Direct Testimony
of
D.M. Gude

BEFORE THE SOUTH DAKOTA PUBLIC UTILITIES COMMISSION

IN THE MATTER OF DETERMINING PRICES FOR UNBUNDLED NETWORK ELEMENTS (UNEs) IN QWEST CORPORATION'S STATEMENT OF GENERALLY AVAILABLE TERMS (SGAT)	)	DOCKET NO. TC01-098

QWEST CORPORATION'S

DIRECT TESTIMONY

OF

D. M. (MARTI) GUDE

OCTOBER 15, 2002

TESTIMONY INDEX

EXECUTIVE SUMMARY

D. M. (Marti) Gude is employed by Qwest as a Director - Cost Accounting. In that position she is responsible for various regulatory and management accounting functions, including the preparation and analysis of embedded cost studies for purposes such as deregulation, cost accounting and regulatory filings.

Her testimony provides the Commission with the information needed to identify accurately the costs that Qwest avoids in selling retail services on a resale basis. Her testimony also presents Qwest's Embedded Avoided Cost Study and provides the Commission with reasonable, accurate resale discounts that are based on that study. Ms. Gude presents resale discounts for five basic service groupings, "packaged / special" services, Operator Service/Directory Assistance services, and Public Access Line service, and provides recommendations for the handling of "volume / term contract" services.

Ms. Gude's testimony also discusses the provisions of the Telecommunications Act of 1996 ("the Act") relating to resale services and emphasizes the competitive and economic importance of setting appropriate resale discounts. She also explains why resale discounts and avoided costs must be calculated using only costs specific to Qwest's South Dakota intrastate operations, not combined interstate/intrastate total State costs.

Ms. Gude explains further that reliance on generic FCC proxy pricing guidelines, which have been vacated and remanded by directives from the United States Court of Appeals for the Eighth Circuit, would be inappropriate in this proceeding. She explains why, in keeping with the spirit of Sections 251 (c)(4) and 252 (d)(3) of the Act, the Commission should rely upon an avoided cost model that produces multiple resale discounts, rather than only a single, average resale discount.

The balance of Ms. Gude's testimony sets forth:

- a description of Qwest's avoided cost study methodologies, assumptions, procedures, exhibits, and resale discount results;
- why ARMIS high level data and invalid FCC proxy guidelines cannot be used to calculate accurate resale discounts;
- why Qwest's cost data specific to South Dakota intrastate retail telecommunication product offerings must be employed to calculate resale discounts in order to satisfy requirements of the Act;
- the importance of excluding all costs associated with services that are not subject to resale from the calculation of the discounts;

- the FCC Part 32 USOA accounts that contain "retailing" costs and explains why entire account balances can not simplistically be considered totally avoided;

- why account and sub-account balances must be carefully analyzed to determine the costs that Qwest will avoid under the resale provisions of the Act;

- how Qwest identified avoided costs and why all costs that are part of intrastate retail rates, including network and general support-related capital costs, must be included in the avoided cost analysis and discount calculations;

- why "recurring rate" resale discount calculations should exclude non-recurring charges and operator service/directory assistance ("OS/DA") costs;

- a description of the Qwest embedded avoided cost study documentation and the study's results;

- why packaged services and non-basic special services should be separately addressed through the development and application of a composite discount; and

- why volume/term contract services, Operator Service/Directory Assistance services and Public Access Line service require separate avoided cost analysis.

The product category results of the Qwest-South Dakota embedded avoided cost study are as follows:

Category	Service Description	Discount
Basic - 1	Basic Exchange Business	7.63%
Basic - 2	Toll	6.65%
Basic - 3	Listings, CO Features, & Informational Services	39.93%
Basic - 4	Basic Exchange Residence	4.62%
Basic - 5	Private Line	5.26%
Composite	Packaged/Special Services	8.88%

I. IDENTIFICATION OF WITNESS

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is D. M. (Marti) Gude. My business address is 1314 Douglas-on-the-Mall, Omaha, Nebraska.

Q. WHAT IS YOUR EDUCATIONAL BACKGROUND AND PROFESSIONAL EXPERIENCE?

A. I received a Bachelor of Science degree in Business Administration, with a major in Accounting, from the University of Nebraska - Lincoln and a Master of Business Administration degree, with honors, from the University of Nebraska at Omaha. I am also a Certified Public Accountant, certified in the State of Nebraska as an inactive registrant.

I was a member of the audit staff for a Big Eight Public Accounting firm for four years prior to joining Qwest's predecessors (U S WEST and Northwestern Bell) in 1979. My public accounting experience included audits for companies in various industries, which included the issuance of opinions on financial statements. At Qwest and its predecessors, U S WEST and Northwestern Bell, I have held various positions in the Budget, Finance, Corporate Accounting and Cost Accounting departments. I have worked in the area of cost accounting since January 1986.

Q. HAVE YOU FILED TESTIMONY AND/OR TESTIFIED PREVIOUSLY ON THE SUBJECT OF COST DISTRIBUTION AND/OR COST ACCOUNTING?

A. Yes. Appendices A-1, A-2 and A-3 of my testimony provide a chronological listing of the dockets / cases, by state, in which I have previously testified.

II. PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. The purpose of my testimony is to provide the Commission with information needed to identify accurately the costs that Qwest avoids in selling its retail services on a resale basis. I also present and describe Qwest's "Embedded" Avoided Cost Study for South Dakota operations, which I have included as Proprietary Exhibit DMG – 2 to my testimony. This study identifies the embedded costs for Qwest retail services that Qwest avoids when it resells its retail telecommunications services on a wholesale basis to competitive local exchange carriers ("CLECs").

My testimony discusses the attributes of the Qwest Embedded Avoided Cost Study and establishes that the study complies with the resale requirements of the Telecommunications Act of 1996 ("the Act"). I also describe how the Commission should be guided by the Act and Qwest's detailed cost records and discuss why the Commission should not calculate discounts based on proxy cost data set forth in the now vacated FCC pricing rules relating to resale discounts.[1]

The discounts produced by the Qwest- South Dakota embedded avoided cost study are as follows:

Category	**Service Description** *	**Discount**
Basic - 1	Basic Exchange Business	7.63%
Basic - 2	Toll	6.65%
Basic - 3	Listings, CO Features, & Informational Services	39.93%
Basic - 4	Basic Exchange Residence	4.62%
Basic - 5	Private Line	5.26%
Composite	Packaged/Special Services	8.88%

* These resale discount service descriptions represent avoided cost study service categories and product/service category outputs from the Company's cost accounting system.

1 The United States Court of Appeals for the Eighth Circuit vacated certain FCC pricing rules, including 47 C.F.R. § 51.609 (b) relating to the calculation of resale discounts, in Iowa Utils. Bd. v. FCC, 219 F.3d 744, 751 (8th Cir. 2000).

III. GENERAL RESALE DISCOUNT ISSUES

Resale Requirements Of The Telecommunications Act Of 1996

Q. WHAT REQUIREMENTS ARE SET FORTH IN THE TELECOMMUNICATIONS ACT OF 1996 FOR ESTABLISHING RESALE DISCOUNTS?

A. The Act requires state commissions to set resale discount rates for retail telecommunications services based upon an analysis of the costs inherent in the rates being discounted.

Section 251 (c)(4)(A) of the Act requires telecommunications carriers acting in the capacity of a local exchange carrier, such as Qwest:

> … to offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers who are not telecommunications carriers. (Emphasis added).

Section 252 (d)(3) of the Act directs that:

> A state Commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier. (Emphasis added).

As this language demonstrates, the Act requires that the wholesale rates must be based on "retail" telecommunications service rates, which means that the discounts must be calculated using only costs that are part of those retail rates. Therefore, in determining which costs Qwest will avoid when selling services on a wholesale basis, only costs that are part of the retail rates can be treated as avoided costs. Thus, the process for calculating the discounts is relatively straightforward: it requires identifying all the costs that make up Qwest's retail telecommunications services rates and determining which of those costs Qwest will avoid when it sells the retail services to CLECs on a wholesale basis.

Importance Of Appropriate Resale Discounts

Q. WHY IS IT IMPORTANT FOR THE COMMISSION TO ESTABLISH ACCURATE RESALE DISCOUNTS IN THIS PROCEEDING?

A. The level of resale discounts can have a far-reaching impact on the development of the telecommunications infrastructure and the promotion of capital investment in South Dakota. During recent years, Qwest has continued to invest significant capital to grow and maintain its network infrastructure in South Dakota, an infrastructure that competitive entrants may now readily use. In replacing South Dakota's existing wholesale discounts, the Commission should guard against setting resale discounts that over-estimate the costs Qwest will avoid in selling retail services at wholesale. Establishing discounts that over-estimate avoided costs will reduce the incentive for competitive entrants to make their own capital investments in South Dakota.

Discounts that are too high could cause competitive entrants only to resell Qwest's products and services without investing in their own network infrastructure. This result would have the competitive entrants relying on Qwest's network and would leave Qwest bearing most of the risk of network investment. In addition, if the Commission artificially sets resale discounts too high, Qwest will be deprived of the compensation it requires to fund capital investments that are to be used to provision retail and resale telecommunications services. At the same time, the Commission should not set the discounts too low – that is, below Qwest's avoided costs – since that would discourage resale competition.

Reliance On FCC Guidelines

Q. DID THE FCC ATTEMPT TO PRESCRIBE CERTAIN RESALE DISCOUNT METHODOLOGIES IN ITS FIRST INTERCONNECTION ORDER, RELEASED ON AUGUST 8, 1996?

A. Yes. In that Order, the FCC described two methods for determining resale discounts. The preferred method required state commissions to determine resale discounts from a Company's detailed avoided cost studies.[2] In the alternative, and only in the absence of a company-specific cost study, the FCC directed state commissions to

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2 See FCC 96-325, *First Report & Order in the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, Section VIII. Resale, at para. 908. (Rel Aug., 1996), ("First Report and Order") See also the preferred method set forth at 47 C.F.R. § 51.609(a).

establish resale discounts based on the FCC's default guidelines, which were not company-specific and, instead were generic and broad. The FCC ordered that these default discounts were to be used only on an interim basis and only until discounts could be established based on an avoided cost study.[3] In addition, the FCC promulgated rules, published at 47 C. F. R. § 51.607 and 51.609(b), that addressed their definition and identification of "avoided retailing costs."

Q. WHAT RELIANCE SHOULD THE COMMISSION PLACE ON THE FCC'S FIRST INTERCONNECTION ORDER AND ITS PRESCRIBED GENERIC AND PROXY GUIDELINES REGARDING AVOIDED COSTS AND RESALE DISCOUNTS?

A. In Iowa Util. Bd. v. FCC, the Eighth Circuit Court of Appeals held that the FCC's rules relating to resale discounts did not comply with the Act and had to be vacated.[4] Thus, the FCC's generic avoided cost guidelines, data and default proxy discounts are no longer in effect and should not be relied upon in this proceeding for determining Qwest's avoided costs or to set the resale discounts for Qwest's retail telecommunications services.

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3 The FCC's rules relating to default discounts, which are now vacated, were set forth at 47 C.F.R. § 51.611.

4 Iowa Util. Bd. v. FCC, 219 F.3d 754-57 (10th Cir. 2000).

In its decision, the Eighth Circuit stated that the language of 47 U.S.C. § 252(d)(3) is clear. That is, wholesale rates shall exclude costs that actually will be avoided by the local exchange carrier, not costs that are potentially avoidable. The Court stated:

> The plain meaning of the statute is that costs that are actually avoided, not those that could be or might be avoided, should be excluded from the wholesale rates.[5]

The Court explained further that:

> The statute recognizes that the ILEC will itself remain a retailer of telephone service with its own continuing costs of providing that retail service. The FCC's rule treats the ILEC as if it were strictly a wholesaler whose sole business is to supply local telephone service in bulk to new purveyors of retail telephone service. Under the statute as it is written, it is only those continuing costs of providing retail service which will be avoided by selling to the competitor the services it requests which are to be excluded. The FCC's rule is contrary to the statute.[6]

Given these directives from the Eighth Circuit, it would be inappropriate to rely on the FCC's vacated definition of avoided costs, assumptions relating to amounts of avoided costs, and default discounts. Instead, the South Dakota Commission should rely upon a detailed, South Dakota-specific avoided cost study that meets the requirements of §252(d)(3) of the Act. Qwest's avoided cost study meets these criteria.

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5 Iowa Util. Bd., 219 F.3d at 755.

6 Id. at 755-56.

Avoided Cost Study Data

Q. CAN APPROPRIATE DISCOUNTS FOR QWEST RETAIL TELECOMMUNICATIONS SERVICES BE DETERMINED WITHOUT EMPLOYING DETAILED COMPANY COST INFORMATION?

A. No. Detailed cost data specific to Qwest's South Dakota retail telecommunications services are essential. Without these data, reliable resale discounts for Qwest's South Dakota-specific operations cannot be determined. That is why Qwest's embedded resale discount study is based on detailed cost information, not theoretical broad-based FCC industry-wide proxy guidelines or non-Qwest specific costs and assumptions. In this regard, Qwest's avoided cost study stands in contrast not only to the FCC's default discounts but also to the other studies presented in earlier South Dakota arbitration proceedings (i.e. the AT&T arbitration study relied in substantial part on the FCC's now vacated assumptions).

I would also reiterate that the FCC itself recognized the importance of using company and state-specific data:

> <u>A state commission</u> that establishes interim wholesale rates <u>shall</u>, within a reasonable period of time thereafter, <u>establish wholesale rates on the basis of an avoided retail cost study</u> that complies with § 51.609.[7]

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[7] 47 C.F.R. § 51.611 (c) (Emphasis added).

Q. PLEASE EXPLAIN YOUR USE OF THE TERM "DETAILED COMPANY COST INFORMATION."

A. In the context of this proceeding, "detailed company cost information" refers to South Dakota-specific costs (not 14 state Qwest or industry-wide data) that have been:

- jurisdictionally separated (split interstate/intrastate) under 47 C.F.R. Part 32/36 rules;
- further refined to reflect South Dakota Public Utilities Commission (SDPUC) decisions and jurisdictional accounting (i.e. SDPUC rather than FCC ordered depreciation rates, and decisions rendered by the South Dakota Commission in Docket Nos. F-3848, F-3849, F-3850 and Docket No. TC93-108, etc.);
- disaggregated to reflect intrastate product detail as obtained from ledgers, subsidiary records and accounting systems maintained by Qwest.

Q. DOES THE LEVEL OF DATA EMPLOYED IN QWEST'S EMBEDDED AVOIDED COST STUDY PROVIDE FOR THE DEVELOPMENT OF APPROPRIATE RESALE DISCOUNTS?

A. Yes. Qwest's study recognizes that the retail costs Qwest will avoid can be determined most accurately by using cost data specific to Qwest's operations in South Dakota. The Company's embedded study also recognizes that the development of individual product category discounts is important since Qwest's services offered in South Dakota vary significantly in the amount and proportion of operating expenses and capital investments that are required. Stated another way, each Qwest basic service category has unique cost characteristics and, therefore, a discount specifically tailored to each category is necessary.

As the Act requires, the Commission should focus on a detailed study that begins with the analysis of Qwest – South Dakota operating costs to determine the retailing costs that are inherent in Qwest's retail telecommunication service rates. Using detailed Company records, Qwest's embedded avoided cost study facilitates the calculation of separate discounts for multiple service category groups. These service groups encompass the telecommunications services that Qwest offers for resale. The service category discount methodology recommended by Qwest recognizes the similarities and differences among Qwest's basic services. This methodology helps to balance service group cost differences and the administration and processing issues relating to the use of multiple discounts, as well as the purchase alternatives afforded to customers, resellers, and facilities-based competitors.

For example, Basic Exchange - Residence service is a capital-intensive service and has few avoided "retailing" costs. Therefore, this service should receive a lower discount than Basic Exchange - Business service or Central Office Features, both of which rely more heavily on retail marketing efforts. A service such as Toll, which can be self-provisioned by facilities-based competitive entrants, should have a separate discount so that it does not residually impact or contaminate other resale discounts for basic services that are more likely to be purchased by resellers. Additionally, some services offered by Qwest are sold as "packaged services" (e.g. CustomChoice™ [8]). To accommodate the unique characteristics of packaged/special services and to address administrative issues relating to a discount for these services, Qwest's study derives a blended/composite discount for packaged/special services.

Reliance On A Multiple Discount Model

Q. WHAT LEVEL OF DISAGGREGATION CURRENTLY EXISTS IN SOUTH DAKOTA'S EXISTING RESALE DISCOUNTS ESTABLISHED AS A RESULT OF EARLIER PROCEEDINGS AND DECISIONS?

A. In earlier post-Act arbitration proceedings, this Commission established an overall composite resale discount of 15.55% for Qwest's retail telecommunications services. The Commission then further refined that discount to recognize that resellers may provide their own operator services or their own billing and collection service. The Commission found that if resellers provided their own operator services, the discount would be set at 12.87%; and if resellers provided their own billing and collection

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8 CustomChoice, a Registered Trademark of Qwest Corporation's parent company.

services the resale discount would be set at 15.49%.[9]

Q. DOES THE LANGUAGE OF THE ACT SUPPORT USING A MODEL THAT DISAGGREGATES AND CALCULATES MULTIPLE DISCOUNTS?

A. Yes. Unique category discounts are in keeping with the spirit and the express language of the Act. The language of the Act refers to wholesale and retail rates, using the plural, not the singular. Section 252(d)(3) states:

> [A] State commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier. (Emphasis added).

This statement contemplates that resellers will avail themselves of more than one service and, therefore, a variety of rates/service categories. As a result, retail services and their associated costs must be analyzed. Nothing in the language of the Act suggests that a single, average discount should be created and applied indiscriminately to all of Qwest's retail services or rates. The FCC itself noted in its Order and agreed that:

> … Avoided costs may, in fact, vary among services. Accordingly, we allow a state to approve non-uniform wholesale discount rates, as long as those rates are set on the basis of an avoided cost study that includes a demonstration of the percentage of avoided costs that is attributable to each

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9 See Docket No. TC96-184 *Findings Of Fact And Conclusions Of Law; Order And Notice Of Entry Of Order* issued March 20, 1997, at 24, §§ 195 and 196.

service or group of services.[10]

The Commission should reject studies that produce only a single average discount. These studies are inappropriate, since Qwest's underlying costs and avoided costs vary from service to service, and the unique cost characteristics of each service are not properly accounted for by a single, average discount. In addition, the averaging of discounts to form only a single discount allows CLECs to engage in rate arbitrage, as it gives them the ability to purchase only those services whose individual discounts would actually be lower than the average discount they would receive. If CLECs purchase only those services, and not the services whose individual discounts would actually be higher than the average discount, they will benefit improperly and Qwest will not recover its operating costs.

Q. PLEASE EXPLAIN FURTHER THE ARBITRAGE OPPORTUNITIES THAT ARISE FROM THE USE OF A SINGLE, AVERAGE DISCOUNT INSTEAD OF DISCOUNTS FOR UNIQUE BASIC SERVICE PRODUCT CATEGORIES.

A. As previously discussed, the use of a single one-size fits-all average discount inherently creates a subsidy that flows from: (1) services a CLEC does not purchase; or (2) services with actual avoided costs that exceed the average discount; to (3) resale services CLECs purchase that have lower actual avoided costs. For example, in Qwest's case, this means that Qwest's Basic Exchange - Residence service, which

10 *First Report & Order,* Section VIII. Resale, ¶ 916.

has a calculated avoided cost discount of only 4.62%, would instead receive a discount of 8.88% - implying a 92% increase in the avoided cost discount for Basic Exchange - Residence service and a discount rate that is in excess of the service's inherent retail costs that are avoided. This additional form of implicit subsidy is contrary to the Act and the FCC's directive to make any subsidies explicit.[11]

Theoretically, this difference could be made up through the resale of services with discounts greater than the average discount percentage. But, in actuality, this will not occur unless resellers purchase all retail services, and in the same proportionate quantities, that Qwest sells in its existing retail business. This is highly unlikely since resellers are not legally bound to buy services in any particular quantities or proportions. In fact, some resellers have indicated their intention or demonstrated their ability to self-provision some services, such as Operator Services/DA (OS/DA) or Toll, or that they are or will be focused on targeting high-end business customers, rather than the rural residential customers of Qwest.

