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BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

<p>In the Matter of the Complaint of</p> <p>BEAVER COUNTY, et al.</p> <p>Complainants,</p> <p>vs.</p> <p>QWEST CORPORATION fka U S WEST COMMUNICATIONS, INC., fka MOUNTAIN STATES TELEPHONE & TELEGRAPH SERVICES, INC.</p> <p>Respondent.</p>	<p>Docket No. 01-049-75</p> <p>AFFIDAVIT OF PHILIP E. GRATE</p>
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regulatory agencies in accounting and finance matters and as an expert witness in proceedings before state regulatory agencies. One of my assignments during this period was the state of Utah. In 2003, I accepted the position of Staff Director Accounting for Qwest.

4. I am a certified public accountant and have been admitted to practice law in the state of Washington. Currently, because my employment with Qwest does not require that I maintain active status, I do not hold an active license to practice as a certified public accountant and am an inactive member of the Washington State Bar Association.

5. I have testified as an expert witness before the Public Service Commission of Utah (Commission) and several other state commissions on regulatory issues, including acting as the accounting witness in general rate cases.

II. SOURCES OF INFORMATION

6. My testimony is based upon matters within my own knowledge or is based upon information from business records of Qwest and its predecessors kept in the normal course of business. In addition, I, and my staff under my direction, have reviewed the records in rate cases and other regulatory proceedings involving Qwest's predecessors¹ in Utah during the period from 1985 through 1997 and Qwest's regulatory financial reports filed with the Commission from 1987 through 1999.

7. In addition, I am familiar with and have reviewed the Uniform System of Accounts of the Federal Communications Commission and applicable decisions of this Commission and the Utah Supreme Court discussing standards relative to the issues in

¹ Hereinafter, Qwest and its predecessors will generally be referred to as Qwest in this Affidavit.

this matter. I identify the specific matters reviewed in the following portion of this Affidavit.

III. FACTS AND EXPERT OPINION

8. During the years 1988 through 1996, Qwest's customers in Utah purchased telephone services from Qwest at rates found just and reasonable in Commission orders issued prior to or following appeals in Docket Nos. 87-049-T35, 88-049-07, 90-049-06, 92-049-05 and 95-049-05. In instances where rates set in these cases were adjusted following appeals, Qwest has made a refund to customers of amounts paid in excess of rates ultimately found just and reasonable in a manner ordered by the Commission.

9. Allegations of misconduct in Docket No. 88-049-18 related to representations made by Qwest to the Commission and Division of Public Utilities (Division) in response to questions regarding the effect of the Tax Reform Act of 1986 (TRA) on Qwest's earnings and filings and responses to data requests which may have disclosed current or anticipated earnings by Qwest in excess of the rate of return found reasonable and used by the Commission in setting Qwest's rates in Docket No. 85-049-02. The allegations had nothing to do with property taxes paid, the amount of property taxes included in financial reports to the Commission, the amount considered in setting rates, or any appeal of Qwest's property tax valuation in 1988 or in any other year.

10. No evidentiary hearing was ever held on the allegations of misconduct in Docket No. 88-049-18, and the Commission never made a finding regarding them. Following extensive discovery, the parties to the docket entered into a release and settlement agreement and a conditional amendment to the release and settlement

agreement in which Qwest agreed, without acknowledging any misconduct, to make a substantial refund to customers to resolve the matter. Following public notices and hearings, the Commission entered an order in Docket No. 88-049-18 on April 19, 1999, approving the release and settlement agreement as amended and releasing Qwest from all claims arising out of any alleged misconduct or earnings in excess of the rate of return found reasonable by the Commission and used in setting rates in connection with rates paid from January 1, 1986 through November 14, 1989. Paragraph 3 of the ordering paragraph in the order provided:

