ORIGINAL

0000013307

RECEIVED

BEFORE THE ARIZONA CORPORATION COMMISSION

2004 NOV 18 P 4:44

AZ CORP COMMISSION
DOCUMENT CONTROL

Arizona Corporation Commission
DOCKETED
NOV 18 2004
DOCKETED BY CA

COMMISSIONERS
Marc Spitzer, Chairman
William A. Mundell
Jeff Hatch-Miller
Mike Gleason
Kristin K. Mayes

IN THE MATTER OF QWEST CORPORATION'S FILING OF 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

NOTICE OF FILING DIRECT TESTIMONY OF F. WAYNE LAFFERTY

-and-

STATEMENT REGARDING REDACTED CONFIDENTIAL INFORMATION

Please take notice that Cox Arizona Telcom, LLC is filing the Public Version of the Direct Testimony of F. Wayne Lafferty, a copy of which is attached. A Confidential Version of the testimony will be provided to those parties who have agreed to be bound by the Protective Order in this docket or as otherwise required by the July 23, 2004 Procedural Order in this docket.

Pursuant to the July 23, 2004 Procedural Order in this docket, Cox Arizona Telcom, LLC states that certain confidential information has been redacted from the Public Version of the Direct Testimony of F. Wayne Lafferty. The redacted information is information that has been designated by Qwest as "Confidential" or "Highly Confidential" pursuant to the Protective Order and consists of:

1. Information concerning specific numbers of Qwest Arizona customers and the types of services they receive;

2. Information concerning Qwest customer general calling patterns; and

3. Information concerning Qwest's cost of providing specific services in Arizona.

RESPECTFULLY submitted this 18th day of November, 2004.

COX ARIZONA TELCOM, LLC

By ______________________

Michael W. Patten
ROSHKA HEYMAN & DEWULF, PLC
One Arizona Center
400 East Van Buren Street, Suite 800
Phoenix, Arizona 85004
(602) 256-6100

ORIGINAL + 15 COPIES of the foregoing filed November 18, 2004, with:

Docket Control
ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, Arizona 85007

COPIES of the foregoing hand-delivered/mailed this 18th day of November, 2004, to:

**Chairman Marc Spitzer
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

**Commissioner William A. Mundell
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

**Commissioner Jeff Hatch-Miller
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

**Commissioner Mike Gleason
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

**Commissioner Kristin K. Mayes
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

**Jane Rodda, Esq.
ALJ, Hearing Division
Arizona Corporation Commission
400 West Congress
Tucson, Arizona 85701

**Maureen A. Scott, Esq.
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

ROSHKA HEYMAN & DEWULF, PLC
ONE ARIZONA CENTER
400 EAST VAN BUREN STREET - SUITE 800
PHOENIX, ARIZONA 85004
TELEPHONE NO 602-256-6100
FACSIMILE 602-256-6800

**Ernest G. Johnson, Esq.
Director, Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

**Timothy Berg, Esq.
Theresa Dwyer, Esq.
Darcy R. Renfro, Esq.
Fennemore Craig, PC
3003 North Central Avenue, Suite 2600
Phoenix, Arizona 85012-2913

**Todd Lundy, Esq.
Qwest Law Department
1801 California Street
Denver, Colorado 80202

**Scott S. Wakefield, Esq.
Residential Utility Consumer Office
1110 West Washington, Suite 220
Phoenix, Arizona 85007

**Thomas F. Dixon
Worldcom, Inc.
707 17th Street, 39th Floor
Denver, Colorado 80202

**Thomas H. Campbell
Michael T. Hallam
Lewis and Roca
40 North Central Avenue
Phoenix, Arizona 85004

**Peter Q. Nyce, Jr
Regulatory Law Office
U. S. Army Litigation Center
901 N. Stuart Street, Suite 713
Arlington, Virginia 22203

**Richard Lee
Snavely King Majoros O'Connor & Lee, Inc.
1220 L Street N.W., Suite 410
Washington, D.C. 20005

**Eric Heath
Sprint
100 Spear Street, Suite 930
San Francisco, California 94105

**Steven J. Duffy
Isaacson & Duffy
3101 North Central Avenue, Suite 740
Phoenix, Arizona 85012

Martin A. Aronson, Esq
Morrill & Aronson PLC
One East Camelback, Suite 340
Phoenix, Arizona 85012

Walter W. Meek
Arizona Utilities Investors Association
2100 North Central Avenue, Suite 210
Phoenix, Arizona 85004

Curt Huttsell
Citizens Communications Company of Az.
4 Triad Center, Suite 200
Salt Lake City, UT 84180

Jon Poston
ACTS
6733 East Dale Lane
Cave Creek, Arizona 85331

Jeffrey W. Crockett
Snell & Wilmer
One Arizona Center
400 East Van Buren
Phoenix, Arizona 85004

ROSHKA HEYMAN & DEWULF, PLC
ONE ARIZONA CENTER
400 EAST VAN BUREN STREET - SUITE 800
PHOENIX, ARIZONA 85004
TELEPHONE NO 602-256-6100
FACSIMILE 602-256-6800

Albert Sterman
Arizona Consumers Council
2849 East 8th Street
Tucson, AZ 85716

By Mary Ippolito

ROSHKA HEYMAN & DEWULF, PLC
ONE ARIZONA CENTER
400 EAST VAN BUREN STREET - SUITE 800
PHOENIX, ARIZONA 85004
TELEPHONE NO 602-256-6100
FACSIMILE 602-256-6800

**A copy of the Confidential Version of the testimony was provided to these parties.

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

MARK SPITZER, Chairman
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
MIKE GLEASON
KRISTIN MAYES

IN THE MATTER OF QWEST CORPORATION'S FILING OF A 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

F. WAYNE LAFFERTY

ON BEHALF OF

COX ARIZONA TELCOM, L.L.C.

November 18, 2004

(PUBLIC VERSION)

A. IDENTIFICATION AND QUALIFICATION OF WITNESS

Q. **What is your name and business address?**

A. My name is F. Wayne Lafferty and my business address is 2940 Cedar Ridge Drive, McKinney, Texas 75070.

Q. **By whom are you employed?**

A. I am a Director of the Barrington-Wellesley Group, a full service management consulting firm serving the telecommunications and public utility industries.

Q. **Mr. Lafferty, on whose behalf are you testifying in this proceeding?**

A. My testimony is presented on behalf of Cox Arizona Telcom, L.L.C., which is a facilities-based provider of local telecommunications services in Arizona.

Q. **Please provide your background and experience.**

A. I have been employed in the telecommunications industry for over eighteen years. As a consultant I have provided advice and testimony on technical and public policy issues regarding competition, interconnection, access charges, universal service and incentive regulation matters facing the telecommunication industry. I have also assisted a start up company raising equity and performing due diligence on potential acquisitions. Before joining BWG, I was an independent consultant providing regulatory policy, technical, and strategic assistance to telecommunications firms. Prior to becoming a consultant, I was a member of the executive leadership team at Citizens Communications that was responsible for all regulatory and government affairs policies, programs and operations. My responsibilities included developing, supporting and implementing all state and federal tariffs, cost studies, interconnection agreements and associated compliance activities for both Citizens' competitive and incumbent operations in over twenty states. I also was the company's chief policy witness before regulatory agencies and was involved in the development of the Telecommunications Act of 1996 ("1996 Act"). Prior to working for Citizens, I held a series of positions of increasing responsibility in the regulatory organization with several GTE Corporation affiliates (now part of Verizon Communications). I have provided testimony on public policy and technical issues in many states including Arizona as well as before the United States Congress. I am a graduate of Duke University with an undergraduate degree in economics and a masters degree in business administration. Exhibit FWL-1 contains a copy of my Curriculum Vitae.

B. PURPOSE OF DIRECT TESTIMONY

Q. Mr. Lafferty, what is the purpose of your Direct Testimony?

A. My direct testimony provides the Arizona Corporation Commission ("Commission") with Cox's analysis, concerns and recommendations concerning Qwest Corporation's ("Qwest") proposed Renewed Price Regulation Plan ("Qwest's Proposed Plan") in Arizona. This testimony addresses many of the claims made by Qwest witnesses in their direct testimony in support of Qwest's Proposed Plan. Specifically my testimony addresses issues related to: (i) the level of competition and Qwest's market power in Arizona; (ii) Qwest's competitive zone proposal; and (iii) Qwest's Arizona Universal Service Fund ("AUSF") proposal. At this time, Cox has not taken a position on the other proposals made by Qwest in this proceeding. However, given the inter-relationship of many of the issues in this proceeding, the resolution of some of the issues not currently being addressed by Cox might modify the recommendations made at this time. For example, Qwest has proposed an incremental revenue requirement of $322M and proposed this amount be recovered at least partially by a draw from the AUSF. As this proceeding moves forward and changes are made in the proposed revenue requirement, Cox's proposals concerning the use of the AUSF could change.

C. SUMMARY OF TESTIMONY

Q. Please provide a summary of your Direct Testimony.

A. Qwest has overstated the level of competition for telecommunications services in Arizona. The simple presence of one competitor to Qwest in a market does not always signify real competition. Competitors must be actively serving the relevant market and offering all the basic services for meaningful competition to exist. Qwest continues to serve the majority of customers in the state with recent trends suggesting the spread of competition is decreasing. While switched access lines appear to have decreased in recent years, competition is not the sole source for this trend. Some of the switched access line loss cited by Qwest has been offset by its DSL line gains, Qwest's own wireless products or its wholesale services. More than half of the competition in Arizona is based on unbundled network elements ("UNEs"), including the UNE-Platform ("UNE-P") and other elements which recent FCC and court decisions have begun to eliminate. Wireless and non network based VoIP companies do not offer comparably priced alternatives to Qwest wireline service and are thus not today realistic sources of competition. Recent regulatory and legal decisions and other trends suggest competition for Qwest's basic wireline services will decrease -- not increase -- in the near future. When all these issues are taken into consideration, the level of competition in Arizona is not adequate to justify the competitive relief requested by Qwest.

Qwest currently retains significant market power. While some of the legal and regulatory barriers to competition have been reduced, significant economic barriers to facilities-based wireline providers remain. The local exchange service business has high entry costs, many of which are fixed in nature. Alternative suppliers must make significant investment to enter the market. The Commission cannot today depend on the marketplace alone regulating Qwest's prices.

As the availability of UNEs decreases further, the economic costs of entry will increase as potential competitors are forced to build more of their own network to reach customers. The combination of the significant investment required for network facilities and the limited availability of investment dollars will result in less wireline competition particularly for residential basic local services. In addition to the high economic costs of entry, Qwest also retains the benefits of significant economies of scale which further restrict competitors from entering the market. No potential competitor comes close to Qwest in network ubiquity or opportunities for operational efficiencies. Qwest built a vast network while it still enjoyed the protections of a monopoly environment and a guaranteed opportunity to earn a reasonable rate of return. New entrants today do not enjoy those same benefits and the regulatory environment is more uncertain than at any time since the 1996 Act was passed. Therefore, due to the existing regulatory uncertainty and fragile state of the emerging competition in Arizona, the Commission must deny or at least modify the extensive relief sought by Qwest in this proceeding.

Qwest has proposed the designation of certain competitive zones in which the company would have complete pricing flexibility. As noted above, the limited level of existing competition and the likelihood of even less competition in the future prevent the marketplace from protecting customers against Qwest's continuing monopoly power. Therefore, it would be premature to allow Qwest the complete price deregulation inherent in the competitive zone proposal.