Facilities-based providers and niche resellers can pick and choose the Qwest services they will resell, combining these services with their own. In this environment, the potential for arbitrage caused by a single, average discount would not be in compliance with the provisions of the Act. Compliance would not occur since the rate

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11 See *In The Matter of Federal – State Joint Board on Universal Service, Ninth Report and Order and Eighteenth Order On Reconsideration*, CC Docket No. 96-45, ¶ 17 (Rel Nov 2, 1999).

reduction resulting from a single, all-encompassing, average resale discount would not correspond with the avoided costs inherent in the retail rates for services offered by Qwest. Given the number and types of resellers, and the options available to each, the single, average, one-size fits-all discount, often supported by resellers, is not appropriate to apply to all Qwest services and its use would be inconsistent with the resale provisions of the Act.

Q. IN ADDITION TO FIVE BASIC SERVICE PRODUCT-CATEGORY DISCOUNTS, DOES THE QWEST EMBEDDED AVOIDED COST STUDY ALSO PRODUCE A COMPOSITE DISCOUNT?

A. Yes. Qwest's embedded study produces five basic service product category discounts as well as a blended or aggregate composite discount. While Qwest supports the development and application of individual category discounts, a composite discount may be useful in certain situations where the application of one of the five basic service discounts would be inappropriate.

Additionally, the development of a composite discount in the Qwest Embedded Avoided Cost Study provides for a general reference and comparison to the single average discount typically produced in high level studies developed by resellers and other parties.

Q. IN WHAT SITUATIONS SHOULD THE COMMISSION CONSIDER USING A COMPOSITE DISCOUNT?

A. The Commission should consider using a composite discount for Qwest packaged and non-basic special services. In addition, a composite discount may be useful for determining appropriate discounts for already-discounted, volume/term contract services. I discuss the unique nature of these services and the need for a different avoided cost analysis for these services later in my testimony.

IV. QWEST EMBEDDED AVOIDED COST STUDY

<u>Overview</u>

Q. HAVE YOU PROVIDED DOCUMENTS SUPPORTING THE QWEST EMBEDDED AVOIDED COST STUDY AND THE DISCOUNTS THE STUDY PRODUCES?

A. Yes. The exhibits to my testimony contain documentation describing the Qwest embedded avoided cost study, the resale discount calculations, and the results. Exhibit DMG - 1 provides a narrative description of the study. Proprietary Exhibit DMG – 2 depicts the calculations and results of the study.

Guidelines For Preparing Qwest's Embedded Avoided Cost Study

Q. WHAT BASIC GUIDELINES UNDERLIE THE QWEST EMBEDDED AVOIDED COST STUDY?

A. The study is premised upon two basic guidelines. First, the Act provides two key guiding principles:

- Section 251(c)(4) of the Act requires that incumbent LECs offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers who are not telecommunications carriers.

- Section 252(d)(3) states that state commissions shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier.

Second, as the Act implies and the FCC correctly recognizes:

- each retail service must meet the statutory definition of a telecommunications service that is provided at retail to subscribers who are not telecommunications carriers.[12]

Neither the Act nor the FCC prescribes a specific listing of services that are subject to the resale requirement, and neither provides a detailed or absolute methodology for determining avoided costs.

12 *First Report & Order*, Section VIII. Resale, ¶ 871, footnote 2088, at 415.

Q. IN ADDITION TO THE BASIC PRINCIPLES YOU JUST MENTIONED, WHAT ADDITIONAL GUIDELINES DID QWEST EMPLOY TO DEVELOP ITS EMBEDDED COST STUDY?

A. Qwest adhered to several additional guidelines in developing its embedded cost study. I summarize these guidelines below:

1. ***Employ an approach that reflects the Act and/or any valid FCC directives for identifying avoided "direct" and "indirect" cost components for services subject to resale.*** Consistent with its filings in other jurisdictions, Qwest's embedded cost study relies on a format that includes:
    - (a) total intrastate booked revenue and operating expense components;
    - (b) "retail" revenue, expense and capital cost components (exclusive of non-resale services);
    - (c) the split of direct and indirect expenses and capital costs;
    - (d) the avoided cost percentage assumptions for separate *"retail"* service direct and indirect cost elements; and
    - (e) the resulting avoided cost estimates and calculated resale discounts.

2. ***Employ "intrastate product-specific" data.*** The first step in the avoided cost analysis is to identify all the costs to include in the analysis. In this regard, it is important to isolate intrastate operations in order to properly evaluate embedded

avoided costs and to calculate cost discounts for specific and disaggregated intrastate resale services.

Exchange Access Service (switched access) is not subject to discount under the requirements of Section 251(c)(4) of the Act because it is a wholesale carrier service, not an end-user retail telecommunications service.[13] Therefore, elimination of all interstate access revenue and Part 36/69 separated costs (including elimination of all interstate CCL loop costs and the End-User SLC[14]) is essential in identifying the body of costs to include in the analysis. Eliminating these costs from the analysis also is consistent with the fact that state commissions only have jurisdiction over intrastate, not interstate, costs.[15]

Since the current Qwest - South Dakota intrastate rates are based on the jurisdictional intrastate cost assignments resulting from the FCC's Part 36/69 separations procedures,[16] and since the prices we are dealing with are intrastate, the embedded avoided cost study and embedded discount calculations must reflect corresponding intrastate data. In other words, only intrastate costs should be

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13 *First Report & Order*, Section VIII. Resale, ¶¶ 873-75.

14 Id. at Section VIII. Resale, ¶¶ 873-74, 984.

15 Section 252(d)(3) of the Act requires that the identified avoided costs be inherent in the rates discounted. Interstate costs are not inherent in intrastate rates.

16 See 47 C.F.R. Part 36 and Part 69.

included in the analysis and discount calculation.

3. ***Isolate and exclude "non-resale services" from the analysis of avoided costs and the calculation of discounts.*** As the Act requires, non-resale services must be removed from an avoided cost study so that the avoided costs that are identified and the discounts that a study produces are unaffected by services that Qwest does not provide for resale. For example, Intrastate Access, Intrastate Third Party Billing and Collection, Centrex UNE-P, E911, Wireless Interconnect Access (RCC and Cellular), Mobile, PAL, OS/DA and Non-recurring charges are excluded from Qwest's study, since these services are not subject to the discount provisions of the Act or would otherwise contaminate resale discount calculations for resale services. [17] (See Schedule 3.1 of Proprietary Exhibit DMG - 2)

4. ***Use appropriate Company/state/product-specific assumptions and embedded cost data to obtain the most meaningful embedded avoided costs and resale discount results.*** Qwest's embedded study employs cost data that are specific to Qwest's South Dakota operations and that are taken from Qwest's Cost Accounting Reporting System ("CARS"). These cost data are company-specific, product-specific, and are properly limited to intrastate operations. These data replace the data and the now vacated, generic assumptions of the FCC that were used in

17 OS/DA and PAL services are excluded in calculating resale discounts for other services. However, separate avoided costs analyses and resale discounts for CLEC resale purchases of OS/DA and PAL services are set forth in proprietary Exhibits DMG-6 and Exhibit DMG-7.

determining avoided costs.

The FCC's generic avoided cost assumptions were not specific to Qwest or to Qwest's South Dakota operations. To ensure accurate calculation of discounts that will apply to Qwest's South Dakota intrastate retail rates, it is necessary to use cost data specific to Qwest's South Dakota operations whenever possible. The use of the FCC's Automated Report Management Information System (ARMIS) public information, the FCC's generalized industry-wide 90% avoided cost default proxy factors (applied to entire, unanalyzed account balances), the default "Total 14 State" discount result, and aggregate product information is clearly inappropriate for calculating accurate resale discount percentages.

5. ***Incorporate Qwest's previous experience with its <u>non-resale</u> "switched access" product in developing avoided costs for resale services.*** Prior to the passage of the Act, Qwest had never had to resell its retail telecommunications products on a large scale; therefore, there were no meaningful historical data for costs that Qwest would actually avoid. Qwest now has post-Act, historical experience selling its retail services on a wholesale basis, and, where possible, Qwest has relied on that experience and actual historical data to determine its avoided costs (<u>e.g.</u>, Customer Operations-Sales expense). Where this type of historical data is still not uniquely identifiable for resale activities, Qwest's study relies on Qwest's experience with selling wholesale access products. This experience provides a reasonable

surrogate and foundation for approximating certain avoided costs for intrastate retail services that are subject to resale. Accordingly, Qwest uses its experience with access products in evaluating avoided costs for certain Customer Operations – Marketing (i.e. product management) expenses and in determining Uncollectibles expense for resale services that will be offered in a wholesale-type environment.

Basic Strengths And Attributes Of The Qwest Embedded Avoided Cost Study

Q. WHAT ARE THE BASIC STRENGTHS AND ATTRIBUTES OF THE QWEST AVOIDED COST STUDY?

A. The Qwest embedded avoided cost study clearly addresses the requirements of the Act. The particular strengths of the study include:

(1) The study is prepared from Qwest's booked financial records. Specifically, the study is based on 2001 actual South Dakota operating results, with data that are consistent with 2001 FCC ARMIS reports where appropriate. The data include detailed sub-account records, product category identifiers, special cost analyses / time studies and the Company's embedded cost accounting system, CAAS/CARS (Cost Accounting Allocation System)/CARS (Cost Accounting Reporting System).

(2) The study utilizes intrastate data, which correspond with the historic intrastate rate setting process and reflect the fact that intrastate retail rates are comprised of intrastate retail costs.

(3) The study removes costs inherent in the 47 C.F.R. Part 32 Uniform System of Accounts (USOA) account balances that are associated with non-resale / excluded services in compliance with the language of the Act and/or since certain services would otherwise contaminate resale discount calculations for resale services. Additionally, Operational Support System (OSS) costs are excluded from the study. They are excluded since they constitute reseller-related wholesale costs that are not avoided due to resale and because Qwest is seeking Commission approval for separate recovery of such costs.

(4) The study incorporates the impacts of state-ordered jurisdictional adjustments for items, such as South Dakota-specific depreciation, as well as the Commission's previously prescribed loop cost allocation methodology.

(5) The study incorporates all cost elements included in South Dakota retail rates, including cost data for capital costs (both direct and indirect), net interArea rent compensation, and property and other-taxes.

(6) The study analyzes Qwest's costs and account balances in detail to determine with specificity the costs Qwest will avoid instead of relying on generic avoided cost assumptions unrelated to Qwest's actual operations.

(7) The study also provides avoided cost discount percentages for multiple service categories, rather than only a single avoided cost discount percentage, which would lend itself to resale arbitrage.

These attributes ensure that Qwest's embedded avoided cost study complies with the Act. Because the study fully complies with the Act and accurately determines Qwest's avoided costs, the Commission should rely on it to establish the avoided cost discounts for Qwest.

Records Employed by Qwest To Develop Resale Discounts

Q. WHY DID QWEST EMPLOY DETAILED SOUTH DAKOTA-SPECIFIC DATA, RATHER THAN RELY SOLELY ON FCC ARMIS DATA, TO DEVELOP ITS EMBEDDED AVOIDED COST STUDY?

A. Relying solely on ARMIS data would not permit a state-specific and intrastate product-specific analysis of costs. ARMIS data contain high level, summary information that are designed for FCC reporting requirements and for the general public. ARMIS data contain only aggregated information for the intrastate products offered by Qwest. Therefore, South Dakota intrastate ARMIS data would be too general in nature to properly identify even the revenues associated with resale services, let alone the avoided retailing costs for Qwest's South Dakota operations. ARMIS does not provide enough intrastate detail to eliminate non-resale service and cost information, as required by the Act.

Q. WHY DOESN'T ARMIS PROVIDE ALL THE NECESSARY INFORMATION TO IMPLEMENT THE RESALE DISCOUNT CALCULATION PROVISIONS OF THE FEDERAL ACT?

A. The FCC's ARMIS reports were never designed for the purpose of determining the intrastate wholesale prices that the Act requires. They constitute only one of many data models that summarize information from many data sources regarding telephone company operations.

The ARMIS reports contain interstate product data for use by the FCC and the general public. However, they do not lend themselves to the more refined intrastate product-specific analysis that is necessary to establish appropriate resale discounts to be applied to specific South Dakota intrastate rates; nor can they be used to facilitate the development of resale discounts that respond to the concerns expressed by the

Eighth Circuit Court[18]. The ARMIS 43-03 - Joint Cost Report, provides annual data for each account prescribed under the FCC Part 32 Uniform Systems of Accounts for "total state" operations prior to FCC Part 36 jurisdictional separation between interstate and intrastate operations. The ARMIS 43-04 - Access Report further delineates the 43-03 Report Subject-to-Separations amounts by splitting revenues, costs and investment between intrastate and interstate operations, as well as the various interstate components (products/rate elements) of interstate access, and billing and collection services. The jurisdictional split reflected in the 43-04 report reflects compliance with FCC Part 36 and Part 69 rules.

However, neither of these reports, nor any of the other ARMIS reports, refines Qwest's financial data to reflect specific intrastate products. These reports will not permit isolating intrastate "non-resale" services that must be excluded from resale discount calculations. Although the FCC originally utilized "Total 14 State U S WEST " ARMIS data to prepare its interim, overall default resale discount for application in all Qwest states, as discussed earlier, the FCC also made it clear that this approach was only for the purpose of setting interim default discounts that would be replaced by company-specific discounts determined through a cost study. Thus, it is clear that more specific Qwest - South Dakota, product-specific, intrastate data should be used. Qwest has provided this Commission with that information in this

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18 Iowa Util. Bd., 219 F.3d at 755-56.

proceeding.

Q. SINCE ARMIS DATA IS TOO GENERAL, WHAT COST DATA SHOULD BE USED TO PERFORM THE EMBEDDED AVOIDED COST STUDIES IN THIS PROCEEDING?

A. The Commission should rely upon Qwest's CAAS (Cost Accounting Allocation System)/CARS (Cost Accounting Reporting System) data. CAAS/CARS is the Company's cost accounting process that produces detailed, product-specific, embedded cost reports. CAAS reports provide product/service financial information on a total state (interstate + intrastate) basis.[19] CARS provides the same product/service financial information on an intrastate, jurisdictionally separated, basis.

There are similarities and important differences between Qwest's CAAS/CARS data and the FCC's ARMIS data. Each report identifies jurisdictional product information, CAAS for total state services, ARMIS for interstate services, and CARS for intrastate services. These reports also share a common data source, the FCC Part 32 booked records of the Company, and many common cost allocation and reporting methodologies, including Part 64 unregulated costing methods. A significant

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[19] An overview of the assignment methodologies used in CAAS, as well as descriptions of the purpose, objectives and cost assignment principles used in the system, are included in Exhibit DMG – 5.

difference, however, is that the FCC's ARMIS reports were never designed or intended to identify and array intrastate, product-specific data. Only the CAAS/CARS data provide this intrastate information for Qwest's operations.

A properly designed embedded avoided cost study requires an input data source containing correct and relevant product and cost information. In developing an embedded avoided cost study for determining Qwest's intrastate retail service discounts, it stands to reason that detailed Qwest *intrastate* product input data sources should be used. Therefore, the use of CAAS/CARS data, rather than the more highly aggregated ARMIS data, is necessary.

Qwest's CAAS/CARS embedded cost data are familiar to state regulators. Qwest has used these data in many Qwest jurisdictions, including South Dakota, where state commissions have required the company to provide embedded cost support and/or detailed product information on an embedded basis. In addition to use and review by state regulators, the Company's CAAS/CARS data and procedures have been periodically audited by the Company's external auditors.

<u>Embedded Cost Study Avoided Cost Percentages</u>

Q. AFTER IDENTIFYING THE COST DATA UPON WHICH TO BASE THE AVOIDED COST DISCOUNT CALCULATIONS, WHAT IS THE NEXT STEP FOR CALCULATING THE DISCOUNTS?

A. The next step is to analyze the categories of costs and to determine what percentage of costs in those categories will be avoided when Qwest sells retail telecommunication services on a wholesale basis.

Q. PLEASE EXPLAIN YOUR EARLIER STATEMENT IN WHICH YOU INDICATED THAT THE AVAILABILITY OF ACTUAL HISTORICAL DATA FOR AVOIDED COSTS FOR USE IN DEVELOPING RESALE DISCOUNTS IS LIMITED.

A. Because the need to identify <u>avoided</u> retailing costs did not arise until 1996 when the Act and its resale provisions became law, Qwest had not previously tracked its costs for such a purpose. There was no reason to do so. However, the six years since passage of the Act have provided Qwest with significant experience in selling resale/unbundled services. As a result, Qwest now has some historical data upon which it can rely to determine avoided retail costs. However, the availability of this information, as specifically related to resale services, is still somewhat limited because, in some cases, the data are unavailable or are difficult to track with accuracy. Examples of costs for which there are not meaningful historical data relating specifically to intrastate resale services are costs relating to product management and uncollectible accounts. In these areas, Qwest's experience providing wholesale carrier access service provides a reasonable surrogate for determining the costs that Qwest will avoid selling intrastate retail services on a wholesale basis.

Q. WHY DO CARRIER COSTS RELATING TO QWEST'S ACCESS SERVICE PROVIDE A REASONABLE SURROGATE FOR PRODUCT MANAGEMENT AND UNCOLLECTIBLE RESALE ACTIVITIES AND COSTS THAT QWEST WILL INCUR TO PROVISION RESALE?

A. As my Exhibit DMG – 3 indicates, product management costs for the resale of retail telecommunications service will be very similar to those incurred for providing wholesale access service. A variety of product management functions are "wholesale" in nature and would be required (not avoided) even if there were no retail operations, because Qwest's product managers focus on developing and bringing its products to the market place.

For years, Qwest has employed product managers to serve the wholesale access service needs of interexchange carriers. Today, Qwest's carrier market unit is dedicated to serving the access needs of interexchange carriers in order to provide these customers with wholesale switched and dedicated access products. This market unit incurs wholesale costs that are characterized and recorded as "Marketing - Product Management" costs under Part 32 accounting rules. Actual recorded costs for carrier access demonstrate that there are numerous product management cost functions performed in providing wholesale, not retail, services today.

The comparison of total Qwest retail services product management costs and actual carrier access service product management costs provides a sound basis for identifying the level of product management costs that Qwest will avoid providing retail services on a wholesale basis. By comparing the product management costs that Qwest has incurred on a retail, product-specific, basis with the total product management it has incurred in a state for carrier access products, Qwest can determine avoided costs percentages for each product group.

For reseller uncollectibles, the use of carrier uncollectibles as surrogate is a conservative approach. Reseller uncollectibles will be similar, if not higher, than those experienced with carriers due to the number of resellers and the churn rate of resellers and their customer base.

Q. WHAT PERCENTAGES OF RETAILING COSTS DOES QWEST'S STUDY ASSUME THE COMPANY WILL AVOID SELLING SERVICES AT WHOLESALE?

A. Qwest's embedded cost study calculated the avoided cost percentages listed below based on Qwest's retail, intrastate service expenses. These percentages are applicable only to the portion of Qwest's intrastate account balances remaining after identifying and removing non-resale/excluded service costs.

Expense Category	Costs Avoided
Marketing - Product Management	0 - 87%
Sales	93 - 99%
Advertising	100%
Customer Services -	
Qwest Billing and Collection	42 - 98%
Uncollectibles - Qwest End-User	44 - 52%

A range is depicted for certain expense types since product categories vary in the amount of retailing costs that are incurred. For example, Qwest's study indicates that Basic Exchange - Residence product management costs are 0%[20] avoided

20 Where Qwest's "access" product history indicates that wholesale product management would equal or exceed a retail product group's potential avoided retailing costs, avoided cost factors were conservatively set at 0% rather than employing assumptions which would reflect incremental cost increases which may occur due to resale. Including incremental costs would result in lower resale discounts.

versus Qwest Central Office (Vertical) Features services product management costs, which are 87% avoided.

Discussion and Analysis Of Avoided Costs

Q. IN DEVELOPING THESE AVOIDED COST PERCENTAGES, WHAT TYPES OF COSTS WERE CONSIDERED TO BE AVOIDED COSTS IN THE QWEST EMBEDDED AVOIDED COST STUDY?

A. The Qwest study identifies "direct" retail (expense and capital-related) costs as well as supporting "indirect" retail (expense and capital related) costs. These costs include customer operations costs, end-user uncollectibles expense, and a proportionate share of a variety of indirect costs (i.e. common overhead type costs).

Q. WHAT TYPES OF COSTS ARE CONTAINED IN QWEST'S CUSTOMER OPERATIONS ACCOUNTS?

A. Qwest customer operations costs are recorded in several USOA accounts defined by the 47 C.F.R. Part 32 accounting rules. Customer operations costs are recorded in two main accounts, Account 6610 – Marketing and Account 6620 – Customer Services, both of which have additional sub-accounts.

