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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of Qwest Communications International, Inc. Consolidated Application for Authority to Provide In-Region, InterLATA Services in Colorado, Idaho, Iowa, Montana, Nebraska, North Dakota, Utah, Washington, and Wyoming	**WC Docket No. 02-314**

Declaration

of

LEE L. SELWYN

on behalf of

AT&T Corp.

October 15, 2002

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DECLARATION OF LEE L. SELWYN

Introduction

Lee L. Selwyn, of lawful age, declares and says as follows:

1. My name is Lee L. Selwyn; I am President of Economics and Technology, Inc. ("ETI"), Two Center Plaza, Suite 400, Boston, Massachusetts 02108. ETI is a research and consulting firm specializing in telecommunications and public utility regulation and public policy. My Statement of Qualifications is annexed hereto as Attachment 1 and is made a part hereof. I have been asked by AT&T to assess Qwest's compliance with the requirements of Section 272(b), the *Accounting Safeguards Order*,[1] and the *Non-Accounting Safeguards*

1. *Accounting Safeguards under the Telecommunications Act of 1996*, CC Docket No. 96-150, *Report and Order*, 11 FCC Rcd 17539 ("*Accounting Safeguards Order*").

Order,[2] and to provide the Commission with an opinion as to the extent to which Qwest is or is not in compliance with these requirements with respect to transactions and other relationships between the Qwest BOC (Qwest Corporation, "QC") and its "new" Section 272 affiliate, Qwest Long Distance Corporation ("QLDC").

2. I have participated in proceedings before the Federal Communications Commission ("FCC" or "Commission") dating back to 1967 and have appeared as an expert witness in hundreds of state proceedings before more than forty state public utility commissions. I have participated in numerous regulatory proceedings involving public utility affiliate relationships and inter-affiliate transactions and transfers. These have included merger proceedings before the California PUC involving Pacific Telesis Group and SBC, and Bell Atlantic and GTE, before the Illinois Commerce Commission involving SBC and Ameritech, before the Connecticut Department of Public Utility Control involving SBC and SNET, and before the Maine PUC involving NYNEX and Bell Atlantic. I also participated in written comments filed with the FCC regarding both the SBC/Ameritech and Bell Atlantic/GTE merger applications. I have participated in a number of Section 271 proceedings, including those in Pennsylvania, New Jersey, California, Minnesota, Delaware, Virginia, Maryland and the District of Columbia. I have participated in the FCC's Section 272 Sunset NPRM, WC Docket No. 02-112. I have also submitted testimony before several state commissions addressing proposals for structural separation of ILEC wholesale and retail operations. I participated in

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2. *Implementation of the Non-Accounting Safeguards of Section 271 and 272 of the Communications Act of 1934, as amended*, CC Docket No. 96-149, *First Report and Order*, rel. December 24, 1996, 11 FCC Rcd 21905 ("*Non-Accounting Safeguards Order*").

proceedings before the California PUC involving Pacific Bell's reorganization of its Information Services (primarily voice mail) business into a separate subsidiary, and the spin-off of Pacific Telesis Group's wireless services business into a separate company. I have participated in a number of matters involving the treatment of transfers of yellow pages publishing from the ILEC to a separate directory publishing affiliate, including a case before the Washington Utilities and Transportation Commission addressing imputation of (then) US WEST yellow pages revenues.

Summary

3. Qwest has attempted to "cure" the various accounting concerns that have been raised with respect to its first Section 272 affiliate, QCC, and the various transactions and interactions between that affiliate and the Qwest BOC entity, QC, by creating and designating an entirely new entity, QLDC, to fulfill the role of the "separate affiliate" that Qwest is required by Section 272 to utilize for its in-region interLATA long distance business. QLDC was created only about three weeks prior to Qwest's September 30, 2002 filing date, and thus has no "history" upon which the Commission can rely in order to evaluate the "past and present behavior of the BOC applicant" so as to provide "the best indicator of whether [the applicant] will carry out the requested authorization in compliance with the requirements of section 272."[3] In fact, of course, QLDC is and must be viewed as the "successor" of QCC

3. *Application of Ameritech Michigan Pursuant to Section 271 of the Communications Act of 1934, As Amended, To Provide In-Region, InterLATA Services In Michigan*, Memorandum Opinion and Order, CC Docket No. 97-137, Rel. August 19, 1997, 12 FCC Rcd 20, 715 ("*SBC Michigan Order*").