Should the Commission determine that some degree of relief is appropriate for Qwest, it should require several important modifications to Qwest's proposal. Most importantly strong competitive safeguards or an anti-discrimination mechanism must be established. Regardless of whether a competitive zone is ever established, prices for competitive services must be set at a level which covers the costs necessary to prevent predatory pricing, a price squeeze or any other anti-competitive behavior. Specifically, the price floor for any competitive service (actually for any service) should be defined by the sum of the prices of the unbundled network elements that are utilized to provision the service plus the long run incremental cost of any other required network functions. As long as UNEs are an important source of market entry, the existing Total Service Long-Run Incremental Cost ("TSLRIC") price floor under Commission rules is inadequate to prevent a price squeeze. If Qwest can price at predatory levels and/or erect a price squeeze barrier, any existing competitors could be forced out of business making Qwest an unregulated monopoly.

If any competitive zones are established, they should be defined at the town or exchange level and not be permitted for smaller geographic areas – such as wire centers (or sub-wire centers) as proposed by Qwest. Only specific services within a zone for which competition exists should be deemed competitive. For example, basic residential and single-line business services may not be competitive, but certain bundles or service packages might be so designated. Pricing and tariff requirements for Qwest services within a competitive zone should follow the same rules mandated for competitors under Commission Rules. Prices also should be consistent across all competitive zones and within a competitive zone itself. The complexities for the Commission and competitors to monitor and react to pricing on a more microscopic level would be extremely cumbersome. The designation of any competitive zones in the future should be specifically approved by the Commission after interested parties have the opportunity to comment and the Commission staff completes an investigation. The regulatory and competitive landscapes are changing rapidly; rules established today could have little bearing on the telecommunications marketplace in the future.

Qwest has also proposed recovering up to $64.04 million of its revenue requirement from the Arizona Universal Service Fund (AUSF). At a minimum this amount should be reduced to no more than $24.5 million to reflect the proper costs pursuant to existing Commission rules. Existing Commission rules require the calculation of AUSF for a large company like Qwest to be based on TSLRIC as opposed to fully allocated costs as proposed by Qwest. Before allowing Qwest to access the AUSF, especially in the significant amount proposed in this case, the AUSF funding mechanism should be restructured to be based on working telephone numbers instead of revenues to make the fund more competitively neutral and sustainable. As technology and product design makes the jurisdiction of revenue indistinguishable, the revenue-based contribution formulas in the current Commission rules are no longer appropriate. The Commission must ensure that the burden of contributing to any universal service program is competitively neutral. In most cases end user customers pay for the AUSF, and these customers should not be burdened with an antiquated process.

Prior to allowing Qwest to draw from the AUSF, the Commission should evaluate the potential for establishing rates in higher cost areas which more closely match the costs of providing the service. In addition, it is unclear whether Qwest's AUSF proposal only designates funds for high cost census block groups ("CBGs") as required by Commission rules. Thus, if Qwest is permitted to use the AUSF, the Commission should verify that only high cost CBGs will receive AUSF. Furthermore, as long as Qwest requires AUSF to offset part of its revenue requirement, Qwest should retain the zone 1 & 2 increments to help maintain a better alignment of rates and costs.

Qwest also requests that all new services in any part of the state be automatically designated as competitive when initially introduced. Given the fragile competitive landscape in Arizona and the uncertain future regulatory environment, especially as it pertains to competition, the Commission cannot determine today that a new service introduced next year will really be competitive. Therefore, Qwest should be required to petition the Commission under Commission Rule R14-2-1108 for competitive designation of any appropriate new services similar to any other competitor. Absent a specific finding of competition, new services should be subject to oversight for prices and terms. Qwest cannot be permitted to usurp the Commission's public policy oversight role. Similarly the Commission's oversight responsibilities of Qwest's promotions which involve services not deemed competitive should not be eliminated.

As Qwest begins to face real sustainable competition, it is realistic to expect the tariff and pricing rules for all telecommunications service providers to converge. The complete competitive zone proposal is not necessary for the Commission to allow Qwest to mirror most of the tariff and pricing rules followed by competitors today. However, as long a Qwest maintains its market power, the other aspects of relief inherent in the competitive zone proposal must be rejected. The Commission cannot risk Qwest becoming an unregulated monopoly in any part of the state.

D. QWEST OVERSTATES THE LEVEL OF COMPETITION IN THE LOCAL EXCHANGE SERVICE MARKET

Q. Qwest Witness Teitzel provides an analysis of the level of competition in Arizona, asserting that a robust competitive marketplace is in place. Do you agree with his analysis?

A. No. Mr. Teitzel looks at several indicators and sources of competition to conclude that the markets served by Qwest in Arizona are competitive. However, many of the criteria he examined do not accurately measure the level of competition. His selection of the number of interconnection agreements and the number of LIS trunks and his reliance on the growth in wireless service and implementation of VoIP to conclude that Qwest faces significant competition in the state are misleading and incorrect. None of these indicators accurately signifies the existence of competition for Qwest's wireline services, especially residential basic local exchange services. In addition, Mr. Teitzel does not consider the implications of recent FCC and District Court rulings which collectively have significantly limited opportunities for local exchange service competition in the future and increased the risk of the remonopolization of Qwest in the Arizona marketplace. The Qwest analysis also neglects to point out that Qwest's own DSL service as well as wireless service provided in conjunction with affiliates of Qwest itself or through partnerships with other wireless providers are not really competition as any lost revenue remains in the Qwest family of companies. When these indicators are put in perspective, the level of competition in Arizona, especially for residential basic local exchange services, is significantly less than Qwest portrays.

Q. On page 4 of his testimony, Qwest Witness Teitzel claims the number of interconnection agreements for Qwest in Arizona is 118 as of February 2004. Does this number of agreements allow the Commission to make any significant conclusions regarding the amount of competition?

A. No. The existence of an interconnection agreement does not reflect actual competition. In addition, many of the reported agreements are with wireless carriers which do not represent real competition for Qwest's wireline service. Another set of these agreements are just for resale, which Qwest reports to be both an insignificant and diminishing amount of competition.[1] Since an interconnection agreement is required to exchange traffic with Qwest and is thus a prerequisite for entering a market, many competitors enter into agreements before they fully develop a business plan. As business plans change and the economics of competing in certain markets deteriorates, competitors never implement some or all of their interconnection agreements. In addition, economic and regulatory realities have recently led many competitors to cut back marketing and scale back operations or cancel marketing and operations all together, resulting in some interconnection agreements becoming inactive. The decisions by AT&T and Sprint to curtail participation in this proceeding are important signs of the decline in competitive activity in Arizona and the potential for significant reduction in the level of competition. Therefore, the mere existence of an interconnection agreement does not provide a reliable

[1] Direct Testimony of David L. Teitzel (Qwest), page 5. Mr. Teitzel shows Qwest had only 5,367 resold lines as of December 2003, a 85.55% drop from 2000.

measure of competition, especially for residential basic local exchange service. Likewise the existence of a tariff or advertisement by a competitor is not a real indicator of competition. To measure competition, the Commission must go beyond the simple existence of a competitor and determine whether the competitor is actually serving customers with comparable products in a sustainable manner.

Q. What are LIS trunks?

A. LIS trunks are local interconnection service trunks which provide the network facilities to transport calls and local telecommunications traffic between Qwest and other local exchange or wireless carriers.

Q. How could the number of LIS trunks overstate the level of competition?

A. First of all, many LIS trunks provide interconnection between Qwest's network and wireless carrier networks. As Mr. Teitzel points out in his testimony, the level of wireless traffic has grown significantly in recent years, which has necessitated more LIS trunks. However, wireless is neither a comparable nor a competitive service to Qwest's wireline service, and accordingly, the growth in LIS trunks to carry traffic between wireline and wireless customers has little bearing on the level of competition especially for residential basic local services.

In addition, the volume of Internet service provider ("ISP") traffic has increased in the United States. In most cases the ISP itself is not served by the same local exchange carrier as the customer using the ISP service. Therefore, an increasing number of LIS trunks are required to carry one-way traffic between ISPs and end-users. Therefore, the growth in ISP traffic and the concomitant increase in the number of LIS trunks cannot be relied upon as indicators of increased competition for retail customers.

Q. Mr. Teitzel relies heavily on wireless traffic to support Qwest's claim of increased competition. Does wireless represent significant competition to Qwest's wireline service?

A. No. Alleged competition from wireless service should not be given much weight because wireless is not a comparable service to Qwest's wireline services, especially residential and small business basic local exchange services. Qwest's monthly residential basic local exchange rate in Arizona is $13.18 and the single-line business basic local exchange rate is $30.40 per month. Rates for wireless service average over $50 per month.[2] Unlimited local and long distance wireless service can cost approximately $150.00 per month compared to under $50.00 per month for a similar wireline product. As of November 15, 2004, Qwest's website states that Qwest's rate for unlimited local and long distance wireless service is $199/month.[3] On a price basis alone, these services are not comparable.

Q. Qwest suggests wireless service is replacing wireline service. Do you agree?

A. No. Wireless service is a compliment to basic local exchange service, not a replacement. In addition to the significant price variations, wireless also does not provide the same coverage and service quality as wireline service in many areas. While many customers have added wireless service in recent years, very few of them have completely eliminated their wireline service to rely exclusively on wireless service.

---

[2] Verizon Wireless, one of the nation's largest wireless carrier reported average revenue of over $50 per customer in 2Q04. Verizon 2Q04 Investor Presentation, slide 9.

[3] See https://www.qwestwireless.com/products/plans/index.jsp?acctype=res

Q. Has any analysis been conducted to support your conclusions regarding wireless service?

A. Yes. Recent data published by the FCC supports the premise that wireless service is not a comparable substitute for wireline service. The July 2003 Annual CMRS Competition survey published by the FCC reported "only a small percentage of wireless customers use their wireless phones as their only phone, and that relatively few wireless customers have 'cut the cord' in the sense of canceling their subscription to wireline telephone service."[4]

In the Triennial Review Order ("TRO")[5], the FCC investigated the ability of wireless service to offer an alternative to the local exchange network facilities and concluded that wireless did not provide such an alternative. Specifically, the FCC concluded the following:

> "For example, we note that CMRS does not yet equal traditional incumbent LEC services in its quality, its ability to handle data traffic, its ubiquity, and its ability to provide broadband services to the mass market."[6]

Clearly the FCC agrees that wireless service is not comparable to wireline service.

In addition, according to the Yankee Group's research, between November 24, 2003 and January 12, 2004, 1,015,000 customers nationwide ported their numbers to another provider.[7] Of those, only 20,000 to 50,000 conducted an intermodal port (i.e., between

---

[4] *In the Matter of Implementation of Section 6002(b) of the Omnibus Reconciliation Act of 1993, Annual Report and Analysis of Competitive Market Conditions with Respect to Commercial Mobile Services,* WT Docket No. 02-379, FCC 03-150, (Rel. July 14, 2003).

[5] *See, In the Matter of Unbundled Access to Network Elements,* WC Docket No. 04-313, *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, CC Docket No. 01-338, Order and Notice of Proposed Rulemaking, FCC-04-179, ¶ 1 (rel. August 20, 2004) (hereinafter referred to as the "TRO").

[6] TRO, footnote 1549.