Account 6610 has three sub-accounts consisting of specific types of marketing costs:

- Account 6611 - Product Management
- Account 6612 - Sales
- Account 6613 - Advertising

Account 6620 is comprised of sub-accounts containing three types of customer operations costs:

- Account 6621 - Call Completion
- Account 6622 - Number Services
- Account 6623 - Customer Services

Q. WHAT INITIAL CONCLUSIONS DID QWEST REACH REGARDING THE LEVEL OF QWEST'S RETAIL "MARKETING" COSTS THAT MAY BE AVOIDED?

A. Of the three marketing cost elements in Account 6610, Qwest will still continue to incur a significant portion of its product management expenses in delivering services to wholesale customers. As a result, only a portion of these expenses will be avoided. Product sales costs comprise a large portion of Qwest's marketing costs. Many, but not all, of Qwest's sales costs will be avoided in facilitating resale. A substantial portion of Qwest's product advertising in the marketplace is largely informative to the general market place and thus supports wholesale and retail operations. Although wholesale and retail operations both derive a benefit from Qwest's advertising, for purposes of this South Dakota avoided cost study I have conservatively treated all product advertising costs to be avoided costs.

I hasten to point out that a portion of the Qwest product management, sales, and advertising costs also relate to Qwest's non-resale services. Qwest is not providing these services at resale, and, therefore, it will not avoid any of the costs associated with these services. None of the costs relating to non-resale services should be considered avoided if a study is to comply with the Act's mandate to calculate resale discounts based on the retail costs that an ILEC will avoid.

Q. IN REGARD TO THE MARKETING (6610) ACCOUNTS, PLEASE DESCRIBE IN MORE DETAIL WHY QWEST WILL CONTINUE TO INCUR SIGNIFICANT MARKETING/PRODUCT MANAGEMENT COSTS IN PROVIDING WHOLESALE SERVICE TO RESELLERS?

A. Qwest will still continue to incur product management costs associated with its current non-retail services at the present levels, and, as Qwest's access service experience indicates, Qwest will incur product management expenses in serving its wholesale customers.[21] Exhibit DMG - 3 provides a listing of various product management functions that Qwest performs today that correlate with wholesale carrier and/or reseller interface functions. Just as many product management functions are currently performed for wholesale carrier services, they must be performed in providing resale and unbundled elements. Thus, only a portion of Qwest's product management costs can be considered avoided due to pure retail efforts.

A closer analysis of product management costs indicates that although Qwest's product managers do some work that would apply specifically to retail offerings (e.g. setting up Qwest specific sales promotions, etc.), product managers also perform product development work that supports wholesale/resold services. For example, activities and costs associated with developing and implementing most product methods and procedures and developing rate list filings will apply whether the service is provided at retail or wholesale. These activities and costs involve the development of product and service price levels and structure based on economic analysis and the development of total product and service revenues relating to price changes, cross-elasticity, and price demand reaction. They also involve investigating the market to determine product and service potential, market demand and product and service demand reaction to multiple variables. Other activities include developing basic cost

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21 The FCC's Order indicated that new wholesale costs such as these should be netted against avoided costs. *First Report & Order*, Section VIII. Resale, ¶ 928.

building blocks and factors for products and services and the analyses of the interaction of cost, price and demand on product and service profitability. All of these activities and costs are essential in analyzing the viability of potential new products and business opportunities and in the delivery of wholesale service. Because these functions are essential to the delivery of all services, only a portion of Qwest's product management costs can be categorized as purely retail, which will be avoided due to the resale provisions of the Act.

Q. PLEASE DESCRIBE QWEST'S ANALYSIS RELATING TO THE AMOUNT OF SALES COSTS THAT IT WILL AVOID SELLING RETAIL PRODUCTS AT WHOLESALE.

A. Qwest will avoid a portion of the sales costs recorded in Account 6612 relating to end-user contact, but it will not avoid all sales costs. In the wholesale environment, reduced end-user costs have been replaced by wholesale customer contact costs that Qwest incurs when it interacts with resellers and CLECs as part of the processes for providing wholesale (resale and unbundled) services. As Qwest loses its existing end-user customers to competing service providers, it also loses the sales costs associated with those customers and it picks up new costs for resellers/CLECs themselves. As new customers of Qwest, resellers/CLECs are in effect, replacement customers for the retail end-user customers lost to other providers who obtain services from Qwest. Qwest must perform many of the same sales functions it previously performed for its end-users in connection with servicing these new wholesale customers. For example, Qwest sales employees must negotiate contracts with the resellers and CLECs and respond to their service-related inquiries and requests. Exhibit DMG - 4 provides a more detailed review of sales functions required in a wholesale environment.

Therefore, Qwest's actual experience and recorded costs for dealing with reseller and unbundled-related cost functions need to be recognized when determining the avoided cost percentage for Account 6612 Marketing - Sales. Accordingly, Qwest's study properly identifies sales costs that are not avoided by identifying recorded sales costs that relate to providing resale and unbundled services and the portion of Qwest's retail-related sales costs that are connected with products that are not subject to resale.

Q. PLEASE DESCRIBE HOW QWEST'S EMBEDDED AVOIDED COST STUDY TREATS ADVERTISING COSTS?

A. Product advertising costs should be separately evaluated from other costs. Most product advertising is informational and it is done in the general market place. As a result, product advertising that Qwest performs for retail services that are offered for resale benefits not only Qwest retail operations, but also its wholesale operations and the CLECs that resell Qwest's services. Qwest's advertising provides for general customer awareness, which is not limited to Qwest retail efforts. Qwest's advertising may even reduce the advertising costs that CLECs and resellers would otherwise incur.[22] An example of this type of advertising cost is Qwest's "*69 - Last Call Return" public advertising campaign. Qwest's customer awareness advertising and Qwest's central office equipment facilitate *69 use by Qwest customer's, as well as customers of a reseller, whenever the customer becomes informed and chooses to use the service. No ordering of service is required; it's automatically available to reseller customers who respond to Qwest's informational advertisement. Revenue collections for Qwest and resellers alike are enhanced whenever end-user customers become informed about, and subsequently use, the *69 advertised service.

Since product advertising is aimed at increasing service penetration and is informative for the general marketplace, it should not be considered to be a cost that is totally retail and avoided due to resale. Considering that product advertising impacts Qwest customers, as well as reseller customers and resellers themselves these costs should be treated as partially avoided costs. Additionally, multiple service provider options create "slamming" issues. Slamming issues increase customer information advertisement costs in the wholesale environment and these incremental advertising costs must also be appropriately considered in determining the percentage of advertising costs that are avoided.

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22 Although resellers will be reselling a variety of Qwest retail telecommunications services, they will not be duplicating Qwest advertising of its trademarked services. However, resellers' customer awareness and penetration will be enhanced as a result of Qwest's advertising of such services.

Even though advertising costs should be treated as partially avoided for the reasons I just stated, a special advertising study is required to segregate the costs. In lieu of conducting this study for use in the current South Dakota avoided cost study, I chose to conservatively treat advertising costs as avoided costs, except for those advertising costs that relate to services that are not offered at wholesale.

Q. WHAT FINAL CONCLUSIONS DID QWEST REACH WITH REGARD TO ITS MARKETING COSTS?

A. Qwest concluded that the FCC's overly simplistic, generic 90% avoided cost factor assumption for all the Qwest marketing costs summarized in Account 6610 is erroneous. This conclusion is based on the fact that the more specific accounting information from Qwest's actual South Dakota operations demonstrates that separate and lower percentages are appropriate. Therefore, the Qwest embedded study develops and employs a separate factor for each resale product group and for each of the three components of total marketing expense - product management, sales, and advertising.

Once these percentage factors are developed, the cost study applies them to the intrastate retail service portion of the account balances on a product-specific basis. [23]

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23 See Qwest Embedded Study Proprietary Exhibit DMG - 2, Schedules 3.6 and 3.6.1.

I emphasize that the percentages developed are only applicable to the intrastate "retail service portion" of the account; they would be too high to apply to the entire account balance.

Q. WHAT INITIAL CONCLUSIONS DID QWEST REACH CONCERNING THE CUSTOMER SERVICE COSTS THAT QWEST MAY AVOID SELLING RETAIL SERVICES ON A WHOLESALE BASIS?

A. Customer Services costs -- Accounts 6621 and 6622 -- include operator service and directory assistance related costs. These costs must either be totally eliminated from the study or included and treated as "not avoided" in order to avoid contaminating recurring retail discount calculations with costs that are not inherent in retail recurring rates. Simply put, and as CLECs and other commissions have recognized, most costs associated with operator service and directory assistance are not part of Qwest's recurring basic service retail rates; therefore, they should not be included in calculating discounts to apply to retail basic service rates. In addition, costs associated with basic operator intercept and customer name and address data base maintenance are functions that will not be avoided in provisioning those services as resale services.

Account 6623 consists of two primary types of expenses: billing and collection and business office non-recurring costs. A proper analysis of the billing and collection portion of the account must recognize that there are costs associated with excluded services, previously identified, as well as costs associated with Independent Company Billing and Collection. Excluded services and independent billing and collection service are not subject to resale and/or Qwest will not have any avoided costs associated with them. Accordingly, Qwest's study properly excludes the costs associated with these services from the discount calculations.

Non-recurring costs recorded in Account 6623 also need special consideration. For existing customers, non-recurring costs constitute sunk cost charges (costs that can not be avoided) that are separate from recurring service end-user and interconnection / CLEC billing. Furthermore, existing customers do not incur non-recurring charges on a routine or monthly basis; therefore, including them in calculating <u>recurring</u> service discounts is improper and would violate the Act's requirement that only costs included in the retail rates are to be treated as avoided. The vast majority of a reseller's customers will come from existing Qwest customers that are transferred to resellers. Qwest's non-recurring charge activities for establishing service for these customers constitute up-front sunk costs that are not avoided due to resale. These are the type of "not actually avoided" costs that the Eight Circuit Court decision[24] was concerned with.

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24 Iowa Util. Bd., 219 F.3d at 755-56.

Q. WITH REGARD TO THE CUSTOMER SERVICE (ACCOUNT 6620) EXPENSES, YOU INDICATED THAT OS/DA COSTS COMPRISE A PORTION OF THE CUSTOMER OPERATIONS EXPENSES THAT SHOULD BE EXCLUDED FROM THE EMBEDDED AVOIDED COST STUDY. WHY SHOULD THESE COSTS BE HANDLED THIS WAY?

A. OS/DA expenses are not included in the costs for basic local exchange service. Instead, OS/DA services have their own rate lists and/or result in separate charges. Furthermore, some resellers self-provision these services through competing ILECs or other providers. Therefore, the costs for these services should not be considered avoided in developing recurring rate discounts for other services. Instead, they should be <u>eliminated</u> entirely from the recurring rate resale discount analysis. Otherwise, the discounts for retail services will be contaminated and erroneously inflated, creating a double-dip in revenue loss. If resellers choose to purchase OS/DA services from Qwest, two alternatives are available for resale discount purposes. The Commission could designate that resellers purchase OS/DA from Qwest through Qwest's established carrier wholesale tariff or the Commission could set a separate resale discount from a separate avoided cost analysis as my Proprietary Exhibit DMG - 6 depicts.

Q. YOU ALSO INDICATED THAT NON-RECURRING COSTS COMPRISE A PORTION OF CUSTOMER OPERATIONS EXPENSES AND THAT THEY

SHOULD BE EXCLUDED FROM THE EMBEDDED AVOIDED COST STUDY. WHY SHOULD THESE COSTS BE EXCLUDED?

A. Customer service costs relating to non-recurring charge compensation and procedures require special consideration. These costs should be excluded from the calculations of resale discounts. Traditional, embedded, non-recurring charges for the establishment of service are separate and unique from retail telecommunications services that are subject to resale. These costs are, by definition, <u>non</u>-recurring in nature; they <u>are not</u> billed to customers on a monthly basis, unlike recurring basic and toll services.

It is critical to understand that the vast majority of Qwest's non-recurring costs constitute sunk costs that Qwest incurs to establish service for its existing end-user customer base. Qwest will never avoid these costs if customers subsequently transfer to a reseller once service has been established. Since they are costs that will not be avoided and since they are not inherent in Qwest's recurring retail rates, including them as avoided costs in the recurring rate discount calculations would be wrong and would result in inaccurate and inflated discounts. It's important to note that Qwest's existing customer base provides resellers with the vast majority of their potential customers and therefore, inappropriately including non-avoided non-recurring costs in the recurring rate discount calculations would erroneously inflate the recurring rate resale discounts. Additionally, since non-recurring charges have their own rate lists or charges, applying inflated discounts to each regularly billed recurring service, each and every month the service is billed, would significantly overstate the amount of the overall costs that Qwest actually avoids.

Furthermore, Account 6623 also includes the non-recurring order processing costs that Qwest incurs for resale and interconnection. Resale and interconnection functions are a direct result of wholesale operations resulting from the requirements of the Act; therefore, these costs are certainly not avoided retailing costs or costs that should be used in determining avoided cost discounts for retail telecommunications services.

In the post-Act environment, non-recurring compensation and procedures for transferring existing customers to resellers will need to recognize the costs of transferring existing end-users to resellers, the costs created by additional end-user churn, as well as the costs associated with processing newly established reseller end-user accounts. Customer transfer costs and charges, as well as reseller non-recurring costs and compensation arrangements, will be very different from the traditional end-user non-recurring compensation currently incurred and collected from Qwest end-user customers, today. Therefore, it would be inappropriate to consider traditional, "sunk", non-recurring costs to be avoided costs in Qwest's resale discount calculations. Doing so would contaminate resale discounts created for recurring rate retail services, which have separate rates and costs.

Therefore, like OS/DA service, the Company's non-recurring customer service operational costs and revenues have been excluded from the Qwest embedded avoided cost study in determining recurring rate resale discounts. In both instances, Qwest operations should not be impacted twice, or on an ongoing basis, for charges that have their own rates/fees, and for costs that are not included in the retail rates for routine recurring telecommunications services. Rather, these charges must be treated as separate issues, addressed on a stand-alone basis, and excluded from the discount study in calculating recurring rate discounts.[25]

Q. DESCRIBE IN MORE DETAIL ANY OTHER COSTS RECORDED IN THE CUSTOMER OPERATIONS ACCOUNT AND EXPLAIN WHY QWEST WILL CONTINUE TO INCUR CERTAIN OF THESE COSTS IN PROVIDING SERVICES TO RESELLERS.

A. Besides OS/DA and non-recurring costs, the customer operations cost category contains customer service costs for billing and collection expenses. Billing and collection costs are another area of customer operations where retailing- type costs

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25 Non-recurring business office costs are sunk costs that are not avoided, and that should be removed from an embedded avoided cost study. However, if they are not removed, separate Qwest analysis would indicate that business office costs (on a per line basis) will not be avoided on a net basis. Any end-user non-recurring costs are offset by incremental reseller costs required for reseller/customer identification, order processing and inquiry. Thus, the avoided cost percentage for any non-recurring costs not excluded from an embedded avoided cost study would be 0%. Exclusion of the costs is the more appropriate and conservative approach of the two.

will be reduced, but certainly not entirely eliminated. Although Qwest does not bill reseller end-user customers, it does bill each reseller for its wholesale service purchases. These reseller billing costs typically are lower than retail end-user billing costs, but they are real costs nonetheless and must be considered and included in the determination of avoided costs. The billing and collection costs that Qwest actually incurs in connection with its wholesale access services demonstrate that these costs cannot be avoided in a wholesale environment. In addition, the billing and collection accounts include unique sub-accounts (6623.3 / .4) for the billing and collection costs billed to Qwest by other exchange carriers (independent companies) for designated carrier independent company (ICO) toll. Qwest will not avoid these costs due to resale, and a proper avoided cost study must recognize this fact and handle these costs as not avoided.

Q. WHAT FINAL CONCLUSION DID QWEST REACH REGARDING ITS CUSTOMER SERVICE COSTS?

A. Qwest concluded that it would be clearly inappropriate to apply the FCC's generic 90% avoided cost factor assumption to all of the Qwest customer service costs summarized in Account 6620. Cost data specific to Qwest's South Dakota operations was required to establish the proper percentages to apply to portions of the account balances. Qwest's study employs a separate factor for each resale product evaluated and for each of the three non-excluded components of "total customer service" (i.e.

call completion, number services, and customer services). Call completion and number services functions (Mechanized Operator Intercept and Customer Database Maintenance) will be performed by Qwest in a resale environment. These customer operations "Customer Service" costs must reflect avoided cost percentages of 0% avoided. The portion of customer service costs associated with Qwest billing and collection expenses is avoided in a range from 42% to 98% for retail services. These percentage factors are applied on a product-category basis in the embedded cost study.[26] Again, I would emphasize that these percentages are only applicable to intrastate retail service amounts, not the entire account balance.

Q. WHAT IS THE SOURCE OF THE UNCOLLECTIBLE REVENUES AVOIDED COST PERCENTAGE THAT QWEST USES FOR EACH OF THE PRODUCT CATEGORIES?

A. The avoided cost percentage for uncollectible telecommunications end-user revenues that Qwest uses for each of the product categories is based on Qwest's uncollectibles experience with carriers in the wholesale access market.[27] For retail services, the Qwest study employs avoided cost percentages of approximately 44 - 52%. However, uncollectible telecommunication - independent company (ICO) revenues

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26 See Proprietary Exhibit DMG - 2, Schedule 3.6.1, line (7).

27 Id., Schedule 3.3, line (15), shows the avoided factor development for uncollectible costs used in the study.

booked to Account 5301.224, associated with designated carrier ICO toll, must be considered 0% avoided. ICO uncollectible revenue amounts are determined by the various independent companies based on their toll traffic and constitute costs billed to Qwest that cannot be avoided due to resale.

Q. HOW DID QWEST DETERMINE THAT THERE ARE NO AVOIDED COSTS ASSOCIATED WITH ANY OF THE OTHER DIRECT COST AMOUNTS IN THE EMBEDDED STUDY, AS DEPICTED IN PROPRIETARY EXHIBIT DMG - 2, COLUMN (d) OF SCHEDULES 2 THROUGH 2.5?

A. Qwest reviewed each account and cost element and determined that:

(1) Qwest's current level of direct maintenance and network operations costs recorded in Plant Specific and Non-Plant Specific USOA accounts (Accounts 6110 - 6530) will not change regardless whether the service sold is to an end-user or to a wholesaler, since Qwest is responsible for maintaining the network and providing the same level of quality service to all customers, wholesale or retail;[28]

(2) Access expense (Account 6540) billed to Qwest by independent companies, and any local reciprocal compensation access charges reflected in the operating results under review, will not change and are not avoided costs in provisioning

28 *First Report & Order*, Section VIII. Resale, para. 919. That provision states that Plant Specific and Non-Plant Specific costs are presumed to be not avoided and Qwest's analysis confirms that this is a valid assumption.

wholesale or resale;

(3) Depreciation /Amortization (Account 6560) should be considered but should be split between direct and indirect costs to recognize that retail operations include a portion of related indirect investment costs. These indirect costs are considered partially avoided. (See Schedules 3.4 and 3.7 of Proprietary Exhibit DMG - 2); and

(4) Capital costs (cost of money) inherent in retail rates should be properly considered but should be split between direct and indirect costs in order to recognize that direct, network-related capital costs will not change due to resale, and that only the portion of the indirect costs attributable to retailing operations would be avoided. (See Schedule 3.8 of Proprietary Exhibit DMG - 2)

Q. HOW DID QWEST CALCULATE THE PORTION OF COSTS THAT ARE AVOIDED RELATING TO GENERAL SUPPORT AND CORPORATE OPERATIONS EXPENSES IN THE EMBEDDED STUDY?

A. The Qwest avoided cost study develops two distinct indirect avoided cost ratios, employing a common formula of *total direct avoided costs* to *total direct costs*. In both ratios, direct costs include the appropriate Part 32 expense accounts in the 6000 series of accounts as well as a "direct" capital cost of money component related to network assets. Although the capital component is not recorded in this USOA Part 32 account series, network capital costs must not be ignored in the avoided cost discount calculations. These costs constitute actual operating costs inherent in the retail rates that are subject to discount, and they require general/corporate operating cost support expenditures. Capital funding for network-related costs, equipment and capitalized expenses requires a variety of indirect general support costs, including treasury and banking, investor relations, legal, accounting, and human resources, just to name a few. Therefore, capital funding costs must share in the assignment of indirect costs and must be used in developing the direct/indirect avoided cost ratio applied to total indirect costs. Failure to do so would materially overstate the amount of avoided indirect costs caused by resale.

Q. WHY DOES QWEST CALCULATE AND USE TWO INDIRECT AVOIDED COST RATIOS IN THE AVOIDED COST STUDY?

A. The study calculates a basic, overall *direct avoided cost* to *total direct cost* factor for application to the majority of indirect costs. However, the basic indirect ratio must be adjusted for applications involving accounts that contain computer-related costs (e.g. General Support – General Support Computers, Depreciation/Amortization – General Purpose Computers, Information Management Expense, and Capital Costs – General Purpose Computers) in order to properly handle computer-related costs that are not avoided due to resale.