(at least for purposes of the Section 272 "compliance" determination) in that it is and will be acquiring many if not most of the tangible and intangible assets and business opportunities that Qwest has previously placed in QCC. As such, QLDC cannot escape QCC's legacy.

4. QCC, and now QLDC, has violated the arm's length requirements of Section 272(b)(5) with its inappropriate use of so-called "Prevailing Company Price" ("PCP") as the basis for inter-affiliate transactions. Moreover, the limited number of QLDC affiliate transactions and practices that Qwest has disclosed thus far confirm that the new entity also violates the nondiscrimination requirement of Section 272(c)(1), the Commission's *Accounting Safeguards Order*, and the *Non-Accounting Safeguards Order*.

5. QLDC and QC also violate the Section 272(b)(3) "separate employees" requirement. Specifically, QLDC is merely a shell company with few employees occupying only a small month-by-month office space within QC's offices, a working situation that is obviously not capable of providing retail long distance services in nine states. QLDC will thus be relying heavily upon QCC, an entity that itself does not have a work force capable (on its own) of supporting the proposed nine-state operation. As a result, both QCC and QLDC will be obtaining the vast majority of their personnel support from the BOC entity, QC, whose employees will be devoting varying amounts of their time, up to and including 100%, to QLDC business. It is difficult to imagine why Congress would have bothered to include in the 1996 *Act* a "separate employees" provision that could so trivially be circumvented by Qwest's business strategy. Moreover, to the extent that QC will be paying its employees for

their work at least a month or more before it receives payment from QLDC for the contracted "services," the effect will be that QC will be providing permanent ongoing financing of QLDC's operations, specifically prohibited by Section 272(b)(4).

6. Finally, by effectively transferring assets, know-how, and business opportunities from QCC to QLDC without specific compensation, Qwest perpetuates whatever improprieties may have characterized previous QC/QCC transactions into the new QLDC entity. QLDC will not be carrying these start-up costs on its books, and will thus be afforded a significant competitive advantage vis-a-vis rivals who are necessarily required to capitalize their enterprises at a level sufficient to support start-up and ramp-up expenditures. Moreover, if QCC had paid QC a price below Fair Market Value for any transferred service and subsequently "gifts" the value obtained from such service to QLDC, the cross-subsidy inherent in the original transaction will simply be carried forward into the "new" Section 272 affiliate. In short, Qwest cannot escape its obligations to demonstrate Section 272 compliance through this transparent "erasure" of prior bad acts.

Background

7. On June 13 and July 12, 2002, Qwest Communications International ("QCI") filed with the FCC consolidated applications for authority to provide in-region interLATA services

in nine states.[4] Those applications were subsequently withdrawn on September 10, 2002, an action arising from possible violations of Section 272 stemming from Qwest accounting irregularities currently under investigation by the Securities and Exchange Commission ("SEC").[5] On September 30, 2002, QCI re-filed a new consolidated Section 271 application for those same nine states,[6] ostensibly addressing the accounting and reporting concerns that had been raised with respect to its original filing.[7] In this re-filed application, Qwest introduced, for the very first time, a wholly new Section 272 interLATA affiliate, Qwest Long Distance Corporation ("QLDC") *in place of* its originally contemplated Section 272 affiliate, Qwest Communications Corporation ("QCC"). Not only had QCC been the designated Section 272 affiliate in the prior June 13 and July 12, 2002 FCC applications, it had also been

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4. *Qwest Communications International Inc. Consolidated Application for Authority to Provide In-Region, InterLATA Services in Colorado, Idaho, Iowa, Nebraska and North Dakota*, CC Docket No. 02-148, *Application*, filed July 12, 2002; *Qwest Communications International Inc. Consolidated Application for Authority to Provide In-Region, InterLATA Services in Montana, Utah, Washington and Wyoming*, CC Docket No. 02-189, *Application*, filed July 12, 2002.