[7] The Yankee Group, "The 2004 State of the Wireless Union", by Roger Entner, (June 2004), page 8.

wireline and wireless or vice versa.)[8] Qwest's own experience provides a similar conclusion. In the first quarter of 2004, while 49,863 access lines were ported to other competitive LECs, only 1,939 access lines were ported to wireless carriers, including Qwest's own wireless operation.[9] Therefore, the significant growth in wireless service does not appear to be at the expense of wireline service. Customers are not cutting the cord. Some usage, especially for long distance calls, may be moving from wireline to wireless phones, but customers are maintaining their high quality wireline service.

Q. Does Qwest offer wireless service?

A. Yes. Qwest has historically provided wireless service through an affiliated company. Therefore, Qwest itself has captured some of the new revenue from the growth in the wireless telecommunications market in Arizona. As of August 2004, Qwest affiliates had **{begin proprietary}{end proprietary}** wireless customers in Arizona of which **{begin proprietary}{end proprietary}** had integrated wireless and wireline service.[10] To the extent some minimal number of lines has been ported by Qwest to wireless carriers, some of these lines have gone to Qwest's own wireless affiliate. In addition, Qwest has announced a partnership with Sprint PCS which allows Qwest to expand the sale of wireless service under the Qwest brand using Sprint PCS's extensive network.[11] Qwest is able to offer service packages or bundles which provide both wireline and wireless service, sometimes over the same telephone number, uniquely positioning Qwest to respond to any threats from wireless carriers which may emerge.

---

[8] Id.
[9] Qwest's response to Cox Request Nos. 3-5 and 2-15.
[10] Qwest's response to Cox Request No. 3-3, Confidential Attachments B and C.
[11] Qwest Communications International Inc. Form 10K filed with the United States Securities and Exchange Commission, page 33.

Q. Mr. Teitzel also holds out VoIP as a source of competition for Qwest. Is VoIP a comparable alternative to basic local exchange service?

A. No. First of all, VoIP is a nascent technology and not a service. VoIP technology is being deployed by some telecommunications service providers, including Qwest and Cox. However, VoIP on its own is not a competitor. Second, basic local exchange service provided using VoIP is, in many cases, not comparable from a price standpoint. When VoIP is used to deliver local telephone service by a provider without a local exchange network (such as Vonage, AT&T or Packet8, which were all cited by Mr. Teitzel as competitors to Qwest)[12], the customer must also purchase a broadband connection. In many cases, Qwest has the only end-user loop facilities, and as a result, a customer wishing to choose a non-network, VoIP-based service must first purchase DSL from Qwest or a cable modem connection. Consequently, customers must pay $30 - $50 for broadband service on top of the $20 - $50 for VoIP service. The $50 - $100 total price for VoIP service greatly exceeds Qwest's $13.18 1FR or $30.40 1FB rate in Arizona. Clearly these services are not comparable.

In addition, Qwest receives additional revenue in many cases from the customer for the DSL service. Qwest also charges more for so-called "naked DSL," where the customer does not also purchase a Qwest local line. Lastly, telecommunications services delivered using Internet VoIP technology, in some cases, are not comparable from a service perspective. Reports of echo and delay in calls made over VoIP networks are common. Also, VoIP-based telecommunications service provided via the Internet does not have full E-911 or CALEA functionality in most cases. VoIP service also does not have an independent power source that permits the service to operate in the event of commercial power failure.

[12] Direct Testimony of David L. Teitzel (Qwest), page 63.

Q. Does Qwest provide service using VoIP technology?

A. Yes. Qwest has announced plans to deploy VoIP technology in all fourteen of the states in its operating region. Actual deployment is now underway in parts of the region. Therefore, Qwest must see benefits from this replacement technology itself. At the end of the third quarter of 2004 Qwest reported:

> "The company currently offers OneFlex in markets throughout the 14-state local service region and plans to complete the rollout of business VoIP to 12 additional out-of-region markets and consumer VoIP to all major metropolitan markets within its local service area by year end."[13]

Q. Mr. Teitzel provides data suggesting a significant drop in Qwest's primary and additional residential access lines in Arizona. Does this data provide an accurate picture of Qwest's market share or revenue loss?

A. No. Mr. Teitzel's data looks at only switched access lines. In recent years Qwest has been actively deploying and selling DSL service. DSL allows a customer to receive both high speed data and voice telephone communications simultaneously over the same line. Therefore, in some cases DSL replaces the need for switched access lines, especially for second lines used previously for modem or fax lines. Based on information filed with the FCC by Qwest, its number of DSL lines more than doubled from June 2001 to June 2004.[14] In addition, Qwest reported a 25% increase in its DSL subscriber base in 2003 and an expansion of its DSL coverage to 45% of its service area.[15] In the Third Quarter of 2004, Qwest added 102,000 DSL lines throughout its 14 state region, and increased the

[13] Qwest Reports Third Quarter 2004 Results, November 4, 2004, Page 5, URL: www.//media.corporate-ir.net/media_files/nys/Q/reports/Q304.pdf.

[14] See Qwest's 477 Reports filed with the FCC and provided in response to Cox Request 2-16.

[15] Qwest Communications International Inc. Form 10K field with the United States Securities and Exchange Commission, page 36.

availability of DSL to 63% system-wide.[16] As Qwest continues to expand the availability of DSL, DSL lines will become a more common replacement for switched access lines. In addition, the revenue from a DSL line is greater than that of residential basic local service switched access line. At a minimum, the Commission should look at both switched access lines and DSL lines when analyzing Qwest's access line trends as DSL offers another means of cannibalizing traditional wireline service by Qwest itself.

Q. Mr. Teitzel's testimony suggests competitors are using bundles or packages to compete and Qwest should have the same flexibility. Could you comment on these suggestions?

A. Yes. Qwest has the ability under its current price regulation plan in Arizona to bundle services. In fact, **{Begin proprietary}{end proprietary}** of Qwest's residential lines in the state are "part of a packaged service offering."[17] However, **{Begin proprietary} {end proprietary}** of residential customers, according to Qwest's figures, would still rely on individual service pricing for wireline service.[18] Therefore, many Qwest customers in Arizona still choose residential basic access line service as a stand alone product for $13.18 per month. Even when the $6.50 Federal Subscriber Line Charge ("SLC") is added, many Qwest residential customers pay less than $20 per month for residential basic local exchange service which is not comparable to wireless or VoIP technology provided services. Similar trends are found for single-line business customers.[19] In addition, bundling opportunities currently allow Qwest to include DSL as well as long

[16] Qwest Reports Third Quarter 2004 Results, November 4, 2004, Page 3, URL: www.//media.corporate-ir.net/media_files/nys/Q/reports/Q304.pdf.
[17] Qwest's response to Cox Request No. 2-12, Confidential Attachment A.
[18] Id.
[19] Qwest's response to Cox Request No. 02-13 where Qwest states that **{begin proprietary}{end proprietary}** of business lines are part of a packaged service.

distance, wireless and other features in a bundle, thus giving Qwest the same flexibility as most of its competitors.

Q. Has the FCC provided any analysis of the level of local exchange service competition in Arizona?

A. Yes. Independent analysis provided by the FCC affords insight into the level of competition in Arizona. Based on data filed with the FCC by both incumbent and competitive telecommunications companies, at the end of 2003, incumbent local exchange carriers ("incumbent LECs") controlled over 78% of the end-user access lines in Arizona.[20] In addition, FCC data shows that 50% of the end-user access lines served by competitors at the end of December 2003 were provisioned at least partially using facilities owned and controlled by the incumbent LECs (i.e., through resale or UNEs including UNE-P).[21] From a facilities standpoint, incumbent LECs controlled over 89% of the end-user access lines in Arizona at the end of 2003, either through their own retail lines or their wholesale UNEs sold to competitors.[22] Therefore, pure facilities-based competition -- where the competitor owns its own switching, transport and loop facilities -- is limited in the state.

Furthermore, these measurements likely underestimate incumbent LEC (including Qwest) share of the market because they were developed from data filed with the FCC prior to the DC Circuit Order and the release of the FCC's Interim UNE Rules which at a minimum have collectively limited the future availability of the UNE-P and some unbundled loops at Total Element Long-Run Incremental Cost ("TELRIC") prices to

[20] Calculated from data presented in the "Local Telephone Competition Status Report as of December 31, 2003," June 18, 2004, Federal Communications Commission, Tables 8 and 9.
[21] Id., Table 10.
[22] Id., Tables 8, 9 and 10. Incumbent LECS served directly or through the sale of UNEs or resale to competitors 89% of the access lines in Arizona.

competitors. Therefore, the FCC's data suggests the vast majority of the wireline service in Arizona relies on Qwest facilities. Qwest still dominates the local exchange service market in Arizona and may actually be in position to enjoy increasing opportunities to dominate in the future.

Q. You mentioned that recent FCC and other judicial rulings will impact local exchange service competition in Arizona. Please explain.

A. The TRO limited the availability of unbundled switching, certain unbundled loops and the UNE-P for business customers. The DC Circuit Court Order[23] expanded the limitations on unbundled switching and the UNE-P to the mass market, which included residential customers. Based on these rulings, Qwest and other Regional Bell Operating Companies ("RBOCs") have concluded that the UNE-P and certain UNE loops do not have to be made available any longer at TELRIC based prices beyond the brief transition period in the FCC's Interim UNE Rule order. The FCC further limited the availability of unbundled loops by eliminating the requirements to unbundle fiber-to-the-curb loops for any such loop when the fiber is brought to within 500 feet of the customer's premise.[24]

In addition, the FCC has issued Interim UNE Rules and has issued a Notice of Proposed Rulemaking ("NPRM") to solicit comments concerning permanent rules.[25] In these rules, the FCC has proposed a 15% increase in the price of the UNE-P as a starting point for changes. Qwest and other parties asked the Circuit Court of Appeals for the DC Circuit

---

[23] *U.S. Telecom Ass'n v. FCC*, 359 F.3d 554 (D.C. Cir. 2004) (hereinafter referred to as the "DC Circuit Order").
[24] See *In the Matter of Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, CC Docket No. 01-338, Order on Reconsideration, released October 18, 2004, para. 9-10.
[25] See *In the Matter of Unbundled Access to Network Elements,* WC Docket No. 04-313, *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, CC Docket No. 01-338, Order and Notice of Proposed Rulemaking, FCC-04-179, ¶ 1 (released August 20, 2004).

to overturn the interim rules,[26] but the Court has decided to defer a decision to provide the FCC an opportunity to develop permanent rules. Though the outcome of the FCC's NPRM is uncertain, at a minimum it is widely expected that UNE switching and the UNE-P will cost more, to the extent these unbundled network elements are still available at all. Given the importance of UNEs and the UNE-P to competitive entry in Arizona, these rulings are expected to curtail the spread of local exchange service competition in the state. As evidence of the impact of the FCC and Court decisions concerning UNEs, Qwest has already reported a significant decrease in the growth of wholesale lines in the third quarter 2004.[27] Qwest also reported a "significant recapture of UNE customers" in the third quarter.[28]

Furthermore, the FCC recently adopted an order requiring competitors opting into existing interconnection agreements to accept the entire agreement and not just portions of the agreement as had previously been permitted.[29] Therefore, a competitor with a targeted business plan might have to accept certain terms which are inappropriate for its own business plan or expend the time and resources to negotiate, and perhaps arbitrate, its own agreement. Collectively, all of these rulings will thwart the spread of competition in the local exchange service market.

---

[26] *Petition for a Writ of Mandamus to Enforce the Mandate of this Court*, United States Telecom Association, et al. v. Federal Communications Commission and the United States of America, United States Court of Appeals for the District of Columbia, (filed August 23, 2004).
[27] Qwest Reports Third Quarter 2004 Results, November 4, 2004, Page 4, URL: www.//media.corporate-ir.net/media_files/nys/Q/reports/Q304.pdf.
[28] Id.
[29] See *In the Matter of Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, CC Docket No. 01-338, Second Report and Order, released July 13, 2004, para. 11.