In 2001, Qwest incurred significant network-related computer costs and interconnection-related computer costs that are not avoided due to resale. Network computer costs are required to run the network support systems, including the network utilized by resellers. Interconnection computer costs are new wholesale costs stemming from Qwest's need to redesign its computer systems / programs (excluding OSS) to recognize CLEC information and meet other requirements of the Act. The proper recognition and treatment of network support costs and interconnection-related computer costs, which are not avoided in the resale of retail telecommunications services, necessitates the development and use of a second indirect avoided cost ratio. This adjusted, indirect ratio is applied only to the computer-related portion of general support expense accounts and capital costs.

Q. DESCRIBE THE TYPES OF COSTS TO WHICH THESE RATIOS WERE APPLIED.

A. The *direct avoided cost* / *total direct cost* ratios are applied to indirect support costs typically recorded in the FCC Part 32 6700 series of accounts. This series of accounts includes general and administrative costs, executive, legal, accounting, human resources, etc. However, in addition to these costs, miscellaneous rent compensation net expense, property and other taxes, other operating expenses, and a general support capital cost element were also included and are considered to be partially avoided.

Q. PLEASE EXPLAIN WHY QWEST INCLUDED MISCELLANEOUS RENT COMPENSATION EXPENSES, OTHER OPERATING EXPENSES, PROPERTY AND OTHER TAXES, AND GENERAL SUPPORT CAPITAL COSTS IN ITS AVOIDED COST STUDY.

A. All of these costs are elements inherent in Qwest's South Dakota retail rate structure. Therefore, under the parameters of the Act, they must be included in an avoided cost study. They constitute indirect costs; therefore, it is appropriate to apportion them using the *direct avoided cost* / *total direct cost* ratio.

- "Miscellaneous Rent Compensation Net" includes Accounts 5240 through Account 5263. "InterArea Rent Compensation" (Accounts 5240.7/.8) is the net of: 1) rental amounts that other Qwest states pay to Qwest's South Dakota operations for use by those states of assets that are part of the South Dakota booked operations; and 2) amounts that Qwest's South Dakota operations pay to other states for the use of corporate facilities located in each of Qwest's other states. "Net InterArea Rent Compensation" (rent revenue/expense) consists of reimbursement/payment for multi-state joint use support investment depreciation, property taxes, house services expense, rents and support investment capital costs. All of these cross-charged costs increase or reduce costs classified as indirect costs in the avoided cost study. "Other Miscellaneous Rent Compensation" accounts include amounts derived from the rental, or sub-rental, of telecommunications plant furnished apart from telecommunications operations (e.g. land and building space, outside plant or central office space, space provided in conduits, pole line space for attachments, etc.) This incidental compensation is utilized (that is netted, or offset, against total expenses) in order to recognize that these costs have separate recovery mechanisms.

- "Other Operating Expense" (Account 7100) costs reflect certain costs relating to employee benefits that are not recorded in the 6000 series of accounts per FCC Part 32 accounting rules and directives. Although recorded in Account 7100, they are operating costs that are inherent in the rates subject to resale and should be included.
- Included in "Indirect General Support Capital Costs" are the cost of money/capital return costs that are associated with buildings, furniture, office equipment, computers, and other general support assets.
- The costs included in "Property and Other Taxes" are non-income tax amounts for property, gross receipts, and franchise and capital stock taxes. These are operating expenses inherent in resale service rates.

<u>Description Of Embedded Avoided Cost Study Documentation</u>

Q. ARE THE QWEST EMBEDDED AVOIDED COST STUDY AND DISCOUNT RESULTS PROVIDED AS EXHIBITS TO YOUR TESTIMONY?

A. Yes. As I mentioned earlier, Exhibit DMG - 1 provides a narrative description of the Qwest Embedded Avoided Cost Study. Proprietary Exhibit DMG - 2, Schedules 2 Composite and 2.1 through 2.5, depict the packaged/special service composite and the five basic service product category avoided costs and discount calculations. Proprietary Exhibit DMG - 2, Schedules 3.1 through 3.8, provides further supporting calculations for Schedules 2 through 2.5.

Q. PLEASE EXPLAIN MORE FULLY THE EMBEDDED STUDY DOCUMENTATION AND THE SCHEDULES THAT ARE ATTACHED TO YOUR TESTIMONY.

A. As previously stated, the data employed in the Qwest Embedded Avoided Cost Study is taken from the Company's 2001 journalized results from operations. The South Dakota CAAS/CARS data originate with ledger data reported through ARMIS (the initial data corresponds to the data reflected in the Company's FCC ARMIS 43-03 and 43-04 Reports). However, the CARS reports, which depict intrastate, product-specific operations, also incorporate state-specific treatment of costs, such as depreciation and employee-related benefit amortization costs. In this study, 2001 ledger amounts reported through ARMIS and jurisdictionally separated intrastate data, as adjusted for differences in state accounting treatment, were used as the starting point. These amounts are shown in Proprietary Exhibit DMG - 2, Schedule 2 – Composite, Column (b) and also in Column (a) of Schedule 3.1.

Q. PLEASE EXPLAIN PROPRIETARY EXHIBIT DMG - 2, SCHEDULES 2 THROUGH 2.5.

A. Proprietary Exhibit DMG - 2, Schedules 2 through 2.5, contain the results of the embedded cost study. These exhibits show the various "*__avoided cost__* ***to*** *__total cost__*" percentage calculations applicable to each product category and the aggregate overall Composite Avoided Cost Percentage ("ACP"), as follows:

2	Packaged Service/Special Service Composite	8.88%
2.1	Business (Category 1)	7.63%
2.2	Toll (Category 2)	6.65%
2.3	Listings, CO Features, & Informational Services (Category 3)	39.93%
2.4	Residence (Category 4)	4.62%
2.5	Private Line (Category 5)	5.26%

Q. PLEASE EXPLAIN THE SUPPORTIVE SCHEDULES CONTAINED IN PROPRIETARY EXHIBIT DMG - 2.

A. Proprietary Exhibit DMG - 2 also contains schedules that provide the additional detail necessary to calculate the avoided cost percentages shown above, as follows:

Schedule 3.1: Provides the individual financial statement detail for each of the excluded (non-resale) products. Under the general guidelines of the Act, these services are subtracted from the "Total Intrastate" results to arrive at the "Retail Intrastate" results, which are used in the avoided cost discount percentage calculations.

Schedule 3.2: Provides a "Retail" services revenue summary that excludes non-recurring revenues.

Schedule 3.3: Provides detail of the calculations of embedded avoided uncollectible revenue/expense by product.

Schedule 3.4: Provides data relating to computer-related costs recorded in Accounts 6124, 6724 and 6560 that are not avoided due to resale.

Schedule 3.4.1: Provides detailed information regarding the Operational Support Systems costs recorded in Account 6724 that are not avoided due to resale since they constitute costs incurred in the provision of resale.

Schedule 3.5: Provides detailed information regarding testing and power costs.

Schedule 3.6 and 3.6.1: Provides detail of the avoided customer operations expense components by product.

Schedule 3.7: Provides the calculation of depreciation expense split between direct and indirect costs.

Schedule 3.8: Provides the calculation of capital costs on a product-specific, total retail service, split between direct and indirect, cost basis (including return and tax gross-up).

Q. WHY WERE CERTAIN QWEST REVENUES AND COSTS, SHOWN ON PROPRIETARY EXHIBIT DMG - 2, SCHEDULE 3.1, EXCLUDED FROM THE STUDY?

A. As I stated previously, there are a number of services that are not subject to resale. Exhibit DMG-2, Schedule 3.1 identifies the services that are excludable either by the Act's definition (e.g. Intrastate Access, Centrex UNE-P, Third Party Billing and Collection, Wireless Interconnect Access (RCC and Cellular), and Mobile) or by virtue of the type of service offered (e.g. E911, OS/DA, PAL and Miscellaneous Other). Additionally, and as previously described, non-recurring costs are associated with service order processing and other business office activities that have their own unique characteristics and rates. Since non-recurring costs will continue to be incurred by Qwest on a resale basis, they are not avoided costs for existing customers. Therefore, non-recurring business office costs and revenues for the resale services are excluded in order to avoid contaminating the recurring discount calculations.

Q. HOW WERE THE EMBEDDED RESALE DISCOUNTS CALCULATED?

A. The Qwest embedded resale discounts were calculated for the five basic service product categories, and the packaged / special service - composite, as a percent of "*total avoided cost*" ***to*** "*total operating costs*", where avoided costs and total operating costs include both "*expenses*" and "*capital cost*" components. Inclusion of capital costs in developing both the numerator and denominator of the discount formula is key to properly calculating any resale discount and is an absolute requirement for developing product category resale discounts. Capital costs must be properly analyzed and included in determining avoided costs, since they are costs which are very much a part of the total operating costs comprising the retail rates being discounted and since the level of investment related costs varies significantly among services.

V. RESALE DISCOUNT ISSUES REQUIRING SPECIAL HANDLING

Reliance On A Multiple Discount Model – Packaged/Special Telecommunications Services

Q. WHAT ARE PACKAGED/SPECIAL SERVICES AND WHY SHOULD A COMPOSITE DISCOUNT BE CALCULATED FOR THESE SERVICES?

A. As I use the term, "Packaged / Special Services" refers to non-basic services or some combinations of retail telecommunications services. For example, Basic Exchange - Residence service and Central Office (CO) Feature services are packaged together in the Company's newly offered "CustomChoice™" product, while Centrex 21 is a non-basic special service made up of Basic Exchange - Business service, coupled with CO features, intercom functions and other unique characteristics.

A composite discount is useful in discounting packaged / non-basic special services, such as CustomChoice™, ISDN, PBX, Centrex, and Advanced Communication Services (ACS) such as Frame Relay, since the number and type of non-basic and/or services packaged together, have changed or varied, and will continue to do so. Often, packaged services will cross basic service category definitions; therefore, application of a basic service discount may be both difficult and inappropriate. In these non-basic or product combination circumstances, the use of a composite discount is recommended in order to ease discount administration and application concerns.

Reliance On A Multiple Discount Model
- Volume / Term Contract Telecommunications Services

Q. WHAT ARE VOLUME/TERM CONTRACT TELECOMMUNICATIONS SERVICES?

A. "Volume/Term" contracts can involve individual case basis ("ICB") pricing agreements where Qwest has custom designed, bid and secured the provision of telecommunications services via a separate large volume pricing arrangement/contract. Or they can involve situations where Qwest has already established customer agreements based upon special reduced-tariff pricing in exchange for "extended term" contractual obligations.[29]

Q. WHAT CONSIDERATIONS ARE IMPORTANT IN DETERMINING IF A RESALE DISCOUNT IS APPLICABLE TO QWEST VOLUME/TERM CONTRACT SERVICE PRICING?

A. Qwest initiated/existing volume/term contracts comprise only a small portion of Qwest's telecommunications services, but, like packaged services, they require special consideration in regard to evaluating avoided costs. Contracted services can be single services, but are more often comprised of several services that are offered at a reduced-retail price. Since contract services are often comprised of more than one service, and since they already reflect reduced pricing due to lower retailing costs and guaranteed terms, a separate avoided cost analysis and/or the use of a re-evaluated

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29 The policy and legal issues concerning whether existing Qwest contracts are assumable or transferable to resellers are not addressed in this testimony. ICB or reduced-tariff/extended term contracts initiated by resellers themselves are not encompassed in this discussion, nor are they at issue, since services procured from Qwest would reflect applicable tariffed or catalog rates and resale discounts. Discussion of this topic is provided for the purpose of addressing unique avoided cost and resale discount calculation issues relating to Qwest initiated/existing and already-discounted volume and term service contracts.

and/or <u>reduced</u> composite, "packaged/special service" discount may be appropriate.

For existing Qwest-initiated contract services, a separate composite discount analysis is appropriate for volume and reduced-retail extended term pricing, because contract rates already reflect substantially reduced "retail marketing" type costs based on the assumption of lower ongoing costs associated with customer sales, advertising, and billing and collection activities for contract customers. Retail cost activities such as these are important elements in determining the avoided costs used in establishing full-price resale discount rates. Contract services reflect a significant level of sunk costs that are not avoided when Qwest has established the customer's service and the customer prematurely terminates its contract to migrate to a reseller. Therefore, for reduced-retail price services, care must be taken to assure that avoided costs are not double-counted.

Q. HOW SHOULD THE COMMISSION DETERMINE THE APPROPRIATENESS OF, AND/OR PROPER DISCOUNT FOR, QWEST INITIATED/EXISTING VOLUME/TERM CONTRACT TELECOMMUNICATION SERVICES?

A. In deciding whether a resale discount on Qwest's volume/term services is even warranted, a separate review of contract law/terms is required. For those contracts legally subject to resale, the discount determination must give due consideration to the retailing costs that are avoided in the reduced-retail environment represented by these contracts. This requires an assessment of any retailing costs that are avoided for services already priced at a reduced-retail rate. Such analysis may indicate either that no further reduction in already-discounted pricing is warranted or that a full-retail service rate discount would be inappropriate because it would result in a double counting (double discounting) of avoided retail costs. (See Exhibit DMG - 1 – Addendum).

Q. PLEASE EXPLAIN HOW DOUBLE COUNTING OF AVOIDED COSTS WOULD OCCUR WITH REGARD TO CONTRACT SERVICES.

A. Double counting of avoided costs would occur if a full-avoided cost discount were applied when the lower rates for these services already account for reduced retail costs. In keeping with the resale discount provisions of the Act and to avoid double discounting, already discounted services require a separate avoided cost analysis, which properly considers only the costs that are inherent in the discounted service rates.

Additionally, contract service discount consideration must recognize that avoided retailing costs for "existing" Qwest contracts would be minimal, if any. For existing Qwest-initiated contracts, retail marketing costs include sunk costs expended in initiating, designing and facilitating the contract. Because Qwest incurs these costs up front, it will not avoid them if customers terminate their existing contracts prematurely in order to transfer their business to a reseller. Accordingly, these costs should not be used in determining a resale discount to apply to existing contract rates that already reflect reduced-retail pricing.

In today's environment, resellers will benefit greatly from the up-front retailing efforts of Qwest, since a reseller would not duplicate the costs incurred by Qwest if existing contracts are merely transferred. Only if, and when, new contracts are actually initiated by resellers will Qwest avoid its retailing costs normally incurred up-front to establish service contracts. If and when resellers initiate their own volume/term discount contracts, they should buy from the tariffed / catalog rate less the resale discount. Discounting Qwest's existing volume/term contract rates by applying full-retail avoided cost discount rates would be a misapplication of the full-retail discount rates, and it would not be in compliance with the "rate" and "cost inherent in the rate" language and directives of Section 252(d)(3) of the Act.

Q. WHAT ANALYSIS AND/OR DOCUMENTATION HAS QWEST PROVIDED AS PART OF ITS EMBEDDED AVOIDED COST STUDY REGARDING VOLUME/TERM CONTRACT SERVICES?

A. Exhibit DMG - 1 – Embedded Avoided Cost Study Executive Summary Narrative Description includes an Addendum that specifically focuses on Qwest's already-discounted contract / term services. The exhibit addendum reflects the results of several sensitivity analyses performed on the Qwest Embedded Avoided Cost Study that address "retailing" avoided cost differences associated with already-discounted services. The sensitivity analyses identify several avoided cost issues, demonstrating why application of full-price retail service discounts to already-discounted services would be inappropriate under the "rate" and "costs inherent in the rate" resale provisions of the Act.

Reliance On A Multiple Discount Model
- Operator Services/Directory Assistance Services

Q. WHAT CONSIDERATIONS ARE IMPORTANT IN DETERMINING IF A RESALE DISCOUNT IS APPLICABLE TO QWEST'S OS/DA SERVICE?

A. Of primary concern is whether resellers will be purchasing Qwest's OS/DA at all. Many CLECs and resellers have demonstrated or indicated that they will self-provision or buy these services through other competing ILEC's or other providers. If Qwest service is not purchased, retailing-related costs associated with the service should not be included and allowed to contaminate the resale discount calculations for Qwest's other services. If Qwest's OS/DA services are to be purchased and Qwest's existing wholesale carrier rates are not employed, then a separate and unique avoided cost analysis and resale discount would be required in order to recognize that when the service is provided, Qwest will not avoid any of its direct operator costs of providing OS/DA.

Q. WHAT ANALYSIS AND/OR DOCUMENTATION HAS QWEST PROVIDED AS PART OF ITS EMBEDDED AVOIDED COST STUDY REGARDING OS/DA SERVICES?

A. Exhibit DMG - 1 – Embedded Avoided Cost Study Executive Summary Narrative Description - Addendum specifically focuses on the avoided costs and resale discount issues relating to OS/DA services. In addition, Proprietary Exhibit DMG - 6 develops an avoided cost resale discount for OS/DA that could be used in lieu of Qwest's existing OS/DA wholesale tariff rate.

Reliance On A Multiple Discount Model
- Public Access Line Service

Q. WHAT CONSIDERATIONS ARE IMPORTANT IN DETERMINING IF A RESALE DISCOUNT IS APPLICABLE TO QWEST'S PUBLIC ACCESS LINE SERVICE?

A. Of primary concern is who is purchasing Qwest's Public Access Line (PAL) service. PAL is not an end user service; rather it is sold primarily to intermediate providers such as Independent Payphone Providers (IPPs) and Qwest's own deregulated FCC PART 64 Payphone service. The FCC has stated that IPPs are not to be considered telecommunications carriers, and thus the resale provisions of the Act do not apply to their wholesale purchases from Qwest.[30] Secondarily, is the question as to whether there are any avoided "retailing" costs if PAL service is sold to a CLEC rather than to an IPP.

Q. WHAT ANALYSIS AND/OR DOCUMENTATION HAS QWEST PROVIDED AS PART OF ITS EMBEDDED AVOIDED COST STUDY REGARDING PAL SERVICE?

A. Exhibit DMG - 1 – Embedded Avoided Cost Study Executive Summary Narrative Description addresses the exclusion of PAL service from the discounts calculated for other services and explains why there are no avoided retailing costs associated with providing PAL service to CLECs rather than IPPs. The Embedded Avoided Cost Study Executive Summary Narrative Description – Addendum discusses the avoided cost assumptions surrounding PAL service and my Proprietary Exhibit DMG - 7 presents a separate avoided cost study summary report for PAL service, in support of a resale discount of zero (0%).

Q. HAVE OTHER COMMISSIONS CONFIRMED THAT A ZERO RESALE DISCOUNT SHOULD BE APPLIED TO QWEST'S PAL SERVICE IF IT IS PURCHASED BY A CLEC?

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30 *First Report & Order*, Section VIII. Resale, ¶876.

A. Yes, they have. The Colorado and Wyoming Public Service Commissions have both implemented a zero resale discount for PAL service. The Colorado Commission stated in rendering its decision on the resale of Qwest's (then U S WEST) PAL service that:

> .... PALs should be available for resale, but that the reseller cannot be an IPP itself. On the other hand, the majority agrees with USWC that its cost of selling PALs to CLECs will be no different from its costs of selling to IPPs, in other words, that the avoided costs will be zero. Consequently, the majority opinion is that resale of PALs should be allowed but with a zero discount. [31]

Subsequent to this Colorado finding and order, in a 2002 cost docket proceeding, the Public Service Commission of Wyoming also adopted the Colorado position, implementing a zero discount for PAL services sold to CLECs in Wyoming.

Reliance On A Multiple Discount Model - Summary

Q. HAS QWEST FILED FOR AND/OR RECEIVED ORDERS TO IMPLEMENT MULTIPLE RESALE DISCOUNTS, RATHER THAN A SINGLE COMPOSITE DISCOUNT, IN COST DOCKET ORDERS ISSUED IN OTHER STATES?

A. Yes. In all of its cost docket cases filed to date, Qwest has requested multiple resale discounts. Orders received in other states, such as Colorado, Iowa, Utah and

Wyoming require the use of product category differentiated discounts.