5. Letter from Peter A. Rohrbach, Counsel for Qwest Communications International Inc. to Marlene H. Dortch, Secretary, Federal Communications Commission, WC Dockets No. 02-148 and 02-189, filed September 10, 2002.

6. *In the Matter of Qwest Communications International, Inc. Consolidated Application for Authority to Provide In-Region, InterLATA Services in Colorado, Idaho, Iowa, Montana, Nebraska, North Dakota, Utah, Washington, and Wyoming*, WC Docket No. 02-314, Supplemental Brief of Qwest Communications International Inc. In Support Of Consolidated Application For Authority To Provide In-Region, InterLATA Services In Colorado, Idaho, Iowa, Montana, Nebraska, North Dakota, Utah, Washington, and Wyoming, September 30, 2002 ("*Qwest Consolidated Application Brief*").

7. *Id.*, at 3-5.

the basis for and subject of the consultative proceedings before the state commissions in each of the nine states.[8]

8. Since the filing of Qwest's various state and previous FCC applications, the Company's general approach to addressing the specific requirements of Section 272 has changed substantively in only one respect: Qwest has revised its procedure for and method of

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8. *In the Matter of the Investigation Into US West Communications, Inc.'s Compliance With Section 271 of the Telecommunications Act of 1996*, Docket No. UT-003022 (Workshop 4). *In the Matter of the Application of Qwest Corporation regarding relief under Section 271 of the federal Telecommunications Act of 1996, Wyoming's participation in a multi-state Section 271 process, and approval of its Statement of Generally Available Terms*, Before the Wyoming Public Service Commission, Docket No. 70000-TA-00-599, Groups 5 and 5A; *In the Matter of the Application of Qwest Corporation, fka US West Communications, Inc., for Approval of Compliance with 47 U.S.C. § 271(d)(2)(B)*, Before the Public Service Commission of Utah, Docket No. 00-049-08; US West Communications, Inc. Section 271 Compliance Investigation, Before the North Dakota Public Service Commission, Docket No. Case No. PU-314-97-1937; *Investigation Into Qwest Corporation f/k/a US West Communications, Inc.'s Compliance With § 271(C) Of The Telecommunications Act Of 1996*, Before the Public Utilities Commission of Colorado, Docket No. 97I-198T, Volume VII; *US West Communication Inc n/k/a/ Qwest Corporation*, Before the State of Iowa Department of Commerce Utilities Board, Docket No. INU-00-2, SPU-00-11; *In the Matter of US West Communications, Inc.'s Motion for an Alternative Procedure to Manage its Section 271 Application,* Before the Idaho Public Utilities Commission, Case No. USW-T-00-3; *In the Matter of the Investigation into Qwest Corporation's Compliance with Section 271 of the Telecommunications Acto of 1996*, Before the Public Service Commission of the State of Montana, Utility Division Docket No. D2000.5.70; *In the Matter of US West Communications, Inc., Denver, Colorado, filing its notice of intention to file its Section 271(c) application with the FCC and request for the Commission to verify US West compliance with Section 271(c)*, Before the Nebraska Public Service Commission, Application No. C-1830; *In the Matter of the Application of Qwest Corporation regarding relief under Section 271 of the federal Telecommunications Act of 1996, Wyoming's participation in a multi-state Section 271 process, and approval of its Statement of Generally Available Terms*, Before the Wyoming Public Service Commission, Docket No. 70000-TA-00-599, Groups 5 and 5A

pricing inter-affiliate transactions. Aside from Qwest's new affiliate transaction pricing methodology, the Company continues to unilaterally revise the specific safeguards that Congress had codified into Section 272 of the 1996 Act into superficial and inadequate practices that fail to comply with the Commission's *Non-Accounting Safeguards Order* and its *Accounting Safeguards Order*. Qwest seems to view the separate affiliate provisions of Section 272 as requiring little more than a set of perfunctory facial "compliance" measures that in no way undermine what Qwest apparently views as its "right" to operate the local and long distance businesses as a functionally integrated activity. Indeed, Qwest's position was succinctly articulated in several state proceedings by its witness, Ms. Judith L. Brunsting, herself an employee of QCC at the time of this testimony and since transferred to QLDC, the originally-proffered Section 272 affiliate:

> It is important to note that while Congress anticipated the need for structural separation between a BOC and the Section 272 subsidiary, the *Act* specifically contemplates that a BOC and its Section 272 subsidiary would be affiliates under a single parent company. The very structure utilized by Qwest Communications International Inc. is contemplated by the terms of Section 272 and FCC decisions. *As affiliates, the 272 Affiliate and BOC have unique financial and business obligations and responsibilities to their boards of directors and ultimately to their shareholders, notwithstanding Section 272 requirements.*[9]

On cross-examination with respect to similar testimony in the Minnesota Section 272 Compliance proceeding, Ms. Brunsting underscored the point that the financial decision

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9. This statement appears in several affidavits filed by Ms. Brunsting, including those filed in Minnesota, Washington, and in the Multistate proceeding. See *supra*, fn. 8.

making relative to the BOC and 272 affiliate will be made centrally and on an integrated basis:

> Q. Would one of those unique financial and business responsibilities be ensuring that Qwest's overall — that Qwest's overall aggregate profits were maximized, even if in order to accomplish that result, certain individual affiliate's profit levels might need to be sacrificed?
>
> A. Yes.[10]

Ms. Brunsting and Qwest miss the point: The "financial and business obligations and responsibilities" that the various Qwest entities have to their respective boards of directors, to the parent Qwest Communications International Inc., and ultimately to its shareholders, would *require* profit-maximization and any lawful self-dealing. The purpose of Section 272 is thus specifically to *constrain* and limit what would otherwise be actions taken in the parent company's and its shareholders' own self-interest. Ms. Brunsting's brazen suggestion, as revealed in her "notwithstanding Section 272 requirements" qualification, that the Section 272 requirements established by Congress and by this Commission are *subordinate* to Qwest's "obligations and responsibilities" to its directors and shareholders, sets forth the theme for all of Qwest's "compliance" actions.

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10. *In the Matter of a Commission Investigation into Qwest's Compliance with Section 272 of the Telecommunications Act of 1996's Separate Affiliate Requirement*, Before the Minnesota Public Utilities Commission, Docket No. P-421/CI-01-1372 ("*Minnesota 272 Proceeding*"), Transcript. Volume 1, January 7, 2002, at 193.

9. In its most recent Section 271 application before the FCC, Qwest notes the Commission's determination in the *SBC Michigan Order* that "past and present behavior of the BOC applicant provides 'the best indicator of whether [the applicant] will carry out the requested authorization in compliance with the requirements of section 272.'"[11] Qwest's introduction of an entirely new long distance affiliate without *any* record of past behavior should be viewed with extreme suspicion by the Commission, especially considering Qwest's intention to use this new Section 272 affiliate *solely for the purposes of obtaining Section 271 approval* and not as an ongoing long distance business entity. As noted in Exhibit 13 to the affidavit of Ms. Marie Schwartz, Qwest intends to merge QLDC into Qwest Communication Corporation ("QCC," the first Qwest 272 affiliate) as soon as possible, operating facilities-based in-region interLATA services out of this newly merged affiliate.[12] If its Section 271 application is granted, Qwest will thus be the first RBOC to provide in-region interLATA authority as a facilities-based provider *without* having first subjected that interLATA entity to Commission inspection during the Section 271 approval process. By creating this QLDC shell entity with no "history" whatsoever while placing the *actual* 272 affiliate, QCC, on the sideline *for the present and solely for purposes of prosecuting its Section 271 application*,

11. *Declaration of Judith L. Brunsting*, filed September 30, 2002, ("*Brunsting Declaration*") at para. 6.