Q. Does regulatory uncertainty contribute to the outlook for local exchange service competition in Arizona?

A. Yes. Regulatory uncertainty plays a significant role in establishing barriers to entry helping to eliminate a competitor's market entry abilities, increasing the cost of entry and reducing the ability of competitors to invest in telecommunications facilities and operations. As noted earlier, the future availability of UNEs at TELRIC rates is uncertain. The FCC has begun a proceeding to define and implement new permanent UNE rules. However, if history is any indicator, an appeal of the FCC's ultimate decision is likely. Therefore, the industry and its investors are likely to continue operating in an increasingly uncertain world for at least a year and most likely longer. The combination of reductions in UNE availability at TELRIC prices and regulatory uncertainty concerning the future rules for interconnection creates an environment where competitors will find it more difficult (and more expensive) to raise capital for investment in network and other facilities. As investors become even more cautious, the cost of borrowing is sure to increase and competitors will be hard pressed to find capital to make significant investments in facilities. The combination of less capital and higher UNE prices can only serve to curtail competition in the local exchange service market, not intensify competition as suggested by Qwest Witness Shooshan.[30]

Q. Have you seen any data which might provide an insight into the impact of these recent FCC and other judicial rulings on the level of competition in Arizona?

A. Yes. In response to discovery from Cox, Qwest provided the number of UNE-P lines it has provisioned at various points in time in Arizona.[31] As of December 31, 2003, Qwest had 103,795 residential UNE-P lines and 71,929 business UNE-P lines in service.

[30] Direct Testimony of Harry Shooshan (Qwest), pages 16-17.
[31] Qwest's response to Cox Request No. 2-1.

However, as of August 31, 2004, these amounts had dropped to 97,344 and 68,154 respectively, a decrease of over 6% for residential lines and 5% for business lines. A reduction was also seen in the number of Qwest UNE loops, which decreased from 36,202 as of December 31, 2003 to 35, 346 as of August 31, 2004 – a decrease of over 2%.[32] Resale of Qwest service also decreased over the same period.[33] Furthermore, during this period, AT&T announced it was withdrawing any marketing or attempts to sign up new customers from the residential local exchange service market nationwide. Therefore, it appears these recent regulatory and judicial rulings may already be having an impact on the level of competition in Arizona.

Q. Has Qwest developed a commercial product alternative to the UNE-P?

A. Yes. Qwest suggests its new Qwest Platform Plus ("QPP") product will become an alternative to the UNE-P and provide additional services not available through the UNE-P.[34] However, QPP will cost more than the UNE-P. Based on the documentation on the Qwest website, it appears QPP is priced using the same UNE loop, switching and shared transport rates as the UNE-P.[35] However, the QPP switch line port charge is significantly higher. In 2005, the QPP port rate is slated to rise by $1.56 per month over the current rate, an increase of 64% compared to the current UNE rate. By 2007, the QPP line port rate will be $2.40 per month or 98% higher than the existing UNE port rate. Therefore, while Qwest may provide an alternative, competitors will pay significantly more and it is unlikely that QPP will provide any meaningful long-term opportunity for competition.

---

[32] Qwest's response to Cox Request No. 2-1.
[33] Qwest's response to Cox Request No. 2-1.
[34] Qwest's response to Cox Request No. 2-18.
[35] URL: www.qwest.com/wholesale/clecs/commercialagreements.html.

Q. Will resale offer a significant alternative for competitors in Arizona?

A. No. As noted earlier, the level of resale has decreased for Qwest in Arizona. At the end of August 2004, Qwest provided only 4,940 resold lines in Arizona as compared to 23,478 lines as of December 2001.[36] The level of resale continues to decrease. Competitors have not found resale to be an economic vehicle for providing local exchange service. UNE-P has provided a more economical solution under the pricing approved in many states; however, in the absence of UNE-P at TELRIC based rates, it is unlikely resale will be used significantly in the future. The resale discount of 12% for basic residential service and 18% for all other services is not adequate to cover competitors' own systems, billing, marketing and other administrative costs and still provide an adequate profit to justify the investment in market entry.[37] Resale is also not a significant revenue loss for Qwest as it still receives 88% and 82% of the retail revenue for residential and business lines, respectively, but avoids most of the marketing, billing and customer service expenses associated with serving the end-user customer.

Q. Does Qwest lose all of the revenue and income associated with a retail line when it loses the line to a competitor?

A. No. I will use the term "wholesale" in this context to refer to revenues received from and services offered by Qwest to competitive LECs. In most cases, a competitor is using Qwest's network in some fashion to enter the market and Qwest is receiving wholesale revenue from the sale of UNEs, resold access lines or other services. Qwest also benefits from reduced expenses associated with foregone marketing, customer care, billing and

[36] Qwest's response to Cox Request No. 2-1.
[37] See "Statement of General Available Terms," Second Amended, July 29, 2004, URL: www.qwest.com/about/policy/sgats/SGATSdocs/arizona/AZ_14th_Rev_Exh_A_8_29_Exh_A_Final.pdf ("SGAT")

other functions. In response to discovery from Cox, Qwest presented the following information concerning its wholesale services provided to competitors:[38]

Service	December 2001	December 2003	August 2004
UNE-P Lines	19,948	175,724	165,498
UNE-Loop Lines	22,955	36,202	35,346
Resold Lines	23,478	5,361	4,940
Total	66,381	217,287	205,784

Therefore, as competition has begun to emerge in Arizona, competitors are often using Qwest's network which provides significant revenue (and profit) opportunities for Qwest. For these wholesale services, Qwest still receives significant revenue. In some cases the UNE loop rate alone provides more revenue than Qwest's 1FR or 1FB service. For example, Qwest's UNE loop rates in Arizona are as follows:[39]

Zone	UNE Loop	% of 1FR	% of 1FB
1	$ 9.05	69%	30%
2	$14.84	113%	49%
3	$36.44	275%	120%

In both zones 2 and 3, Qwest receives more revenue from the UNE Loop than from the $13.18 1FR rate. In zone 3, the same holds true for the $30.40 1FB rate.

The revenue implications of Qwest's sale of UNE-P service are even more significant. Revenue from UNE-P service can be approximated by the following UNE rates: UNE Loop, line port, local usage and shared transport. Qwest's revenue for each UNE-P line

[38] Qwest's response to Cox Request No. 2-1.
[39] See SGAT.

is approximated by adding the rates for the UNE Loop, UNE line port, local usage and shared transport. The local usage and shared transport revenue is developed by multiplying the local usage UNE rates by an estimate of the monthly usage on the average line.

UNE Service[40]	Zone 1	Zone 2	Zone 3
UNE Loop	$ 9.05	$14.84	$36.44
UNE Line Port	$ 2.44	$ 2.44	$ 2.44
UNE Local Usage[41]	$ 0.79	$ 0.79	$ 0.79
UNE Shared Transport	$ 0.67	$ 0.67	$ 0.67
Total	$12.95	$18.74	$40.34
% of 1FR	98%	142%	306%
% of 1FB	43%	62%	133%

In all three zones, Qwest receives basically the same or greater revenue from the UNE-P service than from the 1FR. In zone 3, the UNE-P service provides more revenue to Qwest than the 1FB. It is true that Qwest may lose the opportunity to sell features and other services to customers who have been lost to competitors through use of the UNE Loop or the UNE-P. However, Qwest also has decreased expenses as customers migrate to competitors. Therefore, the loss of customer access lines to competitors is not a total – or even a significant -- loss of revenue for Qwest, and since expenses will also be

[40] Id.

[41] The local usage and shared transport revenue per line is based on the average number of minutes per month per line developed from Qwest's responses to Cox Request 2-23 and 2-24. Qwest reported **{begin proprietary}{end proprietary}** calls per month for residential lines and **{begin proprietary}{end proprietary}** calls per month for business lines. Qwest reported **{begin proprietary}{end proprietary}** minutes per call for residential lines and **{begin proprietary}{end proprietary}** minutes per call for business lines. These amounts result in **{begin proprietary}{end proprietary}** minutes per month for residential lines and **{begin proprietary}{end proprietary}** minutes per month for business lines. When weighted by the % of residential (**{begin proprietary}{end proprietary}**) and business (**{begin proprietary}{end proprietary}**) access lines in the state, the result is **{begin proprietary}{end proprietary}** minutes per month for the average call in Arizona. The percentage of business and residential lines were derived from Qwest's response to Cox Request 2-2.

eliminated for lines which move to competitors, the impact on Qwest's profits are minimized. In addition, UNE-P customers won back by Qwest are converted back to Qwest service at very low cost.

E. QWEST HOLDS SIGNIFICANT MARKET POWER IN ARIZONA

Q. Does the access line loss information presented by Qwest Witness Teitzel provide any indication that Qwest is no longer a dominant carrier in Arizona?

A. No. As discussed earlier, Qwest has overstated its actual access line loss and the implications of any line loss on its revenues and profits. Based on the information provided by Mr. Teitzel and the data reported by the FCC, Qwest still holds the vast majority of the market share in Arizona. There is no compelling evidence that the loss of lines and the existence of competitors -- albeit at levels that are more reduced than those put forward by Qwest -- has significantly decreased Qwest's market power in Arizona.

Q. Did the Telecommunications Act of 1996 ("1996 Act") remove all barriers to competitive entry in the local exchange service market in Arizona?

A. No. The 1996 Act only eliminated most of the legal and regulatory barriers to local exchange service competition. Also, the 1996 Act and subsequent FCC decisions established the requirement for incumbent LECs like Qwest to sell unbundled network elements at forward-looking cost-based rates. However, neither the 1996 Act nor any FCC or Commission actions have eliminated the high financial costs of entry in the local telecommunications market. Competitors have three basic choices for entering this market:

1. purchase of network elements or resale from the incumbent LEC;
2. construction of their own network facilities; or
3. a combination of the above two methods.

As shown above, the future availability and pricing for network elements are uncertain; at a minimum, UNEs will be more expensive in the future. Construction of a competing network carries a huge up-front fixed cost as switches, transport and loop facilities must be leased or purchased along with operation support systems. Whether it constructs a network or purchases UNEs from the incumbent LEC, the competitor must still incur significant investments in systems and administrative services, including but not limited to: billing and customer care; marketing; and regulatory and legal expenses. Therefore, regardless of whether a competitor builds a network or purchases UNEs from Qwest, a competitor faces very high costs of market entry, many of which are fixed. High fixed costs are a significant economic barrier to market entry.

Q. Do high economic costs of market entry provide any indication of the ability to enter the local telecommunications market?

A. Yes. Economic theory suggests if market entry barriers are low, alternative suppliers will enter the market when retail prices exceed marginal cost. Thus, Qwest would immediately experience more competition if retail prices were increased above the cost for a similarly-situated facilities-based provider to offer the same service(s). However, if large upfront capital investments make the fixed cost of market entry high -- as is the case in the local exchange service market -- then alternative facilities-based suppliers will find it difficult entering the market even if retail prices rise above marginal cost. Though some parties may try to argue that the entry barriers to the local telecommunications marketplace have been completely removed by the 1996 Act, the statute only began the process to remove the legal and regulatory barriers; it did nothing to remove the economic entry barriers created by the high fixed costs in the telecommunications industry. The higher the required investment and fixed costs of a business, the harder it is for a facilities-based competitor to enter the market and compete with the existing incumbent, i.e., Qwest.