Q. PLEASE SUMMARIZE WHY THIS COMMISSION SHOULD SET MULTIPLE DISCOUNTS IN THIS PROCEEDING.

A. As my testimony has indicated, this Commission should set multiple discounts for a variety of reasons that are supported by the Act. In summary, the Commission should recognize that:

- Qwest has multiple services and rates that resellers will avail themselves of under the provisions of the Act;
- the proportion of retailing costs comprised in various rates vary dramatically among services offered by Qwest;
- resellers make no pledge, and are not bound, to purchase all Qwest retail services in the same "composite" mix currently provided to Qwest customers;
- the Act provides the foundation for unique category discounts, and the FCC acknowledged that multiple discounts may be appropriate;
- a single discount facilitates reseller arbitrage;
- packaged, special, and miscellaneous services should be treated separately from basic services;

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31 *Investigation and Suspension of Tariff Sheets filed by U S WEST Communications, Inc. with Advice Letter No. 2617, Regarding Tariffs for Interconnection, Local Termination, Unbundling and Resale of Services*, Docket No. 96A-331T, Decision No. C97-739, adopted July16, 1997, Section I W b 7 c.

- volume / term contracts initiated by Qwest constitute already discounted retail services which have different avoided costs than comparable full-retail services;
- OS/DA service has separate rates, and many resellers will self-provision, or use alternative providers other than Qwest, in providing this service to its customers; and
- PAL is a unique service and that the cost of providing PAL service to CLECs will be no different than the cost of providing PAL service to Independent Payphone Providers, thus there are no avoided retailing costs.

VI. CONCLUSIONS AND FINAL RECOMMENDATIONS

Q. WHAT FINAL CONCLUSIONS AND RECOMMENDATIONS ARE YOU OFFERING IN CONNECTION WITH QWEST'S AVOIDED COST STUDY?

A. **First,** five product-category, basic service resale discounts, rather than a single, average discount should be adopted in this proceeding. Using only a single aggregate discount is inappropriate given the fact that the cost characteristics of all services are not the same and that reseller purchases will not correspond to the retail mix presently sold by Qwest. Some services are capital intensive (such as Basic Exchange - Residence service), while other services are more labor intensive; and some services require more retailing sales and/or product management support in relation to total product costs than do other services. The Commission should therefore adopt the five basic service product categories reflected in the Qwest avoided cost study, since they provide the differentiation required for proper product segmentation. The use of basic service product category discounts also averts the improper reseller arbitrage that becomes available with a single discount when resellers pick and choose which services to resell.

Qwest recommends that the Commission adopt Qwest's Embedded Avoided Cost and Resale Discount Study and the product category discounts listed below:

Category	Service Description	Discount
1	Basic Exchange Business	7.63%
2	Toll	6.65%
3	Listings, CO Features, & Informational Services	39.93%
4	Basic Exchange Residence	4.62%
5	Private Line	5.26%

Second, Qwest proposes that the Commission adopt the use of a composite discount of 8.88% for Packaged / Special Services such as CustomChoice™, ISDN, PBX, Centrex 21, and Advance Communications Services (ACS) such as Frame Relay.

Third, the Commission should find that if Operator Service/DA services are obtained from Qwest, the existing wholesale tariff should be employed or a separate resale discount of 8.21% should be applied to Operator Service/DA retail rates.

Fourth, the Commission should uphold the terms of Qwest's existing customer contracts with respect to whether contracts can be assumed or transferred. If the Commission determines that Qwest initiated and existing contracts are subject to the Act's resale discount provisions, then the Commission should recognize that full-retail discounting of an already discounted service would result improperly in double discounting. To avoid this result, the Commission should employ a separate avoided cost analysis and establish separate resale discounts for contract services as outlined in the Volume / Term Contract discussion of my Exhibit DMG – 1 Addendum.

Fifth, the Commission should conclude that the cost of providing PAL service to CLECs would be no different than the cost of providing PAL service to Independent Payphone Providers, thus there are no avoided retailing costs, and therefore a zero resale discount should be applied.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes it does.

D. M. (MARTI) GUDE - HAS TESTIFIED ON THE SUBJECT OF EMBEDDED COST STUDIES IN THE FOLLOWING:

STATE	CASE/ DOCKET NO.	CASE NAME	DATE OF TESTIMONY	DATE OF CROSS
Iowa	RPU-88-9	Rate Design Case	D - 7-29-88 * R - 12-13-88 *	1-11-89
Iowa	RPU-88-6	Iowa General Rate Case Rehearing	R - 6-8-89	6-22-89
Iowa	RPU-91-4	In the Matter of the Petition of the Consumer Advocate Division of the Department of Justice Requesting Reduced Rates for U S WEST Communications, Inc.	D - 9-25-91	Settlement reached prior to Hearing
Iowa	TCU-93-3	In Re: McLeod Telecommunications, Inc. (Resale of Centrex Plus)	D - 8-25-93	9-13-93
Iowa	RPU-93-9	In Re: U S WEST Communications, Inc. (Iowa Earnings Investigation)	D - 11-30-93 SR - 2-21-94	3-23-94
Iowa	RPU-95-11	In Re: U S WEST Communications, Inc. (Rate Rebalancing)	D - 9-22-95 R - 2-20-96	Testimony Withdrawn and Proceeding Terminated
Minnesota	P-421/CI-86-354	NWB Earnings Investigation	R - 9-28-87 *	12-87
Nebraska	C-1874	In the Matter of the Application of U S WEST Communications, Inc. for Authority to Increase its Residential Basic Local Exchange Rates Pursuant to Neb. Rev. Stat. Section 86-803(9).	D - 11-25-98 R (oral) - 12-17-98	12-17-98
North Dakota	10,823	IMTS Deregulation	D - 1-13-88 *	1-20-88
North Dakota	PU-314-99-119	U S WEST Communications, Inc. SB 2420 Residential Price Changes Investigation	D - 5-30-2000	6-7-2000

D. M. (MARTI) GUDE - HAS TESTIFIED ON THE SUBJECT OF EMBEDDED COST STUDIES IN THE FOLLOWING:

STATE	CASE/ DOCKET NO.	CASE NAME	DATE OF TESTIMONY	DATE OF CROSS
Oregon	UX 22	In The Matter of the Petition of U S WEST Communications, Inc., To Exempt From Regulation U S WEST's IntraLATA Toll Service	D - 8-9-99	Petition Withdrawn by USWC
South Dakota	F-3848, 3849, 3850	In the Matter of the Inquiry into Northwestern Bell Telephone Company's Allocation of Revenues, Investment, and Expenses Among All Services Offered	D - 9-1-90 SR - 11-15-90	12-4-90
South Dakota	TC99-098	In the Matter of the Petition of U S WEST Communications, Inc. to Reclassify U S WEST's Directory Assistance Service	D - 9-20-99	Settlement reached prior to Hearing

* Filed as D. M. Conley

D = Direct
R = Rebuttal
SR = Surrebuttal
Sup = Supplemental

D. M. (MARTI) GUDE - HAS TESTIFIED ON THE SUBJECT OF EMBEDDED AVOIDED COST STUDIES IN THE FOLLOWING:

STATE	CASE/ DOCKET NO.	CASE NAME	DATE OF TESTIMONY	DATE OF CROSS
Arizona	T-00000A-00-0194 Phase II	In the Matter of Investigation Into Qwest Corporation's Compliance With Certain Wholesale Pricing Requirements for Unbundled Network Elements and Resale Discounts	D - 3-15-2001 R - 6-27-2001	7-19-2001
Colorado	96S-331T	Re: The Investigation and Suspension of Tariff Sheets Filed by U S WEST Communications, Inc., with Advice Letter No. 2617, Regarding Tariffs for Interconnection, Local Termination, Unbundling and Resale of Services	D - 12-13-96 (Filed by D. Elder) R - 3-28-97 Sup R - 4-9-97	4-16-97
Idaho	QWE-T-01-11	In The Matter of Determining Prices for Unbundled Network Elements (UNE) in Qwest Corporation's Statement of Generally Available Terms (SGAT)	D - 6-29-2001	
Iowa	RPU-96-9	In Re: U S WEST Communications, Inc. (Cost Docket)	D - 3-26-97 Sup D - 5-19-97 R - 7-30-97	Panel: 5-29-97 D - 6-2-97 R - 9-19-97
Minnesota	P-421/AM-00-1165 P-421/C-98-10	In the Matter of Qwest Corporation's Refiling of its Proposed Tariffs Regarding Termination Liability Assessments as Applied to Resale Arrangements	D - 2-6-2001	3-26-2001

D. M. (MARTI) GUDE - HAS TESTIFIED ON THE SUBJECT OF EMBEDDED AVOIDED COST STUDIES IN THE FOLLOWING:

STATE	CASE/ DOCKET NO.	CASE NAME	DATE OF TESTIMONY	DATE OF CROSS
Montana	D96.11.200	IN THE MATTER OF the Interconnection Contract Negotiations Between AT&T Communications of the Mountain States, Inc. and U S WEST Communications, Inc. Pursuant to 47 U.S.C. Section 252	D - 12-26-96 R - 1-22-97 SR - 1-29-97	2-4-97
Montana	D2000.6.89	IN THE MATTER of Qwest Corporation's Application to Establish Rates For Interconnection, Unbundled Network Elements, Transport and Termination, and Resale Services	D - 8-25-2000 Sup D - 10-9-2000 R - 2-15-2001	Issue settled via Stipulation
Nebraska	C-1385	In Re The Matter Of A Petition For Arbitration of an Interconnection Agreement Between AT&T Communications of the Midwest, Inc. and U S WEST Communications, Inc.	D - 10-29-96	10-31-96 and 11-1-96
Nebraska	C-1473	In The Matter Of Cox Nebraska Telecom, Inc.'s Petition For Arbitration Pursuant To Section 252(b) of the Telecommunications Act of 1996 To Establish An Interconnection Agreement with U S WEST Communications, Inc.	D - 10-1-97	10-1-97
Nebraska	C-1415	In the Matter of the Commission on its Own Motion to Investigate U S WEST Communications' Cost to Establish Rates for Interconnection, Unbundled Network Elements, Transport and Termination and Resale Services	D - 8-12-98	12-10-98

D. M. (MARTI) GUDE - HAS TESTIFIED ON THE SUBJECT OF EMBEDDED AVOIDED COST STUDIES IN THE FOLLOWING:

STATE	CASE/ DOCKET NO.	CASE NAME	DATE OF TESTIMONY	DATE OF CROSS
Nebraska	C-2516/PI-49 (Phase 3)	In the Matter of the Commission, on its Own Motion, to Investigate Cost Studies to Establish Qwest Corporation's Rates for Interconnection, Unbundled Network Elements, Transport and Termination and Resale Services	D - 9-14-2001	N/A
New Mexico	96-411-TC	In The Matter Of the Interconnection Contract Between AT&T Communications of the Mountain States, Inc. and U S WEST Communications, Inc., Pursuant to 47 U.S.C. Section 252	Reply - 12-20-96 R - 1-21-97	2-14-97 and 2-17-97
New Mexico	96-310-TC 97-334-TC (Phase II)	In the Matter of the Consideration of the Adoption of a Rule Concerning Cost Methodologies	D - 7-8-98 R - 8-5-98	8-27-98
North Dakota	PU-453-96-497	AT&T Communications of the Midwest, Inc. Interconnection Arbitration Application	D - 1-13-97 R - 2-14-97	2-28-97
North Dakota	PU-314-97-12	Re: U S WEST Communications, Inc. Interconnection / Wholesale Pricing Investigation	D - 12-22-97	Wholesale portion was postponed indefinitely
Oregon	UM 962	In The Matter of the Investigation of Wholesale Discounts Applicable to Resale	D - 6-15-2001	

D. M. (MARTI) GUDE - HAS TESTIFIED ON THE SUBJECT OF EMBEDDED AVOIDED COST STUDIES IN THE FOLLOWING:

STATE	CASE/ DOCKET NO.	CASE NAME	DATE OF TESTIMONY	DATE OF CROSS
South Dakota	TC96-184	In The Matter Of the Interconnection Contract Negotiations Between AT&T Communications of the Midwest, Inc. and U S WEST Communications, Inc. Pursuant to 47 U.S.C. Section 252	D - 1-17-97 R - 1-24-97	2-6-97
Utah	96-095-01	In the Matter of MCI metro Access Transmission Services, Inc.'s (MCImetro's) Consolidated Petitions for Arbitration with U S WEST Communications, Inc. (U S WEST) Pursuant to Section 252(b) of the Federal Telecommunications Act of 1996	R - 11-22-96	Did not go to Hearing
Utah	99-049-20	In the Matter of the Investigation of the Resale Discount Rates of U S WEST Communications, Inc. For Service Provided to Other Utah Certified Local Exchange Carriers	D - 10-29-99 Sup D - 12-3-99	1-6-2000
Washington	UT-960310	In the Matter of the Petition for Arbitration of an Interconnection Agreement Between MCImetro Access Transmission Services, Inc. and U S WEST Communications, Inc. Pursuant to 47 U.S.C. Section 252	R - 11-8-96	11-19-96

D. M. (MARTI) GUDE - HAS TESTIFIED ON THE SUBJECT OF EMBEDDED AVOIDED COST STUDIES IN THE FOLLOWING:

STATE	CASE/ DOCKET NO.	CASE NAME	DATE OF TESTIMONY	DATE OF CROSS
Washington	UT-960369	In the Matter of the Pricing Proceeding for Interconnection, Unbundled Elements, Transport and Termination, and Resale	D - 3-28-97 R - 4-25-97	7-18-97
	UT-960370	In the Matter of the Pricing Proceeding for Interconnection, Unbundled Elements, Transport and Termination, and Resale for U S WEST COMMUNICATIONS INC		
	UT-960371	In the Matter of the Pricing Proceeding for Interconnection, Unbundled Elements, Transport and Termination, and Resale for GTE NORTHWEST INCORPORATED		
Washington	UT-960369 UT-960370 UT-960371 (Phase II)		D - 7-9-98	Testimony was stipulated
Wyoming	70000-TA-01-700	In the Matter of Determining Prices for Unbundled Network Elements (UNE) in Qwest Corporation's Statement of Generally Available Terms (SGAT)	D - 7-31-2001 R - 5-10-2002	6-19-2002

D = Direct
R = Rebuttal
SR = Surrebuttal
Sup = Supplemental

D. M. (MARTI) GUDE - HAS TESTIFIED ON THE SUBJECT OF COST STUDY FACTORS IN THE FOLLOWING:

STATE	CASE/ DOCKET NO.	CASE NAME	DATE OF TESTIMONY	DATE OF CROSS
Arizona	T-00000A-00-0194 Phase II	In the Matter of Investigation Into Qwest Corporation's Compliance With Certain Wholesale Pricing Requirements for Unbundled Network Elements and Resale Discounts	R - 6-27-2001 (NOTE: This testimony also dealt with Avoided Cost issues, as shown on Appendix A-2)	7-19-2001
Colorado	99A-577T	In the Matter of Qwest Corporation's Statement of Generally Available Terms and Conditions	R - 7-20-2001	8-7/8-2001
Minnesota	P-442,421,3012/ M-01-1916	In Re Commission Investigation of Qwest's Pricing of Certain Unbundled Network Elements	R - 4-18-2002	5-15-2002
	P-421/CI-01-1375 12-2500-14490-	In the Matter of the Commission's Review and Investigation of Qwest's Unbundled Network Element (UNE) Prices		
Nebraska	C-2516/PI-49 (Phase 2)	In the Matter of the Commission, on its Own Motion, to Investigate Cost Studies to Establish Qwest Corporation's Rates for Interconnection, Unbundled Network Elements, Transport and Termination and Resale Services	D - 8-29-2001 R - 9-6-2001	9-19-2001
Utah	01-049-85	In The Matter Of The Determination Of The Unbundled Loop Of QWEST CORPORATION	R - 8-16-2002	

D. M. (MARTI) GUDE - HAS TESTIFIED ON THE SUBJECT OF COST STUDY FACTORS IN THE FOLLOWING:

STATE	CASE/ DOCKET NO.	CASE NAME	DATE OF TESTIMONY	DATE OF CROSS
Washington	UT-003013 (Part D)	In the Matter of Continued Costing and Pricing of Unbundled Network Elements, Transport, Termination, and Resale	R - 3-7-2002 Sup R - 4-17-2002	No oral cross-examination requested by any party

D = Direct
R = Rebuttal
SR = Surrebuttal
Sup = Supplemental

BEFORE THE SOUTH DAKOTA PUBLIC UTILITIES COMMISSION

IN THE MATTER OF DETERMINING PRICES FOR UNBUNDLED NETWORK ELEMENTS (UNE's) IN QWEST CORPORATION'S STATEMENT OF GENERALLY AVAILABLE TERMS (SGAT)	DOCKET NO. TC01-098

QWEST CORPORATION'S

DIRECT TESTIMONY EXHIBITS

OF

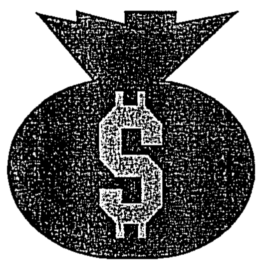
D. M. (MARTI) GUDE

OCTOBER 15, 2002

Qwest Corporation
Docket No. TC01-098
Exhibit to Testimony of
D. M. (Marti) Gude
Exhibit DMG – 1

QWEST
EMBEDDED AVOIDED COST STUDY
EXECUTIVE SUMMARY

NARRATIVE DESCRIPTION



AVOIDED
RESALE COSTS

[BASED ON 2001 EMBEDDED COST DATA]

I. PURPOSE, SCOPE, AND APPLICATION

The purpose and scope of the Qwest Embedded Avoided Cost Study is to identify avoided retailing costs and determine appropriate resale discounts to be applied to Qwest retail service prices when such services are provided to resellers for resale. This embedded avoided cost study was developed and employed to determine avoided costs, and to calculate resale discounts that comply with Section 251 (c)(4) and Section 252 (d)(3) of the Federal Telecommunications Act of 1996.

Section 251(c)(4) requires local exchange carriers, such as Qwest to:

> .... offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers who are not telecommunications carriers.

Section 252 (d)(3) of the Act states:

> A state Commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection and other costs that will be avoided by the local exchange carrier.

The Sections that follow describe the Qwest Embedded Avoided Cost Study and its approach to fulfilling the resale discount requirements of the Act.

II. DESCRIPTION OF SERVICE GROUPINGS

The Act specifically addresses the determination of discount rates based on the retailing costs inherent in those retail rates. Given the language of the Act, the fact that Qwest offers more than one retail telecommunication service, and the fact that resellers are not required to purchase all of Qwest's retail services for resale, the Qwest Embedded Avoided Cost Study prepares discounts based on the identification of avoided costs for five separate basic service product groupings. In addition to the five basic service groupings, a composite discount is developed for "Packaged / Special" service applications. Packaged / Special service applications are those services which are comprised of more than one of the five basic service groupings or that do not share the unique characteristics of a basic service category. The discount percentage developed, for each of the five basic service product groups and for the composite group, is applicable to the services comprising that group.
The discount groupings for intrastate retail services are as follows:

Category

Basic 1 - **Basic Exchange Business**
Business Basic Exchange

Basic 2 - **TOLL**
MTS
WATS
800 Service

Basic 3 - **Listings, CO Features and Informational Services**
Listing Services
Informational Services (976, 960, Versa Net - Regulated, etc.)
Central Office Features

Basic 4 - **Basic Exchange Residence**
Residence Basic Exchange

Basic 5 - **Private Line**
Intrastate Private Line

Composite - Packaged / Special Services
"CUSTOMCHOICE™" type services
Centrex Services
Integrated Services Digital Network (ISDN)
Advanced Communications Service (e.g. Frame Relay, LAN, MegaBit services)
PBX – Trunks, DSS, and UAS

III. DESCRIPTION OF STUDY

General

This embedded cost study determines the retailing costs for Qwest retail telecommunications services that are avoided due to resale. It calculates discount percentages to apply to retail rates when retail services are offered on a wholesale basis to resellers. The study is based on an analysis of intrastate costs that are inherent in the intrastate service rates. It identifies intrastate services, which meet the definition of retail telecommunications services subject to resale under the terms of the Act; and it analyzes total operating costs for these services in order to determine the avoided retailing costs addressed by the Act.

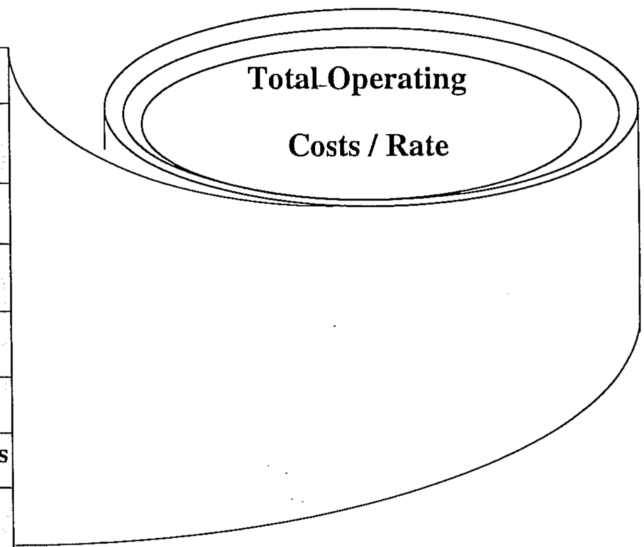
Qwest retail service rates are comprised of Total Operating Costs. Total Operating

Costs include direct and indirect Operating Expenses and direct and indirect Capital Costs. The study analyzes total intrastate embedded costs in order to determine total avoided retailing costs. The relationship of avoided costs to total costs is used to develop the resale discount rates.