12. *Supplemental Declaration of Marie E. Schwartz*, filed September 30, 2002 ("*Schwartz Declaration*"). According to the letter at Exhibit MES-QC-13, "Once Qwest can certify that QCC is compliant with generally accepted accounting principles (GAAP), the two long-distance affiliates will merge together. At that point, Qwest will sell long-distance services, in and out-of-region, through its own network. Until then, QLDC will provide in-region interLATA long distance traffic—by contracting with an un-affiliated interLATA network vendor."

Qwest makes it impossible for the Commission to evaluate the "past and present behavior of the BOC applicant" as "the best indicator of whether [the applicant] will carry out the requested authorization in compliance with the requirements of section 272."

10. The singular purpose of QLDC's creation — purported "compliance" with Section 272 — gives Qwest every incentive to ensure that, from the beginning, QLDC scrupulously complies with the requirements of the *Act* and Commission affiliate transaction rules. Despite this purpose and incentive, and despite Qwest's recent experience with the consequences of improper pricing, accounting, and discriminatory treatment, QLDC continues to bend, break, evade and avoid the requirements of Section 272, in much the same manner as did QCC before it.

Qwest's use of "Prevailing Company Price" to establish rates for all services provided from the Qwest BOC entity, QC, to QLDC violates the "arm's length" affiliate transactions requirement of Section 272(b)(5).

11. Qwest's affiliate transaction contracts govern and record the services provided by QC for its Section 272 affiliate, currently designated as QLDC. Section 272(b)(5) provides that these transactions must be conducted on an arm's length basis, reduced to writing and posted on the internet. Making the agreements and rates publicly available in this manner is supposed to assure that, as required by Section 272(c), competing providers have the opportunity to review all transactions between the BOC and its Section 272 affiliate and "opt-in" to any agreement. QC is required to honor any competing carrier's request for these services on the same terms and conditions as QC offers to QLDC. In addition, these public

postings allow competitors to, on an ongoing basis, review transactions between the BOC and its affiliate in order to ensure that no cross-subsidization occurs. This posting is supposed to include details as to the specific service being provided, the number of employees involved in the provision of the service, the transfer price(s) applicable to the transaction, the method used to determine that(those) price(s), and the frequency with which the service is furnished.[13]

12. Qwest's affiliate transactions are posted on the Qwest website. This website contains the Master Services Agreement ("MSA") and several work orders provided pursuant to the MSA. QC has currently contracted with QLDC to provide twelve (12) services, including joint marketing planning, finance services, and space rental in QC offices.[14] QLDC has not contracted to provide any services to QC.[15] Qwest's website indicates that all services except "Employee Discount for Telecommunications Services" are provided at "Prevailing Company Price." Employee discounts are provided based on tariff rates.

13. The Commission has approved a hierarchy of three methods for pricing affiliate transactions under the "arm's length" requirements of Section 272(b)(5). In general, for services provided between affiliates, if a tariff exists for that service, the BOC (or the

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13. Qwest affiliate transactions are available on the Qwest website at http://www.qwest.com/about/policy/docs/QwestLD/Overview.html.

14. *Id.*

15. *Id.*

affiliate, as the case may be) must charge the other at the tariffed rate. If no tariff exists for the service, but the affiliate provides more than 50% of its total output of the service to third-parties, the purchasing affiliate must be charged the same rate ("Prevailing Company Price" or "PCP") that is being charged to those third parties. If neither tariffed rates nor Prevailing Company Price apply, the regulated affiliate (i.e., the BOC) must charge its unregulated affiliate the higher of Fully Distributed Cost or Fair Market Value for the service. Services provided by the unregulated affiliate to the regulated affiliate are to be charged at the *lower* of Fair Market Value or Fully Distributed Cost.

14. For the specific case of Section 272 affiliates, the Commission altered this hierarchy slightly. 47 CFR 32.27(d) provides:

> In order to qualify for prevailing price calculation ... sales of a particular asset or service to third parties must encompass greater than 50 percent of the total quantity of such product or service sold by an entity. Carriers shall apply this 50 percent threshold on a asset-by-asset and service-by-service basis, rather than on a product line or service line basis. In the case of transactions for assets and services subject to section 272, a BOC may record such transactions at prevailing price regardless of whether the 50 percent threshold has been satisfied.