Q. Are there any other economic indicators which suggest Qwest has significant market power in Arizona?

A. Yes. Qwest's market power is compounded by its significant scale economies. No competitor in Arizona or anywhere else in the Qwest region comes close to having the number of access lines/customers, ubiquitous network facilities, or geographic reach of Qwest. Qwest has a ubiquitous network connecting almost all portions of fourteen contiguous states. These scale economies provide Qwest unique opportunities to efficiently design, procure and manage networks, staff call centers, develop operation support systems and manage support and other administrative personnel. No other competitor can attain these opportunities.

Q. Does the regulatory uncertainty you mentioned earlier contribute to Qwest's market power?

A. Yes. The uncertainty created by the TRO, DC Circuit Order and FCC's Interim Rules and related NPRM all combine to make the local exchange telecommunications industry a risky business at this time. Often the threat that competitors will enter or re-enter a market if the dominant firm raises prices is adequate to control market power. However, the uncertainty surrounding the future availability and pricing of UNEs combined with the high fixed costs of entry and scarce available capital resources provide little, if any, assurance that the marketplace on its own will control Qwest's dominant market position.

F. QWEST'S COMPETITIVE ZONE PROPOSAL IS INAPPROPRIATE

Q. Qwest has proposed the Commission designate certain geographic areas in Arizona as competitive zones in this proceeding. Could you please explain Qwest's proposal for identifying competitive zones?

A. Yes. According to Mr. Teitzel's testimony, a competitive zone would be established whenever a customer could receive "communications services from at least one other provider."[42] The alternative provider could offer services through its own facilities, by solely using Qwest's UNEs or by exclusively reselling Qwest's services. According to the testimony of Qwest Witness Shooshan, Qwest's retail services in a zone could be reclassified as competitive based on the mere *presence* of one wireline competitor. As discussed earlier, many of the other alleged forms of competition cited by Qwest are not comparable to Qwest's ubiquitous wireline service and should not be considered in any measurement of competition. One competitor, which might be focusing on a particular niche customer set, geographic area or product group, is not adequate evidence of competition and is insufficient to protect consumers from the market power of the incumbent, Qwest.

Q. Based on your understanding of Qwest's proposal, how would the competitive zones be characterized?

A. Qwest Witness Teitzel provides an overview of Qwest's proposal. Based on my understanding of his testimony, a competitive zone would have the following characteristics.[43]

---

[42] Refer to the Direct Testimony of David L. Teitzel, page 73.
[43] Refer to the Direct Testimony of David L. Teitzel, pages 72-75.

- The geographic area would be defined by a wire center or a subset of a wire center;
- All services within a competitive zone could be priced in a fully flexible manner.
- Price and other miscellaneous changes for all services within a competitive zone could be implemented immediately upon notice to the Commission;
- Prices would not be subject to approval or investigation by the Commission;
- Prices and terms for services within competitive zones would be different from prices outside competitive zones;
- Prices in different competitive zones could be different;
- Prices and terms for different customers within a single competitive zone could also be different.

Q. Is Qwest's geographic definition for a competitive zone reasonable?

A. No. Both customers and competitors must have a clear understanding of the boundaries. Customers think in terms of town, cities, counties and states, so any other definition would be hard for them to grasp. Within the industry, exchanges or towns are often published in tariffs or exchange maps on file with the Commission and could provide a reasonable boundary. Most customers would understand towns or exchanges, but not wire centers. An arbitrary designation of a subset of a wire center is even more vague and would be confusing for customers, competitors and the Commission. The current Commission practice of identifying competitive services on a statewide basis is simple and easy for everyone to understand. However, realizing that some competitors focus on specific markets, if any competitive zone is to be allowed, it could be defined at the town or exchange level in order to avoid significant confusion. However, clear customer communication by Qwest regarding the boundaries would be required.

Q. Should all services within a competitive zone be priced flexibly?

A. No. Even if a specific zone was deemed to be competitive under Qwest's proposal, not all customers and not all services within the exchange or town should be treated the same. Qwest is still a carrier of last resort, giving it the obligation to serve any customer requesting service. While competitors might be competing for toll services or bundled services for certain customer sets in certain geographic areas, not all customers and services will have the same options. At a minimum, Qwest should not be provided the same level of flexibility to price basic local exchange service for residential and small business customers as it has to price other services. The majority of customers still receive local service on a standalone basis without purchasing a costly bundle, and these customers should not be left without the protection of the normal tariff and pricing rules.

Q. Would any meaningful controls remain on Qwest's pricing and operations in competitive zones?

A. No. Qwest proposes its freedom to make changes to prices or terms merely upon notice to the Commission and without being subjected to any investigation or approval requirements. While Qwest would remain under the jurisdiction of the Commission, the Commission's oversight powers will mainly be limited to addressing complaints filed against Qwest. According to Qwest, the Commission will also have the authority to reclassify competitive zones as non-competitive. However, this control would only provide prospective relief and would not monitor Qwest's performance during the time a zone was deemed competitive. Re-regulation could also be disruptive to customers, especially if Qwest is forced to increase rates to eliminate discriminatory situations.

Q. How do Qwest's proposed tariff and pricing obligations for competitive zones compare to existing rules for competitors in Arizona?

A. As proposed, Qwest would enjoy significantly less oversight than its competitors. Competitors are required to file tariffs specifying the maximum allowable rate.[44] Their rates must not be less than their total service long-run incremental cost of providing the service. Cross subsidization between a competitor's various services is also prohibited. Changes to competitors' prices can only be made if the resulting price is below the maximum tariff published rate and above the cost based price floor. Increases above the competitor's maximum tariff price must be submitted to the Commission for approval.[45]

Q. Is Qwest's proposal to allow unlimited price changes with no advance notice or commission oversight adequate?

A. No. At a minimum Qwest should follow the existing pricing rules for competitors found in Sections R14-2-1109 and R14-2-1110. Competitive neutrality requires Qwest not be afforded flexibility that is not available to its competitors. Qwest has not specified whether it proposes that its maximum rates would be established in tariffs for competitive

[44] Commission Rule R14-2-1109.
[45] Commission Rule R14-2-1110.

zones, if at all. Qwest should be required to file tariffs for competitive zones which identify the maximum permissible rates in the same manner as competitors. In addition, the Commission should modify the price floor rules for Qwest to address the potential for a price squeeze on competitors. Qwest should not be allowed to price its retail services below the sum of the rates for the UNEs that competitors must purchase to compete. As an incumbent provider subject to the unbundling rules in Section 251 of the 1996 Act, Qwest must not be able to set retail prices less than the wholesale prices this Commission has established for UNEs which Qwest is required to sell to competitors. The Commission should approve Qwest's price floors in advance of any competitive zone being designated.

Q. Under Qwest's competitive zone proposal, could prices differ for the same service provided to customers inside and outside the competitive zone?

A. Yes. The competitive zone proposal would effectively deregulate and deaverage Qwest's retail rates in parts of Arizona. Prices for any or all services inside the competitive zone could differ from prices for the same service(s) elsewhere in Arizona. Prices could even be different in two separate competitive zones or even for two customers in the same competitive zone.

Q. Should prices in competitive zones vary?

A. No. Prices for certain services may vary inside and outside a competitive zone. However, the same rules and prices should apply to each competitive zone and customers in every zone should be charged the same prices for the same services. The customer-by-customer pricing which Qwest proposes could result in two customers on the same street receiving different prices for the same service, setting the stage for unreasonable price discrimination between the two customers. The administrative complexities alone make Qwest's proposal unworkable. The Commission would have great difficulty monitoring the multitude of rates which could result from Qwest's proposal as well as addressing the almost certain large number of customer complaints. I live in a town with several competitive grocery stores; however, all my neighbors pay basically the same price for a gallon of milk at any one store. Local telephone services should be no different.

Q. Has Qwest proposed any specific areas be designated competitive zones at this time?

A. Yes. Qwest is requesting many parts of the Phoenix and Tucson MSAs be classified as competitive zones. According to Qwest, at least one competitor is providing some service in at least part of each of the designated areas. However, Qwest has not shown that all services provided by this one competitor are competitive with Qwest's services or even comparable to all the services provided by Qwest within the competitive zone.

Q. Should the Commission approve Qwest's competitive zone proposal?

A. No. As discussed earlier, Qwest maintains dominant market power in the delivery of basic local exchange services within its Arizona markets. It has overstated the level of competition, and its analysis and proposal ignores the fact that the future availability of competitive alternatives is withering away. Qwest has reported decreases in the growth of UNE-P, UNE Loop and resale lines in recent months. Statewide data reported by the FCC shows that, though the number of competitive LEC lines increased in 2003, the percentage of lines served using incumbent LEC UNEs also increased significantly – from 21.8% in 2001 to 33.07% in 2003.[46] Given all the regulatory uncertainty surrounding the future availability of reasonably priced UNEs, the probability of future competition relying on UNEs must be discounted. In addition, complete pricing deregulation would eliminate the competitive safeguards inherent in any price floor rules.

If the Commission decides to implement some form of competitive zones, the many vague and confusing aspects of Qwest's competitive zone proposal will need to be modified as discussed earlier. However, at the present time the market place is not competitive and the pricing flexibility requested by Qwest is unwarranted.

Q. You mentioned earlier that the mere presence of just one potential alternative provider was not an adequate gauge of competition. Could you please explain?

A. Yes. The presence of a competitor provides no assurance that all of the customers in the alleged competitive zone have true choices for comparable services. Competitors often target specific customer classes to market particular services and rarely embrace serving all customers in an area with all its services. Furthermore, competitors often compete with bundles which do not provide a comparable basic local exchange service alternative for the **{Begin proprietary}{end proprietary}** of residential customers which purchase service without a bundle.

[46] Calculated from data presented in the "Local Telephone Competition Status Report as of December 31, 2003," June 18, 2004, Federal Communications Commission, Table 10 and the "Local Telephone Competition Status Report as of December 31, 2001," July 23, 2002, Federal Communications Commission, Table 8.

Q. Does Qwest's proposal for total pricing freedom in a competitive zone raise any competitive concerns?

A. Yes. Given Qwest's market power, the potential for anti-competitive predatory pricing should be a significant concern for the Commission. Generally, economic theory defines predatory pricing as setting prices below marginal costs. In most cases, pricing below cost or losing money on a transaction is a bad business decision, but probably not an illegal one. However, when the entity losing money has significant market power in a variety of services and locations as Qwest does in Arizona, the decision to lose money even temporarily is a dangerous abuse of predatory pricing. Given (i) the scale and scope of Qwest and (ii) Qwest's proposal that it be granted the ability to establish multiple prices for the same service within a single competitive zone as well as in different zones, Qwest would have the ability to strategically price services below cost until the remaining competitors are driven out of the market. Qwest would be able to recoup its losses by pricing services higher in less competitive portions of the same competitive zone or in other, less-competitive zones, particularly since Qwest does not appear to propose to set maximum rates for its services in competitive zones. Qwest also may be able to cross-subsidize competitive zone prices with revenues from areas that are not designated as a competitive zone. After eliminating its competitors in a competitive zone, Qwest would be free to raise prices above the level a competitive marketplace would establish – again, this is exacerbated by the lack of any maximum prices for Qwest within the competitive zone. Once Qwest's competitors are driven from a market due to Qwest's below-cost pricing, multiple barriers to entry including, but not limited to, the high cost of building a network, regulatory uncertainty and limited sources of capital, would not allow competitors to easily re-enter the market even as Qwest increased prices. As a result, consumers would be harmed by the artificially elevated prices Qwest would be able to charge. The competitive zone proposal must not provide the opportunity for a market dominant firm such as Qwest to engage in predatory pricing and drive the remaining competitors out of the market.