Intrastate Operating Costs / Retail Rate Structure

Intrastate rates are comprised of many Operating Cost components. They include:

Uncollectible Costs
Plant Specific / Non-Plant Specific Costs
Customer Operations Costs
Corporate Operations Costs
Other Operating State & Local Tax Costs
Other Operating Income & Expense Costs
Miscellaneous Rent Compensation - Net Costs
Operating Capital Costs



Discount Formula

The Qwest Embedded Avoided Cost Study employs the following discount formula:

Total Operating Costs = Operating Expenses + Operating Capital Costs

Avoided Costs = Marketing, Billing, Collection, and Other Retailing Related Expenses and Capital Costs

Discount Percentage = Avoided Costs / Total Operating Costs

Example:	Total Operating Cost (TC)	= $25.00
	Avoided Costs (AC)	= $3.00
	Avoided Cost Percentage (ACP)	= 12% (AC / TC)

Data Sources & Data Flow

Resale discounts are applicable only to retail telecommunications services. Therefore, this cost study eliminates costs associated with non-retail telecommunications services. Failing to properly eliminate non-retail service costs would contaminate the resale discount calculations for covered retail services with service costs for non-retail services. Removal of non-retail services from an avoided cost study is required in order to be compliant with the resale pricing provisions of the Federal Act.

In order to remove non-retail services, detailed Company cost accounting records are required. Several data sources are used to isolate and identify the intrastate retail and non-retail services and their respective operating cost elements. High level FCC ARMIS (Automated Report Management Information System) data is insufficient for an analysis of intrastate products and services. The FCC ARMIS reports were developed to assess interstate costs and products, not to detail and array intrastate costs and intrastate products and services. Only Company cost accounting records provide the required intrastate service embedded cost data. The detailed Company data sources and the data flow used in the preparation of the Qwest Embedded Avoided Cost Study are as follows:

Data Sources

- Qwest booked results from operations, recorded under FCC CFR 47, Part 32 accounting rules;

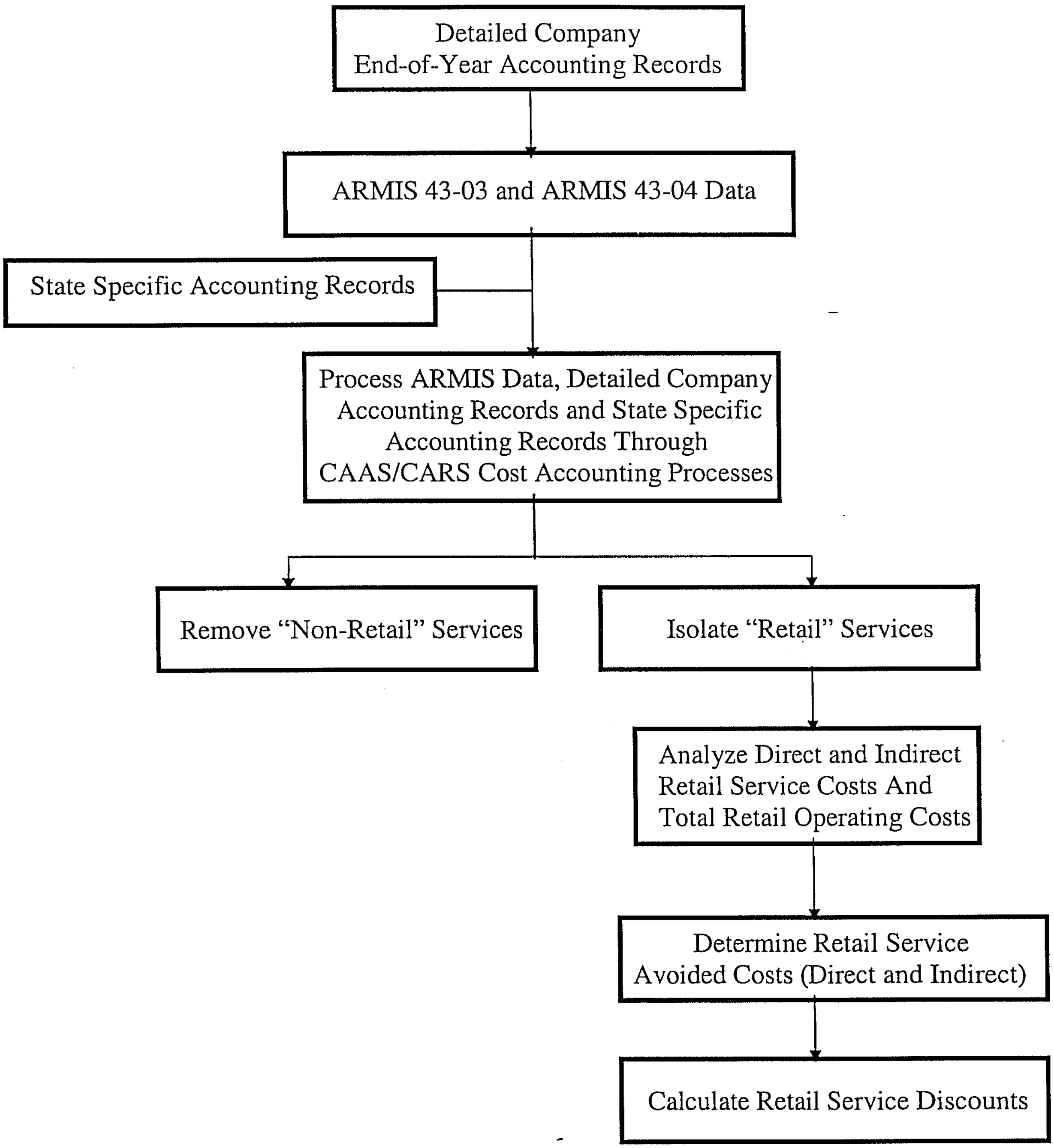
- FCC ARMIS Reports
  - ARMIS 43-03 (Summarizes Combined Results from Operations)
  - ARMIS 43-04 (Contains Intrastate Results from Operations);

- State specific accounting records;

- Qwest CAAS/CARS (Cost Accounting Allocation System / Cost Accounting Reporting System) Embedded Cost Product Reports.

Qwest Corporation
Docket No. TC01-098
Exhibit to Testimony of
D. M. (Marti) Gude
Exhibit DMG – 1

<u>Data Flow</u>



Data Flow Description

Data employed in the Qwest Embedded Avoided Cost Study is taken from the Company's Cost Accounting Allocation System / Cost Accounting Reporting System (CAAS/CARS). CAAS/CARS data originates with the Company's journalized accounting records and it corresponds to ARMIS Report 43-03 and 43-04 data for the State, but at a much greater level of detail for intrastate services. CARS reports, which depict intrastate product-specific operations, also incorporate State specific treatment, rather than the FCC's treatment, of costs such as depreciation and employee related benefit amortization costs. The CARS reports array Qwest intrastate product data, which is not provided in the FCC ARMIS interstate reporting process.

The Qwest Embedded Study begins with detailed USOA Part 32 accounting data. This is the same data that is summarized to higher level when reported via FCC ARMIS reports. Since the data contained in the ARMIS 43-03 (Combined Interstate/Intrastate) and ARMIS 43-04 (Jurisdictionally Separated Interstate/Intrastate) reports has been summarized to a higher level, its use is limited in determining avoided costs, without augmenting the data with the USOA Part 32 detailed accounting data and State-specific accounting records. This more detailed and State-specific data is what is processed by the Qwest CAAS/CARS cost accounting system. Since the Federal Act requires the discounting of intrastate "retail" services, augmentation of consolidated ARMIS 43-04 <u>intrastate</u> data must be made.

Qwest's CAAS/CARS costing system ties to ARMIS reporting, while relying on the detailed journal records, that were originally summarized in the ARMIS reporting process. The use of detailed accounting records facilitates the identification and removal of non-retail services, and a detailed analysis and study of intrastate retail product costs.

Cost Identification

The identification of avoided retailing costs is accomplished by a detailed analysis of Qwest's "retail" services, and the expenses and capital costs inherent in the "Intrastate" rates for these services. Cost analysis is performed by employing detail from Qwest books and records maintained in conformance with the FCC CFR 47, Part 32 Uniform System of Accounts (USOA). The FCC's major classifications of expense and main expense accounts are utilized and augmented with Qwest detail sub-accounts and product cost accounting systems data. Accounting records and product cost records from Qwest's CAAS/CARS system are employed in order to isolate retail services and non-retail services, as well as identify the retailing costs for retail services that will be avoided in selling services to resellers at wholesale prices.

In order to determine avoided costs, a general understanding of Qwest's wholesale/retail cost relationships was developed. Specific costs and work functions were reviewed in order to gain a more detailed understanding of the costs and to determine more specifically, which cost elements would continue to be incurred by Qwest in a resale (wholesale) environment, and which elements would be associated strictly with Qwest's retailing operations. This understanding and information was augmented with time study, cost analysis, and special studies performed by Qwest's cost studies groups. From this information Qwest was able to develop embedded avoided cost percentages. These percentages were then applied to embedded costs in the Qwest embedded avoided cost study. This type of cost identification and analysis is typical as a part of the Qwest CAAS/CARS cost accounting process.

Non-Retail / Excluded Services

The identification of non-retail services is accomplished by employing product cost data from the Company's CAAS/CARS cost accounting system. Product cost reports identify embedded costs for Qwest's products and services. The following non-retail services were identified and removed from study consideration:

Non-retail Services Excluded:

- All Interstate services - Includes all Part 36 jurisdictionally separated Interstate services; i.e. interstate Access and Subscriber Line Charges (SLC) which are under the FCC's jurisdiction.

The following services are not telecommunications end-user subscriber services under the terms of the Act:

- Intrastate Access service
- Third Party Billing and Collection
- Wireless Interconnect Access
- Centrex UNE-P
- E911
- Mobile

Other Excluded Services:

- Operator Services / DA - These services are not included in the study since Operator Service/DA services have their own rate lists and/or result in separate charges and, as AT&T and other resellers have previously indicated, such services could be provided by competing ILEC's or they could be separately contracted from Qwest. Therefore, the costs for these services should not be considered avoided in developing recurring rate discounts for other services. They must be eliminated entirely from any resale discount analysis or the discounts for retail services are contaminated and erroneously inflated, creating a double-dip in revenue loss. A separate study is performed for OS/DA services.

- Public Access Lines (PAL) – This service is available for resale by CLECs but is eliminated from the general study since the costs of providing PAL service to CLECs will be no different than the cost to provide service to Independent Payphone Providers (IPPs). A separate avoided cost study is conducted for PAL service.

- Traditional Non-recurring Business Office Services - Traditional, "embedded", non-recurring charges for the establishment of service are separate and unique from retail telecommunications services that are subject to resale. The costs are by definition, **non**-recurring in nature and they are not billed to each and every customer, each and every month, like recurring basic and toll services are. They have their own rates/pricing elements and are charged only when applicable. For the existing customer base, these costs are costs that are expended up-front and Qwest can not avoid them. Since up-front costs are sunk costs and, since customers are not regularly and routinely billed for non-recurring charges, creating contaminated resale discounts for "**recurring**" rate services by including non-recurring cost impacts is inappropriate.

IV. STUDY ASSUMPTIONS

The need for identifying avoided "retailing" costs stems from the resale provisions of the Federal Act and thus, there had been no historical requirement to uniquely identify such costs in the past. No previous FCC Part 32 USOA accounting requirements existed to separately account for all avoided retailing activities. Therefore, actual historical information is limited or not directly available via traditional FCC reporting standards. As a result, the following key assumptions were employed:

- Plant Specific and Non-Plant specific network direct costs of operations are required to provision resale and thus, no direct costs are avoided due to resale.

- Indirect (General Support) costs are arguably not avoided due to resale. However, for purposes of this study a portion of the indirect support costs are conservatively considered to be partially avoided. Two approaches were employed. Some indirect costs were considered to be avoided costs in proportion to the direct costs avoided. This was accomplished by employing a ratio of Avoided Direct Costs to Total Direct Costs, with all direct Expenses and direct Capital Costs considered. Other indirect costs were determined to include partially avoided costs through the use of special studies and analyses (e.g. uncollectibles and information management/computer costs).

- Certain costs, such as wholesale/interconnect systems development computer related costs were identified and considered to be costs that should not be treated as avoided retailing costs.

- Incremental costs of resale are to be considered and netted against avoided retail costs.

- The level of Product Management costs currently incurred to provision Qwest's Carrier Access service provides a reasonable surrogate for the Marketing - Product Management costs that are required to provision resale services.

Product Management - Carrier Access Surrogate

The level of Product Management costs for the resale of retail telecommunications service will be very similar to those incurred for providing wholesale Access Service. A variety of product management functions are "wholesale" in nature and would be required (not avoided) even if there were no retail operations, because Qwest's product managers focus on developing and bringing its products to the market place.

For years, Qwest has employed product managers to serve the wholesale Access service needs of interexchange carriers. Today Qwest's "Carrier" market unit is dedicated to serving the access needs of interexchange carriers in order to provide these customers with "wholesale" switched and dedicated access products. This market unit incurs wholesale costs that are characterized and recorded as "Marketing - Product Management" costs under Part 32 accounting rules. Carrier Access actual recorded costs demonstrate that there are numerous product management cost functions performed in providing wholesale, not retail, services today.

Work function and activity costs recorded for Qwest's Carrier Access wholesale service costs were studied and determined to be representative of wholesale/resale telecommunications products product management functions and cost expectations. A comparison of total Qwest retail services product management costs and Carrier Access service actual product management costs facilitates the identification of product management costs that would be avoided when providing retail services on a resale, "wholesale", basis. Separate comparisons were performed for each basic service category group. By comparing total incurred product management costs, by retail product category, with incurred Carrier Access product management costs in the State, separate avoided cost percentages were established for each product group. For product groups where Carrier Access product management costs equal or exceed retail product category service costs, the percentage avoided was set conservatively at 0% rather than assuming product management cost increases due to resale.

V. DESCRIPTION OF COSTS - AVOIDED COST TREATMENT

The following accounts were analyzed in order to identify "retailing" costs inherent in Qwest's operating costs and retail service rates. In many instances, detailed sub-account information and/or an understanding of detailed cost elements within accounts was required in order to isolate costs which will not be avoided due to resale.

Uncollectibles

Uncollectibles - Account 5300

Under FCC Part 32 USOA accounting rules, this account is used to summarize, for reporting purposes, the contents of Accounts 5301 and 5302. Account 5301 is charged with amounts concurrently credited to Account 1181, Accounts Receivable Allowance - Telecommunications. Account 5302 is charged with amounts credited to Account 1191, Accounts Receivable Allowance- Other.

Qwest maintains additional uncollectible sub-account detail in order to further delineate uncollectible costs. The following sub-accounts are necessary to refine the avoided cost analysis.

Account 5301.2 - Uncollectible - Telecommunications - Intrastate End-User
This account contains intrastate end-user uncollectibles for retail services. Except for sub-account 5301.224, these costs are considered partially avoided.

Account 5301.224 - Uncollectible Exchange Carrier/Ind. Co.
Sub-account 5301.224 further refines Account 5301.2 - End-User Uncollectibles to allow for separate identification of Exchange Carrier / Independent Company originated uncollectibles charged to Qwest. Independent Company uncollectible costs billed to Qwest will not be avoided due to resale.

Account 5301.5 - Intrastate - Carrier Access Service Uncollectible
This sub-account relates to wholesale access services, which are non-resale services. Carrier Access uncollectible costs will not be avoided due to resale. Additionally, Carrier Access uncollectible data is utilized as a surrogate for reseller uncollectibles and the development of the avoided cost uncollectible percentage estimates applied to Account 5301.2, excluding sub-account .224. This is a conservative surrogate, since reseller uncollectibles are anticipated to be at least as great as the uncollectibles experienced with Qwest's wholesale Access Service sales to carriers.

Account 5302 - Uncollectible Other
This account contains other (non-telecommunications customer) uncollectibles not covered by Account 5301. These costs will not be avoided due to resale, since they relate to non-resale type revenues.

Plant Specific / Non-Plant Specific Accounts 6100 - 6500

Plant Specific / Non-Plant Specific Operations accounts are used to record costs related to specific kinds of telecommunications plant, provisioning, network operations, access and depreciation expense. Except where noted, these costs are considered not avoided due to resale.

Plant Specific Costs

Maintenance - Accounts 6110 - 6410

Maintenance related expenses constitute costs associated with keeping Qwest's network infrastructure, facilities and equipment in sound working order. As such, these costs are not avoidable since resellers will expect the Qwest network to provide resellers with the same level and quality of service afforded to wholesale/retail operations today.

Account 6110 - Network Support
Account 6200 - CO Switching, Transmission, OSP Systems
Account 6310 - Information O/T
Account 6410 - Cable and Wire
All of the above listed accounts contain direct costs of operations, which are not avoided due to resale.

Account 6120 - General Support Maintenance
With the exception of Account 6124, accounts in the 6120 series are considered an "indirect", rather than a "direct", cost of operations. For retail services, a portion of Account 6120 is considered partially avoided in proportion to a ratio of Direct Avoided Costs/Total Direct Costs.

Account 6124 - General Purpose Computers Operations
This account includes work and costs associated with operating general purpose computers, maintaining operating systems, providing direct or indirect supervision, support, administration, training, or office services for all Account 6124 functions. For the general support computer related charges recorded in Account 6124, avoided costs due to resale were determined via a separate study.

Plant - Non-Specific Costs

Other PP&E - Account 6510

This account contains costs related to Property Held For Future Use and Provisioning Expenses not transferred to other plant specific accounts or charged to construction. These costs will be required and will not avoided due to resale.

Network Operations - Accounts 6531 - 6535

These costs include: Account 6531 - Power; Account 6532 - Network Administration; Account 6533 - Testing; Account 6534 - Plant Operations Administration; and Account 6535 - Engineering. These network operations costs will not be avoided due to resale.

Access - Account 6540

This account includes amounts paid to other exchange carriers for the provision of carrier access and local interconnection. These costs will not be avoided due to resale.

Depreciation/Amortization - Account 6560

This account contains expense for the depreciation/amortization of capitalized costs. It contains network and general support asset related costs. Network related costs are required and will not be avoided due to resale. General Support related depreciation/amortization expense for retail services is considered partially avoided, either in proportion to a ratio of Direct Avoided Costs/Total Direct Costs or, for computer related costs, via the use of a separate study.

Customer Operations Expenses

Marketing - Account 6610

This account contains "retailing" costs specifically referenced in the Federal Act. It is, however, comprised of three sub-accounts, which must be analyzed separately.

Account 6611 - Product Management

This account includes costs incurred in performing administrative activities related to the marketing of products and services. A variety of activities are included, such as: competitive analysis, product and service identification and specification, test market planning, demand forecasting (integration of retail, wholesale, and resale demand), product life cycle analysis, pricing, rate and tariff development, cost study work performed in support of specific regulatory dockets, identifying and analyzing costs for regulatory filings, and numerous others. Some of these functions are retail only, others are required for wholesale / resale operations.

For retail services, only a portion of this sub-account will be avoided due to resale. Product Management in a resale environment will be similar to Product Management costs presently incurred in providing wholesale Access service. Carrier Access product management costs provide a reasonable surrogate for determining the level of costs expected due to resale.

Account 6612 - Sales

Sales costs incurred by the Qwest retail organization are considered to be retail costs and are treated as 100% avoided. Sales costs incurred in the selling of products and services in a wholesale environment are not avoided costs. Wholesale Sales costs include determination of individual reseller/unbundled customer needs, development and presentation of customer proposals, sales order preparation and handing and preparation of sales records.

Only a portion of this account will be avoided due to resale.

Account 6613 - Advertising
This account contains costs incurred in developing and implementing promotional strategies to stimulate the purchase of products and services. It does not include non-product advertising (i.e. Corporate image advertising, stock, bond or employment advertising).

Qwest's product advertising and stimulation efforts in the market place are informative and cover retail services that can ultimately be resold by resellers. Thus, product advertising is informative not only to Qwest customers, but also to reseller customers and to resellers themselves. Qwest's advertising benefits resellers by limiting their need to duplicate these customer awareness costs. Therefore, such costs should be treated like other wholesale type costs that are not avoided costs.