The source of this difference, the *Accounting Safeguards Order,* allows 272 affiliates to pay such "Prevailing Company Prices" as a *rebuttable presumption.*[16] The Commission has never suggested that this *Order* stretches the exemption from the 50% requirement to embrace situations in which *no sales whatsoever* are being made to unaffiliated third parties, an

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16. *Accounting Safeguards Order*, 11 FCC Rcd 17539, 17601.

interpretation that, in my view, would make no sense — yet all of Qwest's so-called "Prevailing Company Prices" exhibit precisely that attribute.[17]

15. The principle underlying the "Prevailing Company Price" standard must be read in the broader context of the Commission's three-level hierarchy. The goal here is to assure that a BOC does not discriminate in favor of its affiliate or utilize affiliate transactions as a device for effecting a cross-subsidy of the affiliate's competitive and nonregulated services. By requiring that service be priced to the affiliate at parity with sales to unaffiliated third parties, the Commission seeks to minimize the incentive for the BOC to underprice the services that the affiliate purchases, since the same prices would be available to third parties. In that context, "Prevailing Company Prices" serve exactly the same purpose as "tariffed rates" for those BOC services, such as billing and collection, that are not ordinarily provided under tariff. However, the offering of the service to third parties must be *bona fide*. The "50 percent rule" seeks to accomplish this purpose by demonstrating that the BOC is actually engaged in the business providing the service in question and that a substantial quantity of non-affiliate sales are being made.

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17. Based upon the services provided by QC to QLDC at Prevailing Company Price, it is highly unlikely that unaffiliated third parties would purchase such services. The single exception to this would be "space and furniture rental." While it is possible for an unaffiliated firm to lease office space from QC in a QC building, it is unlikely that such a lease would be provided to a third party on a month to month basis, without a demising wall separating the two companies' offices, as appears to be the case with the space provided by QC to QLDC. For the lease conditions, see http://www.qwest.com/about/policy/docs/QwestLD/documents/WO_ol_101002.pdf

16. The *only* substantive difference between non-tariffed services that are offered by a BOC generally and those that are being provided specifically to the Section 272 affiliate arises in the requirement that the latter be *posted on the Internet* and be available for purchase on the same terms and conditions by third parties (with the sole exception of joint marketing). The Commission determined that offering these services constitutes a check on the BOC's pricing policies, since "... the rates and services subject to section 272 must be made generally available to both affiliates and third parties."[18] The practical result of this determination implies that merely *offering* such services to third parties at publicly posted prices is somehow equivalent to the "50 percent rule" in limiting the BOC's ability to cross-subsidize its affiliate and/or discriminate against competitors.

17. While there may be nothing particularly sacrosanct about "50 percent" as a basis for demonstrating the existence of actual market transactions, the utter absence of *any* transactions at the "offered price" raises serious and entirely legitimate concerns as to the *bona fides* of the putatively "offered" service. There are at least two reasons why third parties would not avail themselves of the services being offered by the Qwest BOC to its Section 272 affiliate:

(1) The "offered price" is excessive, in that third parties can purchase equivalent services at lower prices; or

18. *Accounting Safeguards Order*, 11 FCC Rcd 17539, 17601.

(2) The nature of the "service" being provided by the BOC to the Section 272 affiliate is so highly specialized and specific to the affiliate that it would be impractical for third parties to utilize it, at any price.

A BOC subject to price cap regulation suffers no financial penalty by deliberately over-charging or undercharging its affiliate for a service, since all that it will be doing is to shift profits out of the affiliate entity and into the BOC entity, or vice versa. In fact, it appears that Qwest has engaged in both of these practices, as its strategic and competitive interests may dictate.