Q. Are there other competitive safeguards which might be violated by Qwest's competitive zone proposal?

A. Yes. The importance of UNEs as a competitive entry vehicle and the requirement for incumbent LECs to offer UNEs on a wholesale basis at TELRIC prices presents another economic dilemma for Qwest's competitive zone proposal. The price deregulation contemplated by Qwest in its competitive zone proposal would give it the ability to price its retail services below the sum of the UNE rates competitors must pay to compete as required by the 1996 Act. As noted earlier, in some cases retail rates may already be below the sum of the required UNEs, meaning Qwest's proposed pricing freedom would only widen the gap. The resulting price squeeze would require competitors to pay more for the UNEs that are needed to provision a service than the prevailing retail rate for the service itself. Competitors would be forced to take a loss or exit the market.

Interestingly in some cases, Qwest and other RBOCs point to the availability of UNEs at TELRIC rates as evidence the marketplace has low entry barriers and that they should be more lightly regulated. However, at the same time the RBOCs advocate increasing the price of UNEs and eliminating some UNEs altogether. The fragile competitive telecommunications marketplace which is just beginning to emerge relies on UNEs as a continued economic market entry vehicle. Qwest should not be allowed to set retail rates below the sum of the UNE prices required for a competitor to offer a comparable service.

Q. Does a wholesale – retail price squeeze exist in Arizona today?

A. Yes. As noted earlier, Qwest's retail 1FR rates are lower than the sum of the required UNEs in zones 2 and 3. Qwest's retail 1FB rate is lower than the sum of the UNEs in zone 3. The increases to UNE rates proposed by the FCC in the Interim UNE Rules and associated NPRM and the rates proposed by Qwest as part of its QPP service will only magnify this difference. In addition, this analysis only considers Qwest's UNE rates. The price floor analysis should also include the costs of other needed functions not captured in UNE rates. Regardless, some rate rebalancing is required to eliminate this price squeeze.[47] Qwest acknowledges the need to align prices with costs, but has not properly defined the appropriate costs or identified the related rate changes.[48]

Q. Has Qwest proposed any price floor studies of its own?

A. Yes. Qwest Witness Teresa K. Million produced several price floor cost studies to support rate changes proposed by Qwest in this proceeding. However, these studies are based on TSLRIC and not the UNE costing methodology which is required to prevent a price squeeze on competitors. In addition, Qwest Witness Million does not propose the use of any price floor for Qwest's allegedly competitive and non-competitive services. As long as Qwest's UNEs are a significant source of competitive entry, the price floor must at a minimum be set to cover the underlying UNE rates plus the incremental costs of any other non-UNE functions or else competitors will be caught in a price squeeze. In addition, Qwest should not be able to avoid the price floor requirements by bundling non-competitive services, especially basic local services with other services. Bundles must also meet the correct price floor standard. Therefore, Ms. Million's proposal is inadequate and should not be accepted by the Commission.

---

[47] As an alternative, to avoid potential rate shock, if any, Qwest could use the existing tariff rates as a temporary price floor until such time as the price floor exceeded the tariff rates.

[48] Direct Testimony of David L. Teitzel, page 84.

Q. The Commission has previously established imputation and other pricing rules to prevent anti-competitive pricing. Are those rules adequate today?

A. No. The Commission's existing imputation rule, R14-2-1310 (C) (1), which basically requires that prices cover TSLRIC costs, does not protect customers against this price squeeze. This imputation rule should be rewritten as follows:

> 1. An incumbent local exchange carrier shall recover in the retail price of each local exchange telecommunications service offered by the company at a minimum the sum of the prices of the unbundled network elements that are utilized to provision such local exchange telecommunications service plus the long run incremental cost of any other required network functions, whether such service is offered pursuant to tariff or private contract.

Only by ensuring retail rates cover the appropriate UNE rates and other incremental costs will the price squeeze be eliminated and customers protected against anti-competitive pricing. This change should be implemented regardless of whether the Commission adopts any aspect of Qwest's competitive zone proposal.

Q. Have other states required a price floor for competitive services?

A. Yes. Many states require that rates cover at least TSLRIC and often additional costs to reflect shared and common costs and/or other essential functions.

Q. Should an imputation test be applied to all Qwest services?

A. Yes. As long as Qwest maintains its dominant market power and as long as UNEs are a source of competitive entry, this test must be applied to any competitive (as deemed by the Commission) and non-competitive retail services. The current TSLRIC price floor outlined in Rule R14-2-1109 (A) is inadequate for a carrier with dominant market power and control over the UNEs required by many competitors to enter a market.

Q. Does the threat of re-regulation provide any real protection for customers?

A. Not really. If an entity with predatory pricing power drives the competition out of business, re-regulation does not offer an adequate solution. In such a scenario, Qwest would get all of its customers back and the competitive LEC would be gone with little likelihood or incentive to ever come back. In addition, re-regulation would be disruptive to customers, especially those who might experience a rate increase. Therefore, the Commission cannot rely on re-regulation to control anti-competitive behavior and protect customers.

Q. Are there any other aspects of Qwest's competitive zone proposal which concern Cox?

A. Yes. While Qwest is proposing specific areas be designated as competitive at the current time, it appears that Qwest would have the ability to automatically designate additional competitive zones in the future. Since a competitive zone allows prices to be de-regulated, the Commission should make a definitive finding of competition following the process under Commission Rule R14-2-1108 before any zones are deemed competitive in the future. The type of competitors and the level of competition will not be the same in all parts of the state. In addition, as discussed earlier, changes in regulation are likely to change the potential for competition to develop evenly across Arizona in the future. Therefore, it is important that interested parties be allowed to provide comments to the Commission on the designation of additional competitive zones in the future. Like the regulatory authorities in many other states, the Arizona Commission should not leave the fox guarding the hen house, as Qwest's unilateral designation proposal would do.

Q. Could Qwest obtain additional pricing flexibility and ability to respond to competition without the need for the competitive zone proposal?

A. Yes. The Commission could implement symmetry to the pricing and tariff rules for non basic services, most new services or even when making price changes to existing basic services. Cox is not opposed to reduced notice periods and streamlined tariff requirements for Qwest as long as Cox's revised competitive safeguards against predatory pricing or a price squeeze are implemented. The process governing pricing of competitive services outlined in Commission Rule R14-2-1109 and the rate change procedures outlined in Commission Rule R14-2-1110 could be applied to both incumbent LECs and competitors as long as Qwest also meets the revised imputation and any other price floor requirements.

Q. Does any other alternative exist for the Commission?

A. Yes. Qwest's current price regulation plan has two basic categories of retail services – Basic (basket 1) and Competitive (basket 3), The Commission could implement a third retail bucket, called Non-Basic, which would contain all retail services except residential basic local exchange services and any services which meet the requirements for competitive designation across the state. This bucket would have more pricing flexibility than basic services without fully deregulating the services. Also, this new bucket of services would still be required to comply with the price floor requirement, but have shorter notice periods and no service specific price ceilings. Qwest's price regulation plan in Iowa has a similar feature.

Q. If the Commission decides to implement some type of competitive zone plan, could you please summarize the changes to Qwest's proposal which should be made?

A. Yes. The Commission must make the following changes to Qwest's proposal.

- Implement the price floor or imputation test described above for Qwest. Prices must at least cover the sum of the required UNEs and the long-run incremental cost of any other required functions to prevent predatory pricing and/or the wholesale – retail price squeeze. Qwest cannot be allowed to price below such floors.
- Eliminate Qwest's self-policing or automatic designation of a zone as competitive. All proposed competitive zones should be submitted to the Commission to allow the Commission and interested parties to ensure compliance with Commission Rule R14-2-1108. All interested parties should be given a chance to comment.
- To avoid confusion and the potential for future complaints, all interested parties must have a common understanding of the requirements and process for Qwest to obtain competitive zone treatment. The geographic level for any sort of competitive zone treatment must be defined consistently across the state at no less than the exchange or town level.

- While it may be necessary for prices and terms to be different inside and outside competitive zones, price should not vary across different competitive zones or within a specific zone.
- All services should not automatically be flexibly priced within a competitive zone. Flexibly-priced services should comply with the test in Commission Rule R14-2-1108 and must be available throughout the entire zone.
- The pricing and tariff rules for Qwest's competitive zones should be no less stringent than the rules for competitors.

Q. Mr. Lafferty, given your analysis, does Qwest meet the standards set by the Commission for competitive classification in Arizona?

A. No. At least two aspects of Commission Rule R14-2-1108 are not met. Section B (5) of the Rule requires the following:

> "The ability of alternative providers to make functionally equivalent or substitute services readily available at competitive rates, terms and conditions."

Qwest has overstated the level of competition in Arizona. Neither wireless nor VoIP provisioned services offer functional or price comparability. The ability of competitors to use Qwest's network at prices which will facilitate economic delivery of substitute service has been reduced by regulatory and other judicial rulings. Trends and recent Qwest results suggest UNE use is already declining. Regulatory uncertainty will limit future investment in telecommunications facilities for at least a year. Therefore, the Commission cannot find that the conditions of R14-2-1108 (B) (5) are met.

In addition, Commission Rule R14-2-1108 (B) (6) requires the Commission also consider the following:

> "Other indicators of market power, which may include growth and shifts in market share, ease of entry and exit, and any affiliation between and among alternative providers or services."

Qwest still possesses significant market power. The high fixed cost of entry and operation in the local exchange service market limits the potential supply of truly comparable facilities-based competitors. Furthermore, regulatory uncertainty will help to sustain and even enhance this market power. The future availability of some UNEs at TELRIC rates is questionable; trends suggest UNE use is down. All of these factors point to continued market power for Qwest, meaning the conditions of R14-2-1108 (B) 6) argue against a grant of the relief proposed by Qwest.

G. QWEST'S ARIZONA UNIVERSAL SERVICE FUND PROPOSAL

Q. Mr. Lafferty, Qwest has proposed using funds from the AUSF to recover a portion of the costs of providing service in residential zones 2 and 3 and business zone 3. Please explain Qwest's proposal?

A. In his testimony, Mr. Teitzel proposed that Qwest be allowed to draw from the AUSF to recover what he termed "extraordinary" costs of providing residential service in wire centers classified as cost zones 2 and 3 and business service in wire centers classified in cost zone 3.[49] Mr. Teitzel claims that the purpose for this proposal is to maintain the same residential and business recurring rates as in the other cost zones that do not require AUSF support. In addition, he believes this proposal will help encourage competition in the higher cost zones.

[49] Direct Testimony of David L. Teitzel, page 88.

Q. What are cost zones?

A. Cost zones were developed in Arizona by Qwest and the Commission for the purpose of establishing wholesale rates for UNEs and other interconnection services in the wholesale cost docket (Docket No. T-00000A-00-0194). These zones represent groups of wire centers with similar levels of costs for providing the various UNEs and other interconnection services. Qwest has three cost zones in Arizona and accordingly three sets of rates for certain interconnection services.