Arguably, all advertising could be considered to be a cost that is not avoided due to resale, since product advertising is aimed at improved service penetration and it is informative to the general market place. Additionally, in branding their own products, resellers may attempt to advantage themselves by relying on Qwest's network and service reliability and image. However, Qwest's product advertising does inform Qwest customers, not just reseller customers or resellers themselves, therefore, such costs may appropriately be considered to be a partially avoided cost in an avoided cost study.

Additionally, as Qwest's Access Service product analysis indicates, multiple service provider options have created "slamming" issues. Slamming issues have precipitated increased customer information advertisement costs in the multiple carrier wholesale environment. Similar circumstances are likely to occur due to multiple resale providers. These incremental advertising costs must also be appropriately considered in determining the percentage of advertising costs that are avoided.

Only a portion of these costs should be considered to be an avoided cost. A special study of advertising costs is employed to determine the proportion of costs that are avoided due to resale.

Customer Services - Account 6620

Customer Services is comprised of several accounts, which must be individually considered and analyzed in order to determine what proportion of costs will be avoided due to retailing activities.

Account 6621 - Call Services
This account includes costs for helping customers place and complete calls, excluding directory assistance. This includes handling and recording; mechanized intercept;

quoting rates; time and charges; and all other activities involved in the manual handling of calls. After isolating and excluding the costs associated with the Operator Services product, costs remaining in this account will not be avoided due to resale.

Account 6622 - Number Services (Directory Assistance)
This account contains costs incurred in providing customer number and classified listings. It includes preparing, compiling and disseminating those listings through directory assistance or other means. After isolating and excluding costs associated with the Directory Assistance (DA) product, costs remaining in this account will not be avoided due to resale.

Account 6623 - Customer Services Expenses
This account includes costs incurred in establishing and servicing customer accounts. This includes initiating customer service orders and records; maintaining and billing customer accounts; collecting and investigating customer accounts and handling adjustments; and instructing customers in the use of products and services. This account has several sub-accounts that must be individually analyzed.

- **Account 6623.1/.2 - Customer Services (Qwest Billing and Collection)**
  These sub-accounts contain customer service and customer accounting costs associated with billing and collections for Qwest services from Qwest customers. For retail services, costs recorded in these accounts are considered partially avoided due to resale, using a functional time study cost analysis. Resellers must be billed in lieu of end-user customers, so only a portion of these costs will be avoided.

- **Account 6623.123 - Customer Service and Service Orders (Non-recurring Charges)**
  This sub-account, which further defines Account 6623.1, contains costs associated with initiating customer services orders and records which are of a non-recurring nature.

  Traditional non-recurring costs incurred and recorded in this account are excluded from the avoided cost study of recurring avoided costs in order to avoid contaminating recurring rate discounts. If such costs are not removed from the avoided cost analysis of recurring services, the costs in this account must be considered 0% avoided. (However, exclusion is a more conservative and more appropriate approach.) Analysis of non-recurring costs indicates that traditional costs for existing customers are sunk costs that have already been incurred and thus, will not be avoided. Any costs avoided due to reseller initiated new customer orders would be offset by Qwest incremental costs for systems modifications to provide for reseller identification. [1]

Account 6623.3/.4 - Customer Services (Independent Company Billing and Collection)
These sub-accounts contain amounts paid to exchange carriers for billing and collection services rendered by them, and charged to Qwest, for intraLATA Toll and interLATA access services. These costs will not be avoided due to resale.

Corporate Operations Costs

Other Executive, Planning, General and Administration. - Account 6700 series

There are two major accounts in this series. Both contain additional sub-accounts, and all contain costs that are indirect and overhead in nature. The two major accounts include Account 6710 - Executive and Planning Expense and Account 6720 - General and Administrative. The costs recorded in these accounts, except for Account 6724, which contains costs associated with Information Management and Computer Programming, are indirect costs. For retail services, these costs are conservatively considered avoided in proportion to the ratio of Direct Avoided Costs/Total Direct Costs.

Account 6724 - Information Management
This account includes work and costs associated with planning, developing, testing, implementing, and maintaining application systems and databases for general-purpose computers that support both regulated and non-regulated operations. It also records costs associated with direct or indirect supervision, support, administration, training, or office services for all Account 6724 functions. These accounts also contain unique costs associated with the development or maintenance of Telecommunications Act / reseller related Operational Support Systems (OSS) and other wholesale/interconnection required development, systems and modification costs. Costs incurred for the development of new systems and/or modification of existing systems to properly identify and track wholesale/interconnection

[1] Non-recurring charges paid by a reseller for a transfer of an existing Qwest customer are covered via a CTC (Customer Transfer Charge). There are no avoided costs when a new customer account is established manually. For any new accounts established by a reseller via electronic interface processing, a separate and unique non-recurring charge may be appropriate, however any avoided cost savings associated with electronic processing would need to be offset with the incremental costs for OSS systems development and any requested manual intervention costs. Contamination of recurring rate discounts with non-recurring charge costs would be inappropriate and would serve only to erroneously inflate recurring rate avoided costs and resale discounts applicable to repeated monthly recurring rate billing.

requirements are not avoided costs. These, in fact, occur because of wholesale activities. OSS developmental activities are required to permit resellers access to Qwest data/systems employed by the Company in its telecommunications services business. As such, OSS wholesale activity costs are afforded the same treatment as non-recurring business office revenues and costs. That is, they are excluded from the avoided cost study and the derivation of recurring rate resale discounts. A separate study of Account 6724 Computer Programming and Information management costs is employed to determine the proportion of costs that are avoided.

Other State and Local Taxes - Account 7240

This account contains charges for all taxes, other than Federal, State and Local income taxes and payroll related taxes. Included are property, gross receipts, franchise and capital stock taxes. Costs for retail services included in this account are treated as indirect costs and conservatively treated as avoided in proportion to a ratio to the ratio of Direct Avoided Costs/Total Direct Costs.

Other Operating Income and Expense - Account 7100

Other Operating Income and Expense accounts are intended to record the results of transactions, events or circumstances during periods that are incidental or peripheral to the major or central operations of the Company. They include all items of an incidental operating nature where work is performed for others and it is not provided for elsewhere. At the FCC's directive, they also include employee related benefit costs associated with recording Other Post-Employment Benefit Costs (OPEBs). This account is conservatively treated as an indirect cost of operations and avoided in proportion to a ratio to the ratio of Direct Avoided Costs/Total Direct Costs.

Miscellaneous Rent Compensation Net - Accounts 5240 - 5263

Total Miscellaneous Rent Compensation – Net amounts are considered to be indirect in nature and are conservatively treated as avoided costs in proportion to a ratio to the ratio of Direct Avoided Costs/Total Direct Costs. Account 5240.7/.8 reflect miscellaneous net revenue/expense charged from one state to another state for inventories and for costs incident to providing regulated services and investment for the benefit of the other jurisdictions. A net charge or credit results from the compensation received for expenses recorded in a state offset by the rental payments made to another jurisdiction for costs recorded in those jurisdictions. Such costs include investment, depreciation, taxes, house services and cost of capital. Other Miscellaneous Rent Compensation accounts include incidental amounts derived from the rental, or sub-rental, of telecommunications plant furnished apart from telecommunications operations (e.g. land and building space, outside plant or central office space, space provided in conduits, pole line space for attachments, etc.) This incidental compensation is utilized (that is netted, or offset, against total expenses) to recognize that associated costs have separate recovery mechanisms outside of resale.

Capital Costs

Capital Costs include the Company's capital funding, cost of money, related costs which are associated with network and general support related equipment, facilities and capitalized labor costs utilized in the provision of telecommunications services. Capital Costs are split between direct and indirect costs. Network facility related costs are direct costs that will not change for retail services sold to resellers. Some non-plant equipment and facilities are conservatively treated as indirect costs that can be associated with retailing efforts. These indirect costs are considered partially avoided either through the use of the Direct Avoided Cost / Total Direct Cost percentage or, for computer related investments, via a percentage developed from a separate study of computer related costs.

VI. DESCRIPTION OF STUDY SCHEDULES

The Qwest Embedded Avoided Cost Study is produced on an EXCEL file, using several workbooks. The primary data source for the study is a mechanized download of product financial information from Qwest's CAAS/CARS cost accounting process.

Schedules 2 through 2.5 depict USOA financial statement detail for Qwest's total operating expenses and its operating capital costs. These Schedules depict the following operating statement components:

- Total Intrastate and Retail Intrastate Service Revenue;
- Total Intrastate and Retail Intrastate Service Operating Expenses (By USOA Account);
- Total Intrastate and Retail Intrastate Service Operating Capital Costs;
- Retail Service Operating Expenses and Operating Capital Costs, split between direct, direct avoided, indirect and indirect avoided costs;
- Accumulation of Avoided Costs;
- Calculation of the Resale Discount percentage.

These schedules depict the calculations for the five basic product category and the aggregate Packaged / Special services category discounts. Schedules 3.1 through 3.8 provide supporting calculations and additional detail for Schedules 2 through 2.5. The Schedules include:

Schedule 3.1: Provides the individual financial statement detail for each of the Non-retail (non-resale) and excluded products / services or costs. Under the general guidelines of the Federal Act, these services / costs are subtracted from the "Total

Intrastate" results to arrive at the "Retail Intrastate" results that are used in the avoided cost discount percentage calculations.

Schedule 3.2: Provides a detailed "Retail" services revenue summary excluding non-recurring revenues.

Schedule 3.3: Provides detail for the calculation of embedded avoided uncollectible revenue expense percentages by product category, using the Intrastate Access Uncollectible expense level as a surrogate.

Schedule 3.4: Provides the detail for the calculation of embedded avoided costs associated with Account 6124, General Purpose Computer Expense, Account 6724, Information Management Expense, and Account 6560, Deprecation Expense – General Purpose (GP) Computers. Schedule 3.4.1 provides additional detail associated with the isolation and exclusion of wholesale-related Operating Support Systems (OSS) costs.

Schedule 3.5: Provides the detail data employed to identify the CARS Power and Testing Expense split for Accounts 6531 and Account 6533.

Schedule 3.6: Provides the avoided cost percentage detail of each of the components of Customer Operations expense by product. Schedule 3.6.1 provides additional detail underlying the development of the Customer Operations avoided cost percentages. The Access service Product Management surrogate avoided cost percentages are developed and compared to actual product category Product Management costs. Where incurred actual costs exceed the Carrier Access service level of Product Management costs, the avoided percentage is conservatively set at zero rather than show incremental cost increases due to resale.

Schedule 3.7: Provides the calculation of Depreciation Expense split between Direct and Indirect Costs. It also identifies the amount of computer related depreciation, which is treated separately in the Study.

Schedule 3.8: Provides detail data employed to split Capital Costs (Return on Investment and Tax Gross-up) between direct and indirect costs and to identify the amount of computer related costs, which are treated separately in the Study.

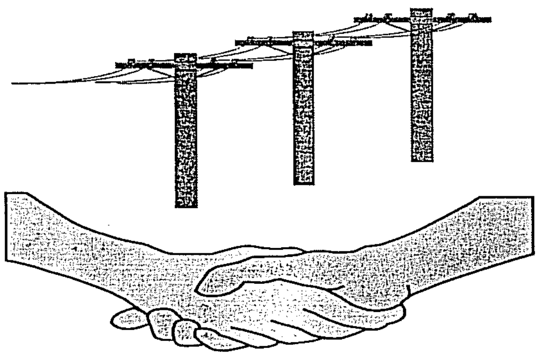
Additional documentation containing the CAAS/CARS download data and manual inputs; the studies supporting the avoided cost percentages used for the Qwest Billing and Collections expenses, Qwest Computer related costs, and the CAAS/CARS - ARMIS reconciliation study are also available as supplemental supporting workpapers.

VII. STUDY RESULTS - SUMMARY

The results of the Qwest Embedded Avoided Cost Study are as follows:

Category	Service Description	Discount
Basic 1	Basic Exchange Business	7.63%
Basic 2	Toll	6.65%
Basic 3	Listings, CO Features, and Informational Services	39.93%
Basic 4	Basic Exchange Residence	4.62%
Basic 5	Private Line	5.26%
Composite	Packaged / Special Services	8.88%

QWEST
EMBEDDED AVOIDED COST STUDY
ADDENDUM



QWEST

VOLUME / TERM CONTRACT SERVICES

OPERATOR SERVICES / DIRECTORY ASSISTANCE

AND

PUBLIC ACCESS LINES

VOLUME/TERM CONTRACT SERVICE AVOIDED COSTS

Qwest policy and legal issues regarding whether existing contracts are assumable or transferable to resellers are not addressed herein. This addendum to the Qwest Embedded Avoided Cost Study is provided only for the purposes of addressing unique avoided cost and resale discount calculation issues relating to Qwest's existing and already-discounted contract services.

Volume/Term contracts, as defined for purposes of this study, can involve Individual Case Basis (ICB) pricing agreements where Qwest has custom designed, bid and secured the provision of telecommunications services via a separate large volume pricing arrangement/contract. Or, they can involve situations where Qwest has already established customer agreements based upon special reduced-tariff pricing in exchange for "extended term" contractual obligations.

Contract services constitute a relatively small portion of Qwest's total telecommunications operations. As such, their inclusion in the large universe of basic service and composite discount calculations has little effect. Although contract services comprise only a small portion of Qwest operations, individually each contract can be fairly substantial. Therefore, a separate avoided cost analysis is warranted in order to avoid distorting any calculations regarding any discount applicable to contract service prices (rates), which already reflect up-front sales costs and anticipated reductions in retailing costs and price discounts from full-retail rates. Any discount calculations and/or discount for established Qwest contracts should reflect only the total contract costs, and any avoided retailing costs, remaining and inherent in the reduced contract pricing.

If transfers of existing contracts should occur, many costs considered avoided in the "full-retail price" study should not be considered avoided for contract services due to the up-front nature of many contract service expenditures or due to the cost savings already reflected in the discount price. Absent appropriate consideration of such costs and cost savings, resellers will be encouraged to simply rely on Qwest to perform the required up-front work in establishing, designing and pricing contract services. Additionally, the application of a full-price discount would duplicate reduced retail costs already reflected in the discount price. Both of these circumstances are unwarranted under the resale provisions of the Act. The discussion that follows addresses and re-evaluates certain of the "full-price" retail service retailing avoided costs described in the Qwest Embedded Avoided Cost Study narrative, indicating where expected retailing cost reductions lend themselves to unique/reduced packaged service discount consideration. The individual and cumulative effects of the issues discussed are shown below.

Billing & Collection (B&C) Costs

Qwest incurred B&C costs generally consist of customer bill rendering, collections, and billing inquiries. As noted in the "full price" study documentation, Qwest will certainly incur B&C costs in billing resellers rather than end-users. Therefore, if contract services are to be resold, a separate analysis Qwest of billing costs is required, since B&C costs may not be avoided. In instances where B&C cost savings have already been passed on in the contract price itself, the savings should not be duplicated in the discount applied to the contract price. For example, for large volume contract customers, Qwest already sends out only one bill and Qwest receives only one payment from these customers that have multiple lines and services. Additionally, billing inquiries for large volume customers are generally handled by Qwest's Account Executives who charge their expenses to Account 6612 – Sales. Therefore, any retail customer inquiry costs considered as avoided B&C costs in Account 6623 - Customer Services in the "full-service" discount calculation should not be attributed to large volume contract sales. Properly adjusting the "full-price" B&C avoided cost percentage to zero percent avoided for these costs lowers the composite discount calculation for large volume contracts by approximately 391 basis points. For extended term contracts billing consolidation savings are less likely to be found in the reduced-price rates and the business office, rather than Account Executives, would handle customer B&C inquiries. Therefore, the adjustment described above for large volume contracts would not be required and the B&C costs considered to be avoided in the "full-price" resale discount composite would continue to be considered avoided costs.

Marketing Costs

Qwest "Marketing" costs consist of Product Management, Sales and Advertising costs. Cost avoidance treatment of Qwest's traditional "full-price retail service" marketing costs already considered in discounted contract pricing should not be duplicated in the avoided cost quantifications relating to any applicable contract service discounts.

- **Product Management Costs**
  Product Management costs are a major component of Qwest's marketing expense. Product Management costs recorded in Account 6611 include costs incurred in performing administrative activities related to the marketing of products and services. A variety of activities are included, such as: product and service identification and specification, pricing, rate and tariff development, cost study work performed in support of specific regulatory dockets, identifying and analyzing costs for regulatory filings, and numerous others. When a customer executes a contract with Qwest these costs are typically expended up-front. If a customer subsequently terminates its account before expiration to take service from a reseller, these costs are not avoided. Once contracts are in place, the ongoing costs for these functions may be reduced or eliminated. Contract price reductions accommodate the anticipated lower cost. Since contract pricing has already accommodated reduced product management costs, there would be very little, or no, additional savings associated with these types of costs to pass on to resellers should resale of Qwest existing contract services occur. Therefore, these cost reductions should not be duplicated in determining contract service discounts. Properly adjusting the "full-price" product management avoided cost percentage to zero percent-avoided lowers the composite discount calculation by

approximately 126 basis points.

- Sales Costs
  Sales costs are another component of Marketing expenses. Sales costs include Third Party Sales Commissions, Custom Systems Design, Account Sales / Servicing, and Telemarketing. A review of these costs indicates that a significant portion of such costs is not applicable to ICB contract services. Therefore, they should not be employed in contract discount rate calculations. Furthermore, many contract Sales costs are incurred "up-front" and Qwest would not avoid them if a reseller assumed an existing contract "mid-stream".

Third Party Sales Commissions comprise approximately 8% of resale services Sales (Account 6612) costs. Third Party Distribution Channel expenses recorded in Account 6612.2 are agent sales commission fees. They constitute costs that are paid up-front to secure term contracts, however, they are not typically incurred in an ICB contract situation. For resale purposes these costs are considered to be 100% avoided. However, if a customer executes a contract with Qwest and then subsequently terminates its account before expiration to take service from a reseller, these costs are not avoided costs, since under these circumstances, the costs will have already been incurred to secure the contract. Properly adjusting the "full-price" sales avoided cost percentage to zero percent-avoided lowers the composite discount calculation by approximately 18 basis points.

Custom Design Work comprises about 4% of resale services Sales costs. These costs are typically incurred when the contracts are initiated; existing customer transfers will not result in these costs being avoided. Costs recorded in Account 6612.3 reflect unique systems design and custom work performed by the Company's Sales and Network representatives on behalf of customers. These costs may be considered to be 100% avoided for resale services, but they are incurred up-front and are not avoided when a customer executes a contract with Qwest and then terminates its account before expiration to take service from a reseller. Properly adjusting the "full-price" sales avoided cost percentage to zero percent-avoided lowers the composite discount calculation by approximately 10 basis points.

Account Sales and Account Servicing Costs recorded in Account 6612.4 make up the largest portion, approximately 47%, of resale services Sales costs. Qwest's Account Sales efforts to obtain the contract obviously are contract initiation costs that would not be avoided if existing customer contracts were moved to a reseller. If a large volume contract customer executes a contract with Qwest, and then terminates its account before expiration to take service from a reseller, Qwest's "retail" contract initiation sales costs are expended up-front. As sunk costs, they are not avoided costs. Therefore, Account Sales efforts involved in ICB contract initiation must not be considered in arriving at a discount to be applied to existing customer contracts that move to a reseller. Properly adjusting the "full-price" avoided cost percentage applied to the Account 6612.4 portion of Sales costs, to reflect an Account Sales avoided percentage of zero % avoided, lowers the composite discount applicable to large volume contracts by approximately 96 basis points. The Account Servicing portion of Account 6612.4 costs would continue to be recognized as avoided costs if existing contracts are transferred, since customer initiated inquiry and activity for large volume contracts should be handled by resellers themselves.

For tariffed extended term contracts, the vast majority of the Account Sales and Account Servicing functions are preformed by Qwest prior to, or at the inception of the contract. Therefore these costs are not avoided costs for term contract services. Since these costs were considered to be avoided costs in the "full-price" resale discount, they must be adjusted out of the calculation of the discount applied to term contract services. Properly adjusting for these functions reduces the composite discount applied to term contract services by 192 basis points.