In consideration of the refund referenced in the foregoing paragraph and the other terms and conditions of the Release and Settlement Agreement as amended by the Conditional Amendment to Release and Settlement Agreement, U.S. WEST, its officers, directors, agents, authorized representatives, parent and affiliate corporations and entities and their respective officers, directors, agents, and authorized representatives, and attorneys **are hereby released and discharged from any and all claims, causes of action, liabilities, obligations, suits, losses, expenses, and costs, of whatever kind or nature, which now exist or which may hereafter accrue, whether known or unknown, because of, for, arising out of, or in any way connected with Docket No. 88-049-18** before the Commission and Case Nos. 890251 and 890252 before the Utah Supreme Court or the subject matter of any of them, **including, without limitation, all claims arising out of or related to any alleged over earnings on the part of Mountain Bell for the period January 1, 1986, through November 15, 1989, including any over earnings resulting from the TRA or any alleged misconduct on the part of Mountain Bell**, including any penalties, interest, late charges, or attorney fees or costs with respect thereto.²

² Report and Order Approving Amended Release and Settlement Agreement, *In the Matter of an Investigation into the Reasonableness of the Rates and Charges of the Mountain States Telephone and Telegraph Company*, Docket No. 88-049-18 (Utah PSC, Apr. 19, 1999) at 20 (emphasis added).

11. In setting the rates in each of the foregoing dockets, the Commission considered Utah property taxes accrued by Qwest during the test year used in setting rates. In each case, the amount of property taxes considered in setting rates was the intrastate portion of Qwest's accrual for property taxes Qwest owed to county treasurers for the test year. Because the intrastate portion of property taxes considered in setting rates in each case was less than the full amount of property taxes accrued by Qwest, rates were lower than they would have been by the difference between the full amount of property taxes accrued and the intrastate portion of the property taxes accrued.

12. In financial reports filed by Qwest with the Commission during the period from 1988 through 1996, Qwest reported the intrastate portion of accrued property taxes for the year. In reports filed prior to assessment by the Property Tax Division, the amount Qwest reported was based on an accrued liability for property taxes. The property tax amounts shown in reports Qwest filed after the assessment reflected the true up of the accrual to reflect the amount assessed, which was also the amount paid. In each case, the intrastate portion of the property taxes included in the reports was less than the total amount of property taxes paid in each year. A schedule of property taxes paid and the intrastate portion of such amount for each year from 1988 through 1996 is set forth in Attachment 1 to this Affidavit. The schedule was prepared jointly by Qwest and the Division. It was reviewed by the Committee of Consumer Services (Committee) and adjusted based on input from the Committee. Adjustments based on Committee input are highlighted in Attachment 1.

13. Qwest appealed the valuation of its property tax assessed by the Property Tax Division of the Utah State Tax Commission in each year from 1988 through 1996.

14. Qwest understands that the Commission and the Division were aware that Qwest was appealing its property tax valuations. For example, Carl Mower, Chief Auditor of the Division, testified before the Utah State Tax Commission in the hearing on Qwest's appeal of the 1988 property tax valuation.

15. In March 1998, Qwest, the Property Tax Division and the Counties entered into a stipulation that reduced the property tax valuations that were the subject of appeals for each year from 1988 through 1996. On April 13, 1998, the Utah State Tax Commission entered its Order of Approval, approving the stipulation. In September of 1998, Qwest, the Property Tax Division and the Counties agreed upon the principal amount of property taxes paid in each year, and the interest on such principal amount, to be refunded by the Counties to Qwest pursuant to the earlier stipulation. On October 2, 1998, the Utah State Tax Commission entered its Supplemental Order, finding that the total amount of the refund of property taxes for tax years 1988 through 1996 was the sum of \$16,900,000, including principal and interest up to and including December 31, 1998. The amounts of the principal and interest components of the refund attributable to each year and the estimated intrastate portion of the components of the refund agreed upon and approved by the Utah State Tax Commission are set forth in Attachment 1 to this Affidavit.