18. The Qwest BOC would have an incentive to overcharge its affiliate for a particular service primarily for one of two strategic reasons: First, where the BOC maintains market power with respect to the service *and* where the same service is also being purchased by rival firms (e.g., billing and collection), by establishing an excessive inter-affiliate transfer price, Qwest can then apply a correspondingly excessive "parity" price for sales to third parties. Second, where for strategic or competitive reasons Qwest does not want to provide the service to third parties at all (for example, to prevent its rivals from competing with its own retail services), the use of an excessive price will work to discourage such transactions. Congress and the FCC have clearly recognized the potential for one or both of these conditions in establishing specific, *cost-based* pricing requirements for Unbundled Network Elements ("UNEs") provided by incumbent LECs to competitive local carriers.

19. On the other hand, where a particular BOC-provided service will *not* be purchased by or provided to third parties (e.g., joint marketing services that QC provides to its long

distance affiliate), Qwest has an incentive to underprice such services so as to accomplish a cross-subsidization of its competitive long distance business from its monopoly BOC entity and ratepayers. Qwest and other BOCs have argued that price cap regulation removes such incentives, but in fact precisely the opposite is the case. Indeed, some BOCs have been able to achieve high double-digit returns on investment under price cap regulation, and the deliberate underpricing of services furnished to an affiliate will work to attenuate the magnitude of earnings reported for the BOC entity while concurrently affording the affiliate a significant competitive advantage over its non-BOC-affiliated rivals. And, in fact, Qwest has provided no indication, either via Section 272(b)(5) postings on its website or through any other evidence, that QC will be charging QLDC or any other Section 272 long distance affiliate the full — and substantial — "Fair Market Value" of joint marketing services, which afford the affiliate unfettered access to the BOC entity's ubiquitous customer base and a unique "first strike" opportunity to sell long distance services to inbound (new) local service customers that is not available to non-BOC long distance carriers.[19]

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19. Qwest has not yet posted a work order contracting for joint marketing services by QC for QLDC. However, the Commission should be aware that, in the case where a BOC provides joint marketing service to its affiliate at FDC, virtually all marketing costs associated with customer acquisition are avoided by the Section 272 affiliate. Avoiding these costs is the only economic reason why the BOC interLATA affiliates are able to offer pricing plans such as their no-minimum, no-monthly fee offers. The BOC does not need to engage in additional advertising or customer acquisition costs to attract local customers, and once the local customer is acquired, the BOC is allowed to preemptively sell the customer the affiliate's long distance service. By contrast, a competing IXC would be required to incur massive marketing outlays in order to attract customers.

20. While the presence of substantial sales to third parties may not by itself be sufficient to demonstrate a lack of market power on the part of the BOC, the *absence* of such sales certainly raises questions as to the legitimacy of any "Prevailing Company Prices" that are putatively being "offered" by Qwest. The use of "Prevailing Company Price" is not consistent with the arm's length requirement of Section 272(b)(5), where neither tariffed rates nor a *bona fide* market price for non-tariffed services exists. In such cases, the Commission requires that the sales of services by the BOC to the Section 272 affiliate be priced at the higher of Fully Distributed Cost or Fair Market Value. As the Commission noted in the *Accounting Safeguards Order*:

> The mere offering of an asset or service to unaffiliated entities is not sufficient to establish a prevailing price. A substantial quantity of business must be conducted with unaffiliated third parties in order to establish a true prevailing price. Specifically, if the percentage of third-party business is small, there can be no assurance that the price agreed upon by the carrier and its affiliate represents the true market price, thus raising legitimate questions as to whether the parties actually negotiated "on an arm's length basis." In such situations, the use of prevailing prices to value transactions could permit an affiliate to charge inflated prices to its affiliated regulated carrier, possibly leading to higher prices for customers purchasing the regulated services.[20]

Likewise, where Qwest can be certain that competitors will not purchase the services provided by QC to its affiliates, there can be no assurance that the price "offered" to competitors represents the true market value.

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20. *Accounting Safeguards Order*, 11 FCC Rcd. 17539, 17600, footnotes omitted.

