modified AFOR, Qwest will be subject to an improved Customer Service Guarantee Program. This program, which has been in place since the 1995 US West rate case, provides compensation directly to customers who experience poor service. Customers are paid bill credits or given alternative remedies for missed appointments and commitments, delayed service, and out-of-service conditions. Ex. 134 (Russell) at 4, 12-13. Under the multiparty settlement, the CSGP will be augmented with additional remedies, including a credit of the monthly recurring charge for delayed primary basic exchange

[1] The program in place as a result of the Qwest/US West merger is known as the Service Quality Performance Program (SQPP). Public Counsel refers to its proposed program, similar in nature, as the Service Quality Incentive Program (SQIP).

service, improved credits for out-of-service conditions, and a new trouble report rate credit for customers. Ex. 4, Appendix C. This latter provision was added to the modified AFOR in place of Staff's previous recommendation for a provision regarding network robustness and redundancy. Ex. 6 (Saunders) at 4, ¶ 4.

The CSGP is best viewed as a hybrid program that has served Qwest customers well. It is, first and foremost, a way to compensate customers and is a program that customers take seriously and appreciate. But it also provides a monetary and public relations incentive to the company to provide good service. If Qwest found itself having to pay a large number of customers each month, or had to frequently refund their recurring charges, this could well prove to be a "customer service and public relations nightmare" for the Company, as Mr. Saunders noted. Tr. 675:3-19 – 676: 5-18.

Public Counsel contends that all of this, however, is not sufficient. Ms. Kimball went so far as to opine that Public Counsel's alternative proposal, containing a punitive Service Quality Incentive Program, is the *only* alternative that will ensure that service quality is preserved or enhanced, and not degraded, as set forth in RCW 80.36.135(2)(d). Tr. 639:16-640:2. Staff does not agree, and believes that the addition of such an "incentive" program is neither necessary nor warranted. Ms. Kimball admitted that she is not aware of any management changes within Qwest that might cause the company to be operated differently in the future than in has been in the past several years. Tr. 621:19-25. Moreover, she agreed that there was no reason, other than the fact that Qwest is seeking an AFOR, that would make Qwest customers differently situated from other telecommunications company customers, and therefore, entitled to a remedy plan different from that offered to any other customer in Washington. Tr. 628:20-629:1. This is not a sufficient reason to require Qwest to be treated differently from other companies.

Qwest's overall service quality, as noted above, compares favorably to that of other companies in this state. It has improved steadily during the period that the SQPP has been in place. From 2001-2005, the total amount of customer credit payments declined significantly, by nearly 70 percent. The number of service quality complaints dropped by 85 percent. Moreover, Qwest's service quality has continued to improve in 2006, without a SQPP. While the number of service quality complaints increased slightly from 2005-2006, the percentage of complaints that were upheld declined, as did the total number of complaints. Ex. 134 (Russell), at 16-18. And in 2006, Qwest's performance was superior to that of other companies in several categories. Ex. 138C.

Public Counsel's proposed SQIP would subject Qwest to several "self-actuating" penalty payments in the event that Qwest does not meet certain metrics regarding service quality. Had this SQIP been in place in 2006, Qwest would have been required to pay over $1.1 million. Tr. 626; 3-9; Ex. 126C. Other companies with similar performance would not have been required to pay anything. Furthermore, Qwest would have been required to pay nearly half of this amount--$500 million—for not meeting a standard that requires out-of-service conditions to be repaired within 48 hours, 99.5 percent of the time. Yet neither Century Tel, nor Verizon, nor Sprint, nor Embarq met this standard. Tr. 633:1-14; 634:15-22; 635:9-18. Staff does not believe this proposed disparity in treatment between companies is warranted. Nor would it be noticeable to customers, since the per-customer payout per year would likely be less than $1 per customer. Tr. 627:7-15.

Ms. Kimball contends that the Commission should institute a SQIP because certain other Qwest states have done so, sometimes as part of an AFOR. Ex. 118C (Kimball) at 18-20. But the level of Qwest's service quality in those states has not been made a part of the record in this docket, and it may be significantly lower. In Washington, it has been both satisfactory and improving. At bottom, Public Counsel contends that:

> The purpose of a service quality incentive program with self-actuating penalties is to place enough dollars at risk in potential financial payments to function as an effective incentive for the Company to make the necessary investments in Washington in order to provide satisfactory service.

Id. at 15. The record in this case demonstrates that in Washington, a SQIP is neither necessary nor appropriate as part of an AFOR in order to assure that Qwest provides continued good quality service to its customers. Staff therefore urges that the Commission approve the service quality measures in the modified AFOR proposal and reject Public Counsel's proposed SQIP.