Q. How has Qwest developed the costs for establishing its proposed draw from the AUSF?

A. According to the Direct Testimony of Qwest Witness Million, costs were developed based on the TSLRIC methodology.[50] The Qwest TSLRIC studies identify the forward-looking long-run incremental costs that are directly caused by a service or group of services plus the costs that are shared among services or groups of services.[51] The intention is to determine the forward-looking costs of replacing the network and other facilities required to offer a service or group of services, using the least cost technologies that are currently available. Ms. Million's analysis considers the base TSLRIC costs to be the direct costs associated with a specific service or the costs that would be eliminated if the service was not offered.[52] According to the Direct Testimony of Qwest Witness Million, for simplicity purposes many of the inputs and underlying assumptions used in her proposal in this proceeding are the same as those used in the wholesale cost docket.

---

[50] Direct Testimony of Teresa K. Million (Qwest), pages 3-4.
[51] Id., page 3.
[52] Id., page 5.

Q. Did Qwest Witness Million develop any other costs?

A. Yes. She also developed network support costs which are shared by a group of services such as network administrative and engineering costs. These costs are not specifically identifiable with a specific service. Qwest Witness Million adds the shared costs to the TSLRIC costs to develop the total direct and shared costs associated with a specific service. In addition, Ms. Million presented fully-allocated costs for individual services, which include the TSLRIC costs, shared costs and an allocation of common costs often referred to as overhead. Therefore, Qwest has presented three sets of costs for certain services in this proceeding.

Q. What is the purpose of the AUSF?

A. The main goal of universal service funds in general is to assure the wide spread availability of basic telephone service at reasonable rates. The AUSF's purpose mirrors this goal and also strives to "maintain statewide average rates and the availability of basic telephone service to the greatest extent possible."[53]

Q. Please explain how the appropriate amount of AUSF is calculated?

A. Commission Rule R14-2-1202 provides the official rules for calculating the amount that a provider may withdraw from the AUSF. Subsection A of this rule reads as follows (emphasis added):

> "The amount of AUSF support to which a provider of basic local exchange telephone service is eligible for a given AUSF support area shall be based upon the difference between the <u>benchmark rates</u> for basic local exchange telephone service provided by the carrier, and the <u>appropriate cost</u> to provide basic local exchange telephone service as determined by

[53] Arizona Corporation Commission Decision No. 65472, December 19, 2002.

the Commission, net of any universal service support from federal sources."

Therefore, a carrier's AUSF claim is calculated as the difference between its "benchmark rates" and its "appropriate cost."

Q. How has Qwest proposed to calculate the AUSF support amount?

A. Qwest has proposed that the appropriate "benchmark rates" be determined as the statewide local exchange rates currently in effect plus the end user common line charge ("EUCL"). Furthermore, Qwest advocates fully-allocated costs as the "appropriate cost."[54] Therefore, the amount of AUSF proposed to be obtained by Qwest is the difference between its current basic local exchange rates plus the EUCL and its proposed fully-allocated costs of providing these services. Residential and business proposed benchmark rates, costs and resulting AUSF amounts have been separately determined.

Q. Is Qwest's choice for the "appropriate cost" appropriate?

A. No. For large local exchange companies, Section R14-2-1202 (D) of the Commission's rules provides the process for establishing the costs. This rule section reads as follows (emphasis added):

> "For a large local exchange carrier, the AUSF support area shall be U.S. census block groups, and the <u>appropriate cost of providing basic local exchange telephone service for purposes of determining AUSF support shall be the Total Service Long Run Incremental Cost</u>. In the event that the FCC adopts a somewhat different forward-looking costing methodology and/or a different geographic study/support area for the Federal universal service fund program, a local exchange carrier may request a waiver from

[54] Direct Testimony of Teresa K. Million, pages 21 and 24.

> this rule in order to utilize the same cost study methodology and/or geographic study areas in both jurisdictions. Any request for AUSF support by a large local exchange carrier shall include a Total Service Long Run Incremental Cost study, or cost study based on FCC adopted methodology, of basic local exchange service. The cost study shall be developed and presented in a manner that identifies the cost for the individual support areas for which AUSF funding is being requested."

Qwest Witness Million's choice of fully-allocated costs violates the specific requirement that Qwest use TSLRIC to calculate its costs. Her choice also appears to contradict Qwest Witness David L. Ziegler's testimony. Mr. Ziegler appears to understand the process for calculating AUSF funding when he states the following:

> "Qwest proposes that the difference between the <u>TSLRIC</u> of basic residential local exchange service in UNE Zone 2 and the sum of the 1FR rate and the FCC Customer Access Line Charge in Zone 2 be recovered from the AUSF."[55]

Mr. Ziegler correctly identifies TSLRIC as the appropriate cost methodology for calculating AUSF.

Q. What is the impact of using fully-allocated costs as opposed to TSLRIC?

A. Since fully-allocated costs include an allocation of shared and common costs, the level of costs is higher than TSLRIC-based costs, expanding Qwest's proposed AUSF draw and creating a large impact on other carriers and their customers who fund the AUSF.

[55] Direct Testimony of David L. Ziegler, pages 12 (emphasis added).

Q. What would be the impact of changing the "appropriate costs" to TSLRIC as required by Commission rules?

A. All else being equal, Qwest's proposed AUSF draw would decrease from $64.04 million to no more than $24.5 million. This amount was calculated by replacing the fully-allocated costs in Qwest Witness Million's Exhibit TKM-02 with the TSLRIC costs she presented in Exhibit TKM-01. In a couple of instances, for business packages, Ms. Million had included costs for both the business local exchange line and features.[56] Since TSLRIC costs were not presented in her exhibit for these features, I retained the fully-allocated cost amounts used by Qwest Witness Million. Thus, I have likely overstated the TSLRIC-based AUSF draw amount. My calculations are shown in Proprietary Exhibit FWL-2. It is important to note that the $24.5 million amount shown on my exhibit assumes the "benchmark rates" are not changed from the Qwest proposal.

Q. As you noted, Section R-14-2-1202 (D) of the Commission's rules requires the AUSF support area to follow U.S. census block groups ("CBGs"). Has Qwest complied with this aspect of the Commission's rules?

A. According to Qwest Witness Million, Qwest used the same inputs and cost model, HAI Cost Model, as used by the Commission in the TELRIC cost docket (Docket No. T-00000A-00-0194).[57] This model developed loop costs based on CBG information. Thus, the inputs appear to be consistent with the Commission's AUSF rules. However, it is unclear whether the cost zones used by Qwest to distinguish the customer lines which would be supported by the AUSF also follow CBGs. Since Qwest has correctly proposed that any AUSF support it receives in the higher cost zones be portable, the Commission should ensure that these zones are defined by CBG boundaries and that only high cost

---

[56] Direct Testimony of Teresa K. Million, page 23 and Exhibit TKM-02.
[57] Direct Testimony of Teresa K. Million, page 23.

CBGs receive funding. Competitors must understand the boundaries for the zones to be able to determine whether they qualify to be considered for any AUSF.

Q. Qwest has proposed its AUSF support would be portable to competitors. Are competitors automatically eligible for AUSF?

A. No. Commission Rule Section R14-2-1203 reads as follows (emphasis added):

> Request for AUSF Support
>
> A provider of basic local exchange telephone service may request that the Commission authorize AUSF support with a filing under R14-2-103 or other method as the Commission may prescribe, and upon compliance with all applicable rules set forth in R14-2-1101 through R14-2-1115. A request for AUSF support shall include a statement describing the need for such funding. The Commission shall determine the appropriate cost of providing basic local exchange service for each AUSF support area for which AUSF support is requested and shall calculate in accordance with R14-2-1202 the amount of AUSF support, if any, to which the applicant is entitled.

Rule Section R14-2-103 appears to be the rate case rules in Arizona. This rule section outlines the various cost schedules which must be submitted to justify rate changes in a traditional rate case or determine the valuation for telecommunications property. Some of these schedules include accounting data and follow the accounting rules traditionally used by incumbent local exchange carriers. Sections R14-2-1101 through R14-2-1115 provide the rules for competitive telecommunications services. While a competitor likely complies with the rules for competitive telecommunications carriers, in the normal course of business, most competitive LECs are not required to maintain their accounting data in the same format as Qwest. Developing the necessary data to comply with Section R14-2-103 would be difficult for many competitors. The administrative burdens would likely outweigh the benefits from receiving AUSF support. Therefore, it is unlikely many competitors would be able to automatically receive AUSF as suggested by Qwest.

Q. Is Qwest's choice for the "benchmark rate" appropriate?

A. Not necessarily. Whether the Commission accepts Qwest's use of fully-allocated costs or the TSLRIC costs required by Commission rules, the benchmark rate must also be reasonable. Though past Commission decisions have strived to "maintain statewide average rates and the availability of basic telephone service to the greatest extent possible,"[58] there is not a hard and fast rule which requires averaged rates for basic local exchange service across all of Arizona. Qwest appears to agree that the Commission has the authority to permit basic local exchange rates to vary across different geographic areas in the state. One of the cornerstones of its competitive zone proposal is the ability to establish de-averaged prices from competitive zone to competitive zone and between competitive and non-competitive areas in its operating territory. Given that Qwest has demonstrated through its cost studies that costs vary significantly among different CBGs and since the Commission has approved different wholesale UNE Loop rates for different cost zones, precedence exists for setting retail rates higher in markets where the cost of service is higher. Before placing a multi-million dollar burden on the customers of the many LECs, IXCs and wireless companies that fund the AUSF, the Commission should consider setting the base rates in the higher cost zones to more closely align basic local exchange service rates with costs.

---

[58] Arizona Corporation Commission Decision No. 65472, December 19, 2002.

Q. Do any of Qwest's other pricing proposals deserve comment?

A. Yes. Qwest has proposed the elimination of the zone 1 and 2 increment charges. Based on information provided by Qwest, these charges are assessed on customers outside the base rate area within an exchange.[59] The zone increments appear to compensate Qwest for the higher cost of serving customers located farther from the center of the exchange – likely customers with longer loop lengths in less dense areas. If one of Qwest's stated goals is to more closely align rates and costs, the zone increment proposal would appear contradictory. In response to discovery, Qwest indicated that the elimination of the zone increment charges would reduce revenue by **{begin proprietary}{end proprietary}**.[60] This revenue could be used to offset some of the AUSF draw regardless of how that draw was calculated.

Q. Do you have any other comments about the proposal to use AUSF money to offset part of the cost of service in this proceeding?

A. Yes. Qwest has proposed an overall incremental revenue requirement of $322 million in this proceeding.[61] Qwest has proposed drawing $64.04 million from the AUSF to partially recover this incremental revenue requirement. I have calculated a lower AUSF amount and suggested additional changes which could further reduce the impact on the AUSF. To the extent the revenue requirement proposed by Qwest is reduced, the need for funding from the AUSF might also be reduced.

---

[59] Qwest's response to Cox Request No. 2-30.
[60] Qwest's response to Cox Request Nos. 2-33 and 2-34.

[61] Direct Testimony of Philip E. Grate (Qwest), page iii.

Q. Do you have any comments about the implications of Qwest's proposals for withdrawing AUSF money on the actual funding of the AUSF?

A. Yes. Qwest's proposed use of the AUSF will increase the need for a larger fund significantly and hence increase the funding burden on the customers of other telecommunications providers in Arizona, including those of Qwest's competitors. Before increasing this burden, the contribution process should be addressed. Currently the AUSF is collecting 50% of its total receipts from customers of the providers of basic "local exchange services" such as incumbent LECs, competitive LECs and wireless companies based on the number of access lines and interconnection trunks in place. The contribution from wireless carriers is based on the number of interconnecting trunks obtained from the local access provider by the wireless provider in conjunction with a conversion factor to determine the contribution from wireless providers using a surcharge on such interconnecting trunks. The other 50% is collected from interexchange carriers ("IXCs") based on each IXC's percentage of intrastate toll revenues.