16. In Qwest's 1988 general rate case, the Commission, in considering proposed adjustments to 1988 salaries and wages, referred to the *Report to the Public Service Commission of the State of Utah by the Task Force on Annualization of Test Year Data*, dated May 14, 1986, submitted by the Division, Utah Power and Light Company, Qwest and Mountain Fuel Supply Company. See Report and Order, *In the Matter of the*

Investigation into the Reasonableness of the Rates and Charges of the Mountain States Telephone and Telegraph Company, Docket No. 88-049-07 (Utah PSC, Oct. 18, 1989) at 20-24. With regard to the application of the known and measurable standard to proposed test year adjustments, the “Recommended Annualization Policy” of May 14, 1986 included the following points that the Commission quoted with approval in its October 18, 1989 Report and Order:

3. The change must be specific in that it occurs at a known moment or moments in time.

4. The effects of the change must be measurable.

....

6. The change must have already occurred or will occur before any increase in rates occurs.

Id. at 21-22.

17. The Commission has discussed the known and measurable standard in other decisions. *See, e.g., Re PacifiCorp*, Docket No. 97-035-01, 1999 WL 218118 (Utah P.S.C. Mar. 4, 1999) (denying utility’s attempt to include an income tax contingency, stating in part: “The record shows that possible future tax assessments [after audit] for the 1997 tax year are unknown at this time.”); *see also id.* (refusing to approve expenses for a dam removal “since. . . the outcome of negotiations is unknown, removal of the dam is an uncertain event. We conclude that this is a post-test-year event. The costs of removal are merely estimates, presented by the Company, grounded in this uncertain future event. . . . We find that the estimates do not satisfy the known and measurable standard.”); *see also In re Little Plains Water Co.*, Docket No. 96-2178-01, 1996 WL 769262, *2 (Utah P.S.C. August 7, 1996).

18. Until the stipulation was reached in 1998, Qwest did not know whether it would prevail in its valuation appeals and the amount of excess property tax paid for each year was not known and measurable. Because the outcome of Qwest's valuation appeals and the refund of property taxes resulting from such appeals were not known until September 1998, no test year adjustments for them would have been made in any test year from 1988 through 1996; the fact that a refund would be received was not known and the amount of any such refund was not measurable.

19. When Qwest accrued the property tax refund in September 1998, it made the following accounting entries:

- a. Debited \$11,479,398 to Account No. 4080.11, Other Taxes
Accrued – Property Tax - Operating.
- b. Credited \$11,479,398 to Account No. 7240.19, Operating Other
Taxes – Property Taxes – Real and Personal Property.
- c. Debited \$5,420,422 to Account No. 1210.99, Interest and Dividend
Receivable – Other.
- d. Credited \$5,420,422 to Account No. 7320.90, Non-operating
Income.

20. When Qwest received the property tax refund in 1999, it made the following accounting entries:

- a. In January it debited \$7,101,502.60 to Account No. 1130.1, Cash.
- b. In January it credited \$7,101,502.60 to Account No. 4080.11,
Other Taxes Accrued – Property Tax – Operating.
- c. In February it debited \$9,572,269.38 to Account No. 1130.1, Cash.

d. In February it credited \$9,572,269.38 to Account No. 4080.11, Other Taxes Accrued – Property Tax – Operating.

e. In March it debited \$5,420,422 to Account No. 4080.11, Other Taxes Accrued – Property Tax – Operating.

f. In March it credited \$5,420,422 to Account No. 1210.99, Interest and Dividend Receivable – Other.

21. The foregoing accounting entries were entered in accordance with Utah Administrative Code R746-340-2.D, “Uniform System of Accounts,” the rule promulgated by the Commission regarding the system of accounts to be used by telephone companies in Utah. The rule provides:

Uniform System of Accounts – The Uniform System of Accounts for Class A and Class B telephone utilities, as prescribed by the Federal Communications Commission at 47 CFR 32 is the prescribed system of accounts to record the results of Utah intrastate operations.