VII. THE MODIFIED AFOR PROPOSAL WILL PROVIDE FOR RATES AND CHARGES THAT ARE FAIR, JUST, REASONABLE, AND SUFFICIENT, AND NOT UNDULY DISCRIMINATORY OR PREFERENTIAL.

RCW 80.36.135(2)(e) directs the Commission to consider whether a proposed AFOR plan will "provide for rates and charges that are fair, just, reasonable, and sufficient, and not unduly discriminatory or preferential." The modified AFOR proposal fulfills this statutory criterion. The rate for stand-alone basic residential service will be price-capped at no higher than $13.50 over the four-year term of the AFOR, which is both sound economically and fair in light of a review of Qwest's overall earnings, as well as in comparison to the rates of other companies within Washington, and Qwest's rates in its other states. Several critical services will remain subject to tariffing requirements. Those Qwest services that will be treated as if they were competitively classified will be subject to a price-constraining competitive market, and will also be subject to prohibitions against below-cost pricing. Finally, Qwest agrees not to geographically deaverage certain services otherwise treated as competitively classified, which will help ensure against nondiscriminatory or preferential pricing.

The stand-alone residential exchange service recurring rate is capped at $13.50 during the four-year term of the modified AFOR proposal. Furthermore, Qwest may increase the current $12.50 rate by up to $1.00 only if it agrees to maintain and augment the Customer Service Guarantee Program in the manner previously described in section VI of this brief. This represents a 50 percent decline from Qwest's original AFOR proposal (which would have permitted the rate to rise to $14.50 over a four-year period). Staff believes that this proposal is fair and economically sound for several reasons.

First, in order to evaluate Qwest's current financial condition, Staff performed an analysis of Qwest's intrastate results of operations for the year ending December 2005. Staff incorporated the regulatory adjustments included by Qwest in its financial reports to the Commission, and also included several additional adjustments that Staff believes are necessary to present a more accurate picture of Qwest's intrastate results of operations. Based on Staff's analysis, Qwest is currently earning below its authorized rate of return of 9.367 percent. Moreover, Staff calculated that even if Qwest's stand-alone residential rate were increased by $2.00 over the term of the AFOR, Qwest would still be earning below its authorized rate of return. Ex. 127C (Strain) at 3, 11-13, 15-16. Thus, a maximum increase of $1.00 appears fair and reasonable.

Second, as staff witness Mr. Wilson has noted, although the market for residential local service is still characterized by vestiges of market power, Qwest is nevertheless experiencing significant competition in this market. Ex. 142C (Wilson) at 49. Staff has therefore conducted an analysis that compares Qwest's basic exchange rates to the hypothetical revenues that would be achieved by pricing residential rates at the total element long run incremental cost (TELRIC) for unbundled network loops. This analysis confirms that residential rates are currently priced below TELRIC rates, and that this would be true even if rates were raised to $13.00. If rates were raised to $14.50, (and they can rise only to $13.50 under the modified AFOR proposal) then residential rates would cover TELRIC costs, but only if one were to assume that Qwest experiences no more line loss—an assumption that is "heroic" at best, given Qwest's significant line losses from 2000-2006. *Id.* at 34 and Table 2, 57-58; Ex. 145C (Wilson); Ex. 146C (Wilson). Thus, from an economic standpoint, when compared to prices paid by competitors, the price-capped residential rate is reasonable.

Third, the proposed maximum $13.50 rate is reasonable when compared to prices charged by other companies in Washington, as well to Qwest's rates in its other thirteen states. Staff notes that the current $12.50 rate, which was put in place in 1998 (Docket UT-970766), has not been changed in nine years. It is currently less that the average rate of $13.90 charged by all other ILECs in the state (and at the low end of the current range of $8.47 to $26.00), and would remain so for another four years under the modified AFOR proposal. Staff further notes that Verizon's current residential rate, increased in its last rate case, is $15.43, and that in July 2007, that rate will rise again to $16.90. Ex. 142C (Wilson) at 59-60; Ex. 147 (Wilson).

Finally, a rate of $13.50 compares quite favorably to the rates charged by Qwest in the other states in its service territory. Only Utah would have an overall lower rate.[2] Rates in other Qwest states are, in many instances, significantly higher than $13.50, and go as high as $23.10 in Wyoming. Ex. 117. These comparisons are a clear indication of the fairness, reasonableness, and affordability of the AFOR's stand-alone residential rate.