There are three inherent problems with this methodology. First of all, not all providers of "basic local exchange services" are treated equally. Contributions from wireless carriers are based on a formula that converts interconnection trunks to lines. As Qwest points out, the number of wireless subscribers has increased significantly in recent years; wireless companies must share appropriately in the burden of contributing to the AUSF. In addition, the number of interconnection trunks provided by different LECs can vary significantly based on traffic patterns, especially for ISP traffic.

Second, some non-network based local exchange companies may not contribute at all. It appears that providers relying upon VoIP technology and not deploying their own network facilities will not be required to contribute to the AUSF. If Qwest is correct and these companies are serving an increasing number of customers, "basic local exchange service" providers that have built their own networks would be treated in a discriminatory manner without changes to the AUSF funding process.

Third, toll revenues are decreasing and are no longer a reliable means of funding the AUSF. The distinction between toll and local revenue is disappearing. Wireless companies now carry a lot of traffic previously handled by IXCs. The allocation of revenue from packages or bundles which include local, toll and broadband services to the various revenue categories is arbitrary at best. Thus, toll revenues may not provide an accurate or sustainable source of future AUSF funding.

Q. Does Cox have a proposal to address these concerns?

A. Yes. Before increasing the size of the AUSF, the Commission should modify the AUSF rules to more fairly distribute the contribution burden. Contributions should be based on working telephone numbers which are easily measured and must be in place for customers to receive telephone service regardless of the technology. It would be fairly simple for the administrator to divide the AUSF funding requirement by the number of working telephone numbers in the state. This methodology would be service provider and technology neutral. As an alternative, the Commission could divide the contribution burden for any one number between the customer's chosen local exchange carrier and his or her IXC(s). This alternative would retain a contribution requirement from the toll providers. Cox recommends these changes be made prior to allowing Qwest to use the AUSF to fund any of its revenue requirement in this proceeding.

Q. Do you have any other comments concerning Qwest's AUSF proposal?

A. Yes. Under some circumstances the use of the AUSF to fund some of Qwest's revenue requirement may be appropriate. Similar to the federal fund, the AUSF is an approved cost recovery mechanism established to help maintain affordable basic local exchange service rates. However, as the marketplace becomes more competitive, the Commission must use caution to ensure that the AUSF does not become a tool for Qwest to replace any revenue it might lose to competition. Thus, AUSF receipts must really be portable to competitors, and the calculation of need must be driven by cost recovery and not revenue recovery. Qwest should not be allowed to merely shift the sources of its revenues from its end-user customers to its competitors and their customers. No telecommunications service provider's competitive losses, including Qwest's, should be subsidized by the AUSF.

H. NEW SERVICES

Q. Qwest Witness Teitzel has proposed to treat all new Qwest services as competitive. Do you agree?

A. Not necessarily. Competitive services by definition must have comparable alternative providers. To make a blanket determination that another provider is offering a comparable service to any service or bundle of services that Qwest might introduce is a leap of faith. As opposed to automatically classifying new services as competitive, Qwest should be required to make a showing to the Commission pursuant to Rule R14-2-1108 that a new service deserves such treatment when the service is introduced. The Commission does not have to hold up introduction of a new service while it addresses Qwest's petition or other filing requesting competitive classification, but some formal action by the Commission should be required before a service is deemed competitive and price deregulation is authorized. There is no need for the Commission to abdicate its authority over pricing as a prerequisite to customers receiving the choices provided by a new service offering that may or may not be deemed competitive. In addition, new services should not be declared competitive on a statewide basis. Once the Commission has determined that a specific zone is competitive, new services which are held to be competitive should be identified as such only in the specific competitive zone(s).

Q. Does an alternative to competitive classification exist?

A. Yes. As previously mentioned, similar to some other states, the Commission could establish a new basket of services to contain non basic services that are also not competitive. This basket would provide increased pricing flexibility and be subject to more symmetrical tariff and notice rules than basic services, but still permitting the Commission some level of oversight. This new category could be used for a new service during a transitional period while the Commission determines whether the new service is in fact competitive or not.

I. PROMOTIONS

Q. Should Qwest be permitted unlimited or unsupervised use of promotions to respond to alleged competition?

A. No. As discussed above, Qwest still retains significant market power in Arizona. As competition emerges, Qwest should have the ability to respond, but the appropriate competitive safeguards must be followed. Cox is not opposed to allowing Qwest symmetrical tariff and notice requirements to those of competitors as long as Qwest is required to certify and provide cost justification if necessary to demonstrate that the price floor or imputation test I advocated earlier is met. However, the Commission must retain the authority to investigate Qwest's pricing and any related complaints and take the appropriate action to correct any anti-competitive behavior, including requiring refunds to competitors should Qwest use a promotion to price in a predatory manner or to create a price squeeze.

J. SUMMARY OF RECOMMENDATIONS

Q. Could you please summarize your recommendations regarding Qwest's proposed price regulation plan?

A. Yes. As noted above, the continuing market power of Qwest, the fragile state of competition and the regulatory and legal turmoil require the Commission to modify Qwest's proposals. However, with a few essential modifications Qwest's proposed Price Regulation Plan could be implemented. Therefore, to protect consumers from anti-competitive pricing and give competition a chance to really work in Arizona, Cox proposes the following changes.

- The current level of competition and the increasing regulatory uncertainty about the availability of competitive alternatives in the future requires the Commission to deny Qwest's competitive zone proposal.

- Subject to the changes noted below, the amount of AUSF requested by Qwest to offset a portion of its revenue requirement should be reduced from $64.04 million to no more than $24.5 million to reflect the proper costs pursuant to existing Commission rules.

  - ❖ The calculation of AUSF should be based on the TSLRIC costing methodology that is required by Commission rule instead of fully-allocated costing as proposed by Qwest.

  - ❖ The use of AUSF withdrawals to cover Qwest's revenue requirement should not be permitted until the AUSF funding mechanism has been restructured to be based on working telephone numbers instead of revenues to make the fund more competitively neutral and sustainable.

- ❖ The Commission should verify that only high cost CBGs will receive AUSF support.
- ❖ The Commission should consider establishing rates for higher cost areas that more closely match the costs of providing the service within a framework consistent with Federal and State statutes and related rules concerning the pricing of services in rural markets.

- As long as Qwest requires AUSF support to offset part of its revenue requirement, Qwest should retain the zone 1 & 2 increments to help maintain more alignment of rates and costs.
- New services should not be designated as competitive without a specific finding by the Commission.
- Commission oversight of Qwest's promotions, which involve services not deemed competitive, should continue.

Should the Commission determine that some form of a competitive zone proposal is appropriate, the following changes to Qwest's proposal should be made:

- The designation of competitive zones should be limited to specific complete exchange or town. Competitive zones should not be permitted for geographic areas less than a town or exchange.
- Only specific services within a zone for which competition exists should be deemed competitive.

- Pricing and tariff requirements for Qwest services within a competitive zone should follow the rules for competitors under Commission Rule Sections R14-2-1109 and R14-2-1110.
- Prices should be consistent across all competitive zones and within a competitive zone itself.
- A price floor defined by the sum of the prices of the unbundled network elements that are utilized to provision the service plus the long-run incremental cost of any other required network functions should be established for all competitive services.
- The Commission should specifically make its own determination of whether any additional competitive zones proposed by Qwest should be approved. Interested parties should have the opportunity to comment on any such proposal.

L. CONCLUSION

Q. Does this conclude your Direct Testimony?

A. Yes.

EXHIBIT

FWL-1

CURRICULUM VITAE

OF

F. WAYNE LAFFERTY

F. Wayne Lafferty

Mr. Lafferty is an 18 year veteran the telecommunications Industry in the United States. He has participated in the operation and evolution of that industry including the analysis and implementation of the 1996 Telecommunications Act which has brought about significant change for that industry. His experiences have touched many areas of the industry including incumbent local exchange ("ILEC"), competitive local exchange ("CLEC"), and long distance and broadband operations. He has first hand experience with the technological, product and regulatory changes driving the dramatic evolution of the telecommunications industry in recent years. In addition, Mr. Lafferty has played a leadership role in the operation of a diversified telecommunications enterprise developing and implementing strategies and programs to provide quality customer and community service, develop employees, grow revenues, build and maintain facilities and operate efficiently. He has first hand experience with managing marketing, regulatory, public relations, strategic planning, acquisition analysis and implementation and other administrative responsibilities.

His specific professional focus over the years has been in the area of state and federal regulatory and public policy development and implementation. His experiences over the years ranged from developing and managing state rate case proceedings to early (pre 1996) efforts to develop the policies to implement competition and deregulation to shaping the rules and regulations guiding the unfolding competitive environment in the telecommunications industry. Throughout his entire career, he has focused on the importance of effective communication and seeking realistic balanced solutions to regulatory, operational and financial challenges using the most effective processes.

Mr. Lafferty is considered a leader in the public policy arena in the United States having testified before state regulators in Arizona, California, Connecticut, Idaho, Illinois, Iowa, Montana, Nebraska, New York, North Dakota, Oklahoma and Wyoming and the United States Congress.

Mr. Lafferty has participated in a variety of telecommunications' activities including:

- Development and implementation of balanced public policy advocacy programs for the benefit of a diversified telecommunications enterprise.
- Implementation of regulatory and operational requirements stemming from the 1996 Act and subsequent regulatory rulings.
- Development of requirements, processes and procedures to negotiate and implement interconnection arrangements.
- Development and analysis of cost studies for products, unbundled elements and interconnection services.
- Analysis of federal and state cost recovery mechanisms including access charges and universal service programs.
- Negotiation of interconnection matters and disputes on behalf of competitive and incumbent telecommunications entities.
- Analysis and implementation of incentive regulatory programs.
- Development of processes to implement the FCC's cost allocation rules (Part 64).
- Development and management of state rate and other major regulatory proceedings during time of significant telecommunications network and product expansion.

- Development of state and federal legislation to implement competition, and revise regulatory rules.
- Development and implementation of a start up telecommunications operation to provide diversified services to over 400,000 customers.
- Divestiture and/or acquisition of telecommunications properties covering over 2,000,000 customers.
- Development and implementation of credit and collection policies for deregulated businesses as premises equipment and other services became deregulated.
- Development of portions of the 1996 Telecommunications Act.

Over his career Mr. Lafferty has held positions of increasing responsibility with GTE Corporation (now part of Verizon Communications) and Citizens Communications/Electric Lightwave. Most of his responsibilities have been in regulatory and government affairs area. However, leadership positions have provided experience with all aspects of managing a diversified telecommunications operation.

In 2001 he founded LKAM Consulting Services to provide consulting services to telecommunications entities (incumbents and new entrants) and other industry players on a variety of regulatory, public policy and interconnection matters. In 2003, Mr. Lafferty became a principal in the Barrington-Wellesley Group continuing his telecommunications consulting activities in the areas of interconnection and regulatory policy and adding the full scope of management consulting to his potential responsibilities. Mr. Lafferty's recent consulting projects have been on behalf of both competitive and incumbent telecommunications interests.

Mr. Lafferty is a native of Baltimore, Maryland and a graduate of Duke University with an undergraduate degree in economics and an MBA. He participates in industry trade associations and has spoken at seminars over the years on a variety of technical and public policy issues. He currently lives in McKinney, Texas (a Dallas suburb).

EXHIBIT

FWL-2

(PROPRIETARY)