22. According to 47 C.F.R. § 32.1, the Uniform System of Accounts (USOA) is a historical financial accounting system which reports the results of operational and financial events in a manner which enables both management and regulators to assess these results within a specified accounting period. USOA Account No. 7240, Operating Other Taxes, USOA Account No. 7320, Non-operating Income, and USOA Account 7600, Extraordinary Items, are Other Income Accounts under Subpart F of 47 C.F.R. Part 32. See 47 C.F.R. § 32.6999(b), Other Income Account Listing, a copy of which is provided as Attachment 2 to this Affidavit. 47 C.F.R. § 32.6999, Structure of Other Income Accounts, provides in subsection (a) as follows:

The Other Income Accounts are designed to reflect both operating and nonoperating income items including

taxes, extraordinary items and other income and expense items not properly included elsewhere.

23. 47 C.F.R. § 32.7240, Operating Other Taxes, subsection (a), provides:

This account shall be charged and Account 4080, Other Taxes - Accrued, shall be credited for all taxes, other than Federal, state and local income taxes and payroll related taxes, related to regulated operations applicable to current periods. Among the items includable in this account are property, gross receipts, franchise and capital stock taxes; **this account shall also reflect subsequent adjustments to amounts previously charged.** (Emphasis added.)

24. USOA Account 7320.90, Non-operating Income, is a subaccount of USOA Account 7300. In pertinent part, USOA Account 7300, Nonoperating Income and Expense, provides:

(a) This account shall be used to record the results of transactions, events and circumstances affecting the company during a period and which are not operational in nature. **This account shall include** such items as nonoperating taxes, dividend income and **interest income.** (Emphasis added.)

25. In *MCI Telecommunications Corp. v. Public Service Comm'n*, 840 P.2d 765 (Utah 1992), the Utah Supreme Court said that for the extraordinary component of the unforeseen and extraordinary exception to the rule against retroactive ratemaking to apply the event “must have an extraordinary effect on the utility’s earnings.” 840 P.2d at 771. In *Beaver County v. Utah State Tax Comm’n*, 916 P.2d 344 (Utah 1996), the Utah Supreme Court said that the “Counties must expect, as is obvious from this case, that initial property tax assessments, especially those of large utility systems, are subject to challenges” 916 P.2d at 352.

26. USOA Accounts 7240 and 7320 were the proper USOA accounts in which to credit the Utah property tax refund. The Utah property tax refund would not have been

properly recorded as an extraordinary item. In pertinent part, USOA Account 7600, Extraordinary Items, provides:

(a) This account is intended to segregate the effects of events or transactions that are extraordinary. Extraordinary events and transactions are distinguished by both their unusual nature and by the infrequency of their occurrence, taking into account the environment in which the company operates. This account shall also include the related income tax effect of the extraordinary items.

(b) This account shall be credited and/or charged with nontypical, noncustomary and infrequently recurring gains and/or losses which would significantly distort the current year's income computed before such extraordinary items, if reported other than as extraordinary items.

27. Taking into account the environment in which Qwest operates, a property tax refund is neither unusual nor infrequent. Qwest actively monitors its property tax assessments in all states and routinely litigates what it believes to be excessive assessments. For example, during the past four years, Qwest has engaged in property tax valuation litigation in Arizona, Idaho, Iowa, Montana, Oregon, Utah, and Washington. Qwest received a refund/credit of \$5.6 million for tax years 2001 through 2004 in Idaho. Qwest received a refund/credit of \$3.3 million in Montana for tax years 2003 and 2004. Qwest received a refund/credit of \$11.1 million in Oregon for tax years 2003 and 2004. Qwest received a refund of \$1.0 million in Utah for tax year 2000. Qwest has property tax valuation litigation currently pending in four states. The amount of property tax in dispute in each state is as follows: Arizona, \$55.6 million; Iowa, \$6.6 million; Utah, \$26.3 million; and Washington, \$24.6 million. These numbers represent disputed property tax amounts and are not necessarily the amounts Qwest would receive as a result of settlements or court rulings.