The modified AFOR proposal also keeps several other important services under tariffing requirements, and thus, under direct Commission oversight. Ex. 4, Exceptions ¶ 3. These are services that entail significant public interest concerns, and can also be viewed as being subject to vestiges of market power. The list of services includes ancillary residential services such as line extensions and extended area service, as well as nonrecurring charges for residential service. Ex. 142C (Wilson) at 66; Tr. 245:17-246:3. It also includes the WTAP program, tribal lifeline and linkup programs, and basic and enhanced 911 service. Since any proposal to change the rates, terms, or conditions of these services is subject to the provisions of RCW 80.36.110 and 80.04.130 (allowing for Commission suspension of changes to tariffs), there are mechanisms to ensure that they are fair, just, and reasonable.

Under the modified AFOR proposal, Qwest will otherwise be treated as if it were a competitively classified company pursuant to RCW 80.36.320. As discussed above in part V of this brief, Staff believes that such treatment is appropriate, given the changing competitive environment in which Qwest now operates, and has concluded that competition will act to constrain Qwest's rates so that they remain fair, just, reasonable, and sufficient.

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[2] Portions of Idaho and South Dakota would have lower rates; Arizona's rates are higher with an EAS adder; all other states have higher rates.

VIII. THE MODIFIED AFOR PROPOSAL WILL NOT UNDULY OR UNREASONABLY PREJUDICE OR DISADVANTAGE ANY PARTICULAR CUSTOMER CLASS.

RCW 80.36.135(2)(f) directs the Commission to consider whether a proposed AFOR plan will "not unduly or unreasonably prejudice or disadvantage any particular customer class." The modified AFOR proposal meets this criterion. First, Staff submits that a discriminatory pricing scheme is only feasible when the producer has sufficient market power to be able to create separate classes of customers between which it will discriminate. With the existence and growth of competition, described in detail above, Qwest will be very unlikely to maintain such a pricing scheme because customers will be able to choose any of a number of alternative providers for many services. In addition, the AFOR plan will continue to place basic services, including stand-alone residential service, under full Commission tariff oversight. The plan will also prevent geographic deaveraging for Qwest's digital business services, analog private line services, and residential exchange service features and packages. Ex. 142C (Wilson) at 77-78. The AFOR plan thus will prevent against any undue prejudice or disadvantage to any customer class.

IX. THE MODIFIED AFOR PROPOSAL WILL PRESERVE AFFORDABLE UNIVERSAL TELECOMMUNICATIONS SERVICE, AND PROTECT AGAINST CROSS-SUBSIDIES.

RCW 80.36.135 directs the Commission to also consider the public policy goals declared in RCW 80.36.300 in determining the appropriateness of a proposed AFOR plan. Many of these goals overlap or duplicate the criteria previously discussed. Two goals in particular, however, merit separate discussion.

First, RCW 80.36.300(1) states the policy goal to "preserve affordable universal telecommunications service." The modified AFOR proposal fulfills this goal. It ensures that the stand-alone residential rate increases to no more than $13.50 during the four-year term. The national average charge for flat rate service in 2006, according to information from the FCC, was $14.75. Moreover, the Commission on September 13, 2006, wrote to the Universal Service Administrative Company that it had reviewed the comparability of urban rates nationwide to residential rates in rural areas of Washington served by non-rural ILECs, including Qwest, and certified that those rates are comparable for purposes of Section 254(b)(3) of the Telecommunications Act of 1996. In addition, the AFOR plan leaves WTAP, link-up programs, and tribal lifeline service under full Commission tariff oversight, to further protect low-income customers. Ex. 4, Exceptions ¶ 3; Ex. 142C (Wilson) at 65-66. By all of these measures, the AFOR plan will preserve affordable universal service.

RCW 80.36.300(4) also declares the policy goal to "ensure that rates for noncompetitive services do not subsidize the competitive ventures of regulated telecommunications companies." Qwest's rates for its noncompetitively classified services have been set either in the last rate case or through tariffs that are subject to review by the Commission. Nothing in the AFOR permits Qwest to use profits from tariffed services to subsidize competitive service offerings. Qwest's wholesale obligations under the Telecommunications Act of 1996 also remain unchanged under the AFOR plan, and Qwest remains subject to the provisions of RCW 80.36.330(3), and the Commission's implementing regulations, prohibiting below-cost pricing. This will ensure that cross-subsidization does not occur under the AFOR plan.

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X. CONCLUSION

The carefully crafted AFOR proposal presented to the Commission by the settling parties meets all of the statutory criteria set forth in RCW 80.36.135**,** achieves necessary public policy goals, and is consistent with the public interest. Staff, therefore, recommends its approval by the Commission.

DATED this _____ day of ___________, 2007.

Respectfully submitted,

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