Telemarketing Costs recorded in Account 6612.1 comprise approximately 41% of resale services Sales costs. Telemarketing costs include work and costs associated with negotiating product sales with customers, recommending and interpreting communications solutions to a customer's business problems, providing customer support consulting, initiating telephone contacts with customers as part of planned sales campaigns, analyzing the customer's primary business issues and assessing the respondent's sales potential. Such work may be performed by the Company's in-house telemarketing agents or by outside contracted service agents. These costs are not typically associated with ICB contracts and for extended term contracts, where these costs may appear to be 100% avoided for resale services, they are sunk costs. That is, they are incurred up-front when "contract" services are initiated. Thus, these costs are not avoided if a customer executes a contract with Qwest and then terminates its account before expiration to take service from a reseller. Properly adjusting the "full-price" sales avoided cost percentage to zero percent-avoided lowers the composite discount calculation by approximately 96 basis points.

- **Product Advertising**
  Product advertising is typically directed to the individual end-user marketplace, not the "contract" segment of Qwest operations. Therefore, advertising costs should not be used in reduced-price contract service discount calculations. If extended term contracts are assumed by resellers, any advertising expended to obtain the customer would be an up-front cost that would not be avoided. Properly adjusting the "full-price" advertising avoided cost percentage to zero percent-avoided lowers the composite discount calculation by approximately 55 basis points.

In summary, the Qwest Avoided Cost Study composite discount calculation, adjusted for the above listed avoided cost issues, results in a reduced composite discount of 1.0% for large volume contracts and 3.9% for extended term contracts.

Note: Account 6623.123 – Customer Service/Service Order reflects business office costs incurred for setting up a customer's service and account. Account 6623.123 costs are costs that are incurred up-front and thus, they are costs that cannot be avoided for existing contract customers who switch to a reseller once their service has been initiated. If Account 6623 costs are not already properly removed from the composite resale discount calculation, identification and exclusion of Account 6623.123 - Customer Service/Service Order costs, which are not avoided costs in reseller contract-takeover situation, is required in arriving at any resale discount applicable to contract services.

OPERATOR SERVICES / DIRECTORY ASSISTANCE AVOIDED COSTS

General

In dealing with Operator Services / Directory Assistance (OS/DA) services, it is important to understand that OS/DA expenses are not included in the cost of basic local exchange service. Instead, OS/DA services have their own rate lists and/or result in separate charges. CLECs and other commissions have recognized, that costs associated with operator service and directory assistance are not part of Qwest's recurring basic service retail rates; therefore, they should not be included in calculating discounts to apply to retail basic service rates. It is equally important to note that many CLECs and resellers have demonstrated or indicated that they will self-provision or buy Operator Services / Directory Assistance (OS/DA) services through other competing ILECs or other providers. Both issues present unique resale discount calculation concerns, requiring that OS/DA cost be isolated and separately analyzed.

Service Not Purchased

A separate analysis of avoided costs is required if Qwest OS/DA service is not purchased from Qwest by resellers since any retailing-related costs associated with OS/DA service should not be included and allowed to contaminate the resale discount calculations for Qwest's other services. In properly calculating resale discounts for other services, the costs for OS/DA service should not be considered. Instead, the costs should be eliminated entirely from the recurring rate resale discount analysis. Otherwise, the discounts for retail services will be contaminated and erroneously inflated, creating a double-dip in revenue loss (i.e., Qwest would receive no OS/DA revenue from the customer and receive lower resale revenues via the application of an inflated discount related to the erroneous inclusion of OS/DA costs in the avoided cost calculation).

Service Purchased

If Qwest OS/DA service is to be purchased from Qwest, and Qwest's existing wholesale carrier rates are not employed, then a separate and unique avoided cost analysis and resale discount would be required in order to recognize, that when the service is provided, Qwest will not avoid its direct operator costs of providing OS/DA.

Discount Determination

Retail Services – Basic Study

As discussed earlier in the Executive Summary Narrative Description - Avoided Resale Costs at pages 8 and 14-15, Customer Services costs recorded in Accounts 6621 and 6622, include operator service and directory assistance related costs. These costs must either be totally eliminated from the basic study or if included, they must be treated as "not avoided" in order to avoid contaminating recurring retail discount calculations with costs that are not inherent in retail recurring rates. In addition, costs associated with basic operator intercept and customer name and address data base maintenance are functions that will not be avoided in provisioning resale services.

<u>Operator Services/Directory Assistance Avoided Cost Study</u>
Developing an avoided cost resale discount for OS/DA that could be used in lieu of Qwest's existing OS/DA wholesale tariff rate is accomplished by separately analyzing the OS/DA costs excluded in the basic study employed for determining the recurring rate resale discounts for other services. The avoided cost analysis is performed by employing the same analysis of accounts and costs as described in the Narrative Description of Avoided Resale Costs. The same avoided cost study process and procedures are employed, with the exception of the starting point. In the "base" avoided cost study and in the subsequent determination of resale discounts for retail telecommunications services, total "intrastate retail service" costs are used. For determining an OS/DA avoided cost discount, only OS/DA product-related costs are analyzed. The starting point data is obtained from the Company's CAAS/CARS Cost Accounting system results, and it corresponds to the cost data "excluded" in the determination of other resale discounts. The avoided cost study procedures and the percentage factors and direct/indirect percentage avoided cost factor elements, are the same as those used in determining the overall, Packages/Special Service "composite" discount.

These avoided cost resale discount study procedures produce a resale discount of 8.21% for OS/DA.

PUBLIC ACCESS LINE SERVICE AVOIDED COSTS

General

Public Access Line (PAL) service is not an end user service; rather PAL is a service sold primarily to intermediate providers such as Independent Payphone Providers (IPPs) and Qwest's own deregulated FCC PART 64 payphone service. The FCC has stated that IPPs are not to be considered telecommunications carriers, and thus the resale provisions of the Act do not apply to their wholesale purchases from Qwest. Due to the unique nature of this service, a separate avoided cost study is performed for PAL service to determine whether there are any avoided "retailing" costs if Qwest's PAL service is sold to a CLEC rather than to an IPP.

Public Access Line (PAL) Avoided Cost Study

An evaluation of avoided costs and the development an avoided cost resale discount for PAL service sold to CLECs is accomplished by separately analyzing the PAL service costs that were "excluded" from the basic avoided cost study employed in determining the recurring rate resale discounts for retail telecommunications services.

In the "base" avoided cost study employed in the determination of resale discounts for retail telecommunications services, the starting point for cost analysis was *total "intrastate retail service"* costs. In a PAL avoided cost study, only PAL product-related costs are analyzed. The source for PAL avoided cost study data is the Company's CAAS/CARS Cost Accounting system results; the same cost amounts "excluded" for PAL service in the determination of other resale discounts in the basic avoided cost study. With the exception of the starting point, determination of a PAL service discount involves an analysis of same accounts and types of costs described earlier in the Narrative Description of Avoided Resale Costs. The PAL study employs the same general avoided cost study processes and procedures described for determining resale discounts for other services.

The assessment of PAL-related marketing, billing, collection, and other costs indicates that the cost of providing service to CLECs is no different than the cost to provide service to Independent Payphone Providers (IPPs). Since there are no avoided retail-related direct costs, the percent of costs avoided in each cost category (both direct and indirect) is zero. Thus, the avoided cost resale discount study produces a resale discount of 0% for PAL service.

Qwest Corporation
SD Docket TC01-098
Exhibit to Testimony of
D. M. (Marti) Gude
Exhibit DMG-2
CONFIDENTIAL

MARKETING - PRODUCT MANAGEMENT

DEFINITION: PRODUCT MANAGEMENT - ACCOUNT 6611

Work and costs associated with planning, developing, forecasting and tracking revenues/objectives for new or existing products and services; planning delivery systems; managing financing; presenting customer education/seminar services; managing and implementing information systems in support of Marketing management systems; maintaining relations with outside firms; and providing new or revised tariffs for exchange, interstate, customer premises and intrastate interexchange services.

By definition alone, it is clear that certain of these costs will not be avoided due to resale, since they relate to services not subject to resale discount (i.e. Interstate Services Development (Special Access)). The Qwest avoided cost study acknowledges that certain of its Product Management functions will be avoided due to resale. However, many of Qwest's "Marketing - Product Management" functions will continue to be performed and costs will be incurred by Qwest in order to interface with, and provide resale and unbundled services to resellers and/or CLECs. As Qwest loses its "retail end-user customers" and associated "Marketing - Product Management" costs, it will pick up numerous resellers and/or CLECs, as "customers", continuing to incur "marketing" costs for similar functions. These costs will be a replacement for the end-user retail costs avoided. These additional functions must be recognized and netted against avoided retail functions when determining the avoided cost % for Account 6611 Marketing -Product Management.

End-User Product Management / Wholesale Resale/Unbunded Common Functional Activities and Interfaces

- Negotiating, Preparing, Administrating and Servicing <u>wholesale</u> contracts
- Identifying and Planning to meet the needs of specific <u>wholesale customers</u>
- Developing and Coordinating special communications requirements for <u>resellers/CLECs</u>
- Preparing Forecast Integration for Qwest retail <u>and multiple wholesale customer forecasts</u>
- Interdepartmental Integration of reseller demand requirements
- Managing Product Life cycle integration of Qwest retail <u>and multiple wholesale customers</u>

- Retail / wholesale customer churn analysis
- Resale discount and unbundled rate analysis / revenue analysis
- Identification and establishment of distribution channels
- Analyzing costs and revenues post price change for resale discount and UNE adjustments
- Regulatory documentation associated with resale discounting and unbundled pricing
- Dealing with reseller/CLEC agent inquiries
- Informing and educating resellers/CLECs on new products, changes and withdrawals

Although Qwest may avoid performing these functions for end-user customer retailing purposes, these functions will continue, as the above list illustrates, in order to meet the needs and interfaces required for resellers/CLECs.

Product Management costs currently incurred by Qwest for its wholesale Carrier Access products demonstrate that Product Management costs will also be incurred for interfacing with resellers/CLECs in provisioning wholesale services. Absent the ability to separately identify actual data for wholesale/resale cost increases (i.e. offsets to end-user avoided costs) the Carrier Access product "Product Management" costs are used as a proxy in the Qwest avoided cost study in order to determine the avoided cost % to apply to intrastate retail service costs included in Account 6611.

MARKETING - SALES

DEFINITION: SALES - ACCOUNT 6612

Sales is defined as work and costs associated with selling products and services. This includes determination of individual customer needs, development and presentation of customer proposals, sales order preparation and handling and preparation of sales records.

Certain of these costs will not be avoided due to resale, since they relate to services not subject to resale discount. In addition, costs will be incurred by Qwest in order to interface with and provide services to resellers, as well as to CLEC's purchasing unbundled elements. As Qwest loses "retail end-user customers" and associated "Sales" costs, it will pick up numerous resellers and/or CLECs, as the "replacement customers", continuing to incur "Sales" costs for similar functions. These wholesale related sales costs will be a replacement for the end-user retail costs avoided. Qwest's wholesale-related Sales cost functions must be recognized and netted against end-user avoided retail Sales functions when determining the avoided cost % for Account 6612 Marketing - Sales.

Account 6612 is comprised of several sub-accounts. They include:

Account 6612.1 - Telemarketing
Account 6612.2 - Third Party Distribution Channel
Account 6612.3 - Customer Systems Design
Account 6612.4 - Other Sales and Services

These sub-accounts are employed to record a variety of sales related operational activities/functions. Many of the functions recorded in sub-account 6612.4 are common to wholesale and retail sales efforts. The following listing illustrates functions deemed common to wholesale/retail activities.

End-User SALES / Reseller/CLEC SALES
Common Functional Activities and Interfaces

(In the following functional activities, "Customer" encompasses End-users, Resellers, or CLECs)

- Performing sales contact work for the purpose of selling products and services to selected accounts, market or industry segment. This includes:

- Interfacing with customers
- Investigating customer preferences
- Developing account plans and negotiating contracts with the customer

- Performing servicing and implementation activities for products and services in a particular market or industry segment. This includes:
  - Fielding, investigating and responding to customer inquires and requests
  - Responding to customer demand requests

Although Qwest may avoid performing these functional activities for end-user customer retailing purposes, these functions will instead be performed for resellers or CLECs, and/or perhaps their customers if their customers contact Qwest directly rather than go through their reseller or CLEC. Since sales functions are be required to meet the needs and interfaces required for wholesale, currently identifiable wholesale (resale and unbundled) Sales costs are netted from Total Sales expenses in determining avoided retail Sales costs.

QWEST CORPORATION
ACCOUNTING SEGREGATION MANUAL
SECTION I – OVERVIEW

I. PURPOSE

The purpose of the Qwest Corporation Accounting Segregation Manual is to detail the segregation of revenues, expenses, taxes and investments associated with the various service offerings of Qwest Corporation.

II. OBJECTIVES OF THE COST MANUAL

This manual contains methodologies that describe the assignment of revenues, expenses, taxes, and investments to the various service offerings and which, if applicable, ensure that no cross subsidization exists between the regulated and deregulated entities of the Company. Definable and measurable assignment methodologies between services reflect the use of cost causation and equitable assignment.

Internal controls have been established to verify the accuracy of the data utilized. These controls include balancing input and output to Company books, performing variance analysis, and cross checking to assure complete carry forward of all driver table values.

Existing data sources are utilized to the maximum extent possible in preparation of assignment methodology. This eliminates the expense of duplicating data. The cost versus the benefit of obtaining data that will achieve an acceptable level of accuracy of the output is given high consideration in determining the methodology assignment of the cost pools. When cost pools are consolidated, cost attribution or causation integrity is to be maintained and the result must be insignificant on a total state or product basis.

III. COST ASSIGNMENT PRINCIPLES

A. The manual assigns cost using the following causal or beneficial relationships espoused by the Cost Accounting Standards Board (CASB):

1. Direct identification of costs with final cost objectives is required when the beneficial or causal relationship is clear and exclusive and the amount is readily measurable.

2. Where costs cannot be directly identified with cost objectives, they should be grouped into logical and homogeneous expense pools and completely distributed to final cost objectives in accordance with a hierarchy of preferable allocation techniques.

3. Traceability is the preferred basis for attributing costs to final cost objectives. Costs should be assigned to the cost objective that causes the cost to be

incurred or, alternatively, to the cost objective that was intended to benefit from the resource expended.

B. These CASB principles were incorporated into the manual utilizing the following cost assignment principles:

1. Costs are directly assigned to specific products or services whenever practicable.

2. Costs that cannot be directly assigned to specific products or services are allocated using a cost causal methodology in accordance with the following hierarchy:

a. Wherever practicable, the allocation of cost is based on a logical assignment method, such as a direct measurement of usage by that product or service.

b. Other costs are, to the extent practicable, allocated by employing surrogate measures having an observable or logical correlation with some other function or investment.

c. Some costs, such as the President's salary, have no readily identifiable measure of specific causal or beneficial relationship; they are considered general overheads. These expenses are allocated based on the methodology as described in paragraph IV. D. below.

C. The criteria considered in selecting the appropriate assignment method insures that:

1. The information necessary to apply the assignment methodology is consistently definable over time and measurable in objective terms, i.e., units, usage.

2. The assignment drivers are available in the Company's existing accounting structure. If other information is required, the cost versus the benefit of the method of obtaining the information is weighed against other alternatives.

3. The methodologies treat similar revenues and costs consistently throughout the system.

4. The methodologies are reviewed to determine their susceptibility to creating artificial volatility and variability in result, from period to period.

IV. ASSIGNMENT METHODOLOGY OVERVIEW

The methodology for assigning revenues, expenses, taxes and investment is summarized below:

A. Revenues are reported in the Uniform System of Accounts (USOA) 5000 series. These accounts include recurring, nonrecurring, and usage sensitive revenues generated by the various products / services (i.e. residence, business, public, interexchange carrier, toll, private line, and directory). They also include miscellaneous and uncollectible operating revenues.

Revenues are directly assigned to products based on USOA where possible. For revenue USOA accounts that are applicable to more than one product, an analysis of billed revenues by Uniform Service Order Codes (USOC) in the billing system is conducted. Special studies are conducted to assign packaged revenues if the packaged revenue is applicable to more than one product category. Miscellaneous revenues are assigned to the products based on an appropriate secondary assignment procedure. Uncollectible revenues are assigned to the products based on the related revenues.

B. The USOA Accounting database is used as the primary data source in assigning expenses (Account 6000 series) to products. Expenses are directly assigned to products where practicable; however, where direct assignment to products is not possible, expenses are assigned using a cost causative or equitable assignment methodology. Examples of such methodologies are:

1. Maintenance expenses are assigned to products in one of two ways:

   a. Service order generated maintenance expenses, such as line testing, are assigned to products based on movement or the applicable investment.

   b. Repair and facilities generated expenses are assigned to products on the same basis as the applicable investment.

2. Depreciation expenses are assigned to products on the same basis as the distribution of related investment.

3. Customer Operations and Services are divided into the following categories of expenses:

   a. Service order generation and associated expenses are assigned to products using Time Distribution studies.

   b. Marketing expenses (Product Management, Sales, and Advertising) utilize direct reporting of financial product category identifiers for cost assignment to products.

   c. Operator expenses are directly assigned to Operator Services products based on work units.

   d. Directory Assistance expenses are directly assigned to Directory Assistance.

   e. Revenue Accounting expenses are assigned using studies of end user bills and are finally allocated to the products based on messages or in service quantities.

4. Corporate Operations expenses utilize the Common cost assignment methodology, as described in paragraph IV. D. below.

C. Taxes and Interest Expense (Account 7000 series) are assigned as follows:

1. Income taxes are assigned based on tax causation.

2. Property and Other Taxes are assigned based on Telephone Plant in Service, revenues, or other applicable allocator(s).

3. Interest Expense is assigned based on investment.

D. Some cost pools are not readily assignable to products using a cost causative basis. These expenses are referred to as Common costs and are initially assigned to Common 1 product or Common 2 product. Common 1 is later spread to all products based on all previously assigned expenses. Common 2 is later spread to all products based on total wages and salaries.

E. Gross Investments (Accounts 1220 and 2000 series) are categorized as primary or secondary (support) investment. Primary investments consist of Central Office Equipment and Cable and Wire Facilities (Outside Plant). Secondary investments consist of Land, Building, Vehicles, Furniture and Office Equipment, Station Equipment and Material and Supplies.

1. Central Office investment is first categorized into usage related and subscriber related pools using Jurisdictional Separations data or special studies. The usage related pools are assigned based on various measures of usage. The subscriber related pools are generally assigned to products using a facilities sensitive methodology.

2. Cable and Wire Facilities investment is apportioned using a two-tier process. The first tier, the non-loop portion, is assigned using Jurisdictional Separations data or usage studies. The second tier, loop portion, is assigned using the methodology described in Section III.11. The Private Line portion is identified and assigned using Jurisdictional Separations Part 36 data.

3. Secondary investments are generally assigned using the expense or investment pool that the particular investment supports.

4. Depreciation and Deferred Tax Reserves are assigned secondarily using the investment relationships to products on a sub-account basis for each cost pool.

V. ORGANIZATION OF THE MANUAL

The Accounting Segregation Manual is organized into seven sections, each of which, is described below:

SECTION I

The introductory section includes the purpose and objectives of the cost manual, the cost assignment principles, a synopsis of the assignment methodologies, and a description of how the manual is organized.

SECTION II

This section contains a listing and description of all products and services supported by the manual.

SECTION III

This section contains detailed methodologies for assigning revenues, expenses, taxes, and investment to products and services. It contains the following subsections:

Section III.1	Secondary Investment
Section III.2	Gross Investment - Plant in Service
Section III.3	Depreciation Reserve
Section III.4	Deferred Taxes and Credits
Section III.5	Revenue Accounts
Section III.6	Plant Operations Expenses
Section III.7	Depreciation Expense
Section III.8	Customer Operations and Services
Section III.9	Corporation Operations
Section III.10	Taxes and Income Accounts
Section III.11	NTS Module
Section III.12	Reserved for Future Use

SECTION IV

Special Studies or Assignment Source Methodologies identified in Section III are described in this section.

SECTION V

Reserved for Future Use.

SECTION VI

The methods and adjustments to Qwest's basic cost accounting system required to comply with the rules and other applicable state specific standards are contained in this section. In addition to the methods, special studies required to perform the adjustments are described.

SECTION VII

This section contains a glossary of terms used in all the previous sections.

Qwest Corporation
SD Docket TC01-098
Exhibit to Testimony of
D. M. (Marti) Gude
Exhibit DMG-6
CONFIDENTIAL

Qwest Corporation
SD Docket TC01-098
Exhibit to Testimony of
D. M. (Marti) Gude
Exhibit DMG-7
CONFIDENTIAL

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on this 14th day of October, 2002, the foregoing **Direct Testimony of Marti Gude and public exhibits** were filed and served upon the parties shown below. Nine confidential exhibits (**Exhibits 3, 4, 5, 6, 7, 8, 9, 10 and 13**) were served only on the Commission and those executing the protective agreement:

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