28. When accrued in 1998, the Utah property tax refund was not a nontypical, noncustomary and infrequently recurring gain and did not significantly distort the current year's income computed before extraordinary items. Specifically, the refund of \$11.5 million (which does not reflect the effect of income taxes) was 0.11% of the Company's operating revenues, 0.14% of the Company's pre-tax operating expenses and 0.48% of the Company's 1998 pretax operating income of \$2,391 million (a figure that included the \$11.5 million property tax refund).

29. As shown in Attachment 3 to this Affidavit, the property tax refund attributable to each year from 1988 through 1996 accounted for:

- a. 0.02% or less of the operating revenue of Qwest in any year and 0.01% of the operating revenue of Qwest for all nine years.
- b. 0.03% or less of the operating expense of Qwest in any year and 0.02% of the operating expense of Qwest for all nine years.
- c. 0.12% or less of the income from operations before taxes of Qwest in any year and 0.08% of the income from operations before taxes of Qwest for all nine years.
- d. 0.42% or less of the operating revenue of Qwest in Utah in any year and 0.26% of the operating revenue of Qwest in Utah for all nine years.
- e. 0.57% or less of the operating expense of Qwest in Utah in any year and 0.33% of the operating expense of Qwest in Utah for all nine years.
- f. 1.72% or less of the income from operations before taxes of Qwest in Utah in any year and 1.23% of the income from operations before taxes of Qwest in Utah for all nine years.

Had the refund attributable to each year been recorded in that year, it would not have significantly distorted income computed before extraordinary items.

30. Qwest properly included the refund in its financial reports filed with the Commission in the applicable periods.

31. The portion of the \$11.5 million property tax refund included in rates paid by Qwest's customers during 1988 through 1996 was \$4,999,910. The portion of the property tax refund included in rates paid by Qwest's customers from November 16, 1989 through December 31, 1996 was \$2,858,248. The derivation of these amounts is set forth in Attachment 1 to this Affidavit.

32. Qwest ceased being subject to cost-of-service, rate-of-return regulation upon issuance of the Commission's February 17, 1998 final order in Docket No. 97-049-08. The Property Tax Division, the Counties and Qwest stipulated to reduce property tax valuations in March 1998 and to the amount of the refund in September 1998. Qwest accrued the refund in September 1998 and received cash payment of portions of the refund in January, February and March 1999.

33. Had Qwest been subject to cost-of-service, rate-of-return regulation following the property tax settlement and refund accrual in 1998, and had a rate case been commenced with a 1998 or later test year, the 1998 property tax refund would not have been considered in setting rates. The 1998 property tax refund pertained to the years 1988 through 1996. Accordingly, it would have been removed from a 1998 or later test year by a "prior period adjustment."

34. As mentioned previously, the property tax refund accounted for 0.48% of Qwest's pre-tax operating income in 1998. Had there been no accrual of an \$11.5 million

Utah property tax refund and no accrual of the related \$5.4 million of interest income in 1998, the amount of annual bonus Qwest paid to its executives for 1998 operations would have been approximately \$5,700 less. The Utah portion of this decreased bonus amount would have been an amount significantly less than \$1,000.

35. The only governmental investigations of alleged financial reporting irregularities by Qwest or its former officers from 1988 through the present relate to financial reports for calendar years after 1999. These investigations have been widely publicized.

Philip E. Grate

Subscribed and sworn to before me this ____ day of February, 2005.

My Commission Expires:

NOTARY PUBLIC

Residing in: _____

CERTIFICATE OF SERVICE

I hereby certify that a true and complete copy of the foregoing **AFFIDAVIT OF PHILIP E. GRATE** was served on the following by electronic mail on February 22, 2005:

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