21. If Qwest intends to price services at Prevailing Company Price, Qwest must prove that generally offering services such as "National Consumer Markets Joint Marketing Planning" is sufficient to assure that the prices being paid by Qwest affiliates for such service are not being subsidized by BOC ratepayers. In reality, of course, no competitor would purchase joint marketing planning services from Qwest. Since Qwest is allowed to provide discriminatory joint marketing services to its affiliates, no competitor would have any reason to purchase planning services for a service that it will never be able to purchase. Similar concerns exist for most of the services being provided by QC to QLDC that have been priced at PCP. It is unreasonable to expect that a Qwest competitor would purchase "Finance Services," for example, from Qwest, since that would require the competing carrier to give Qwest unfettered access to its books. For services such as payroll, a competing carrier would have to give Qwest the names and addresses, salary levels, and other highly valuable information about each of the competitor's employees. None of these services, involving proprietary, confidential and trade secret information, could realistically be "provided" by Qwest to nonaffiliated third parties. Knowing this, Qwest's nominal "offer" of these services to competing carriers is not sufficient to establish the PCP as a "true market price."

22. Qwest's practice of indiscriminately designating *all* services being provided to its Section 272 affiliate as being charged at "Prevailing Company Price" is itself unusual enough for the Commission to question the "rebuttable presumption" that use of this method is proper. According to affiliate transactions posted on their websites, SBC, Verizon and BellSouth *combined* appear to have priced only a total of ten (10) services using the

Prevailing Company Price method. Each of those services, such as billing or directory assistance, are likely to be provided in significant volume to third parties; it does not appear that *any* of the other RBOCs have interpreted the Commission's 50% exception to be applicable where *no third party sales* actually or can reasonably be expected to take place.[21] Qwest itself purported to use the greater of Fully Distributed Cost/Fair Market Value method for these same services provided by QC to QCC during each of the state Section 272 proceedings. On September 1, 2002, however, Qwest apparently changed its policy, since virtually all services posted since that date and provided by QC to any Section 272 affiliate have designated "Prevailing Company Price" as their pricing method.

23. As part of its supplemental Section 272 filing, Qwest has included reference to non-public documents providing back-up for its affiliate transactions. These records were provided by Qwest to my firm on October 11, 2002. Qwest provided backup pricing studies for each of the services being provided by QC for QLDC. ***

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21. BellSouth prices Directory Assistance at PCP. SBC prices certain proprietary information/confidential information at prevailing company price. Verizon prices certain Centrex services, certain technical service, data exchange and database access, billing, operator assistance, "service express" and certain telephone services, and CARE records at PCP. Affiliate transactions for other BOCs are available at: http://www.sbc.com/public_affairs/regulatory_documents/affiliate_agreements/0,5931,144,00.html; http://bellsouthcorp.com/policy/transactions/; http://www.verizonld.com/regnotices/index/cfm?OrgID=1

22. Documents provided by Qwest supporting the prices used for QC provision of services to QLDC include Fully Distributed Cost studies for each service priced at Qwest's "Prevailing

(continued...)

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24. Qwest's policy also renders meaningless the FCC's Fully Distributed Cost/Fair Market Value affiliate pricing guidelines. ***

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22. (...continued) Company Price." The prices from these FDC studies match the prices on the pricing addendums to each work order. An example of these backup materials is provided in Exhibit 2.

25. ***

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26. QC has previously provided these services to QCC at Fully Distributed Cost by claiming that "customization" of the service renders a Fair Market Value study impossible. However, the Administrative Law Judge in the Minnesota state proceeding found that:

> The fact that some"customization" of accounts payable, payroll, human resources or any other generic corporate operational function may be required does not render such functions incapable of being subject to a fair market value assessment. The activities described by Qwest are generic and frequently "outsourced" (i.e., purchased from a third-party provider).

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23. *Planning for Joint Marketing Service - Long Distance: Estimated Hours for September*, dated October 8, 2002, Qwest Document No. 002645, provided in Exhibit 2.

24. *Id.*

25. 47 CFR 32.27(c)

> Customization is part of the purchase price for that activity and does not impair Qwest's ability to obtain market valuation for these services.[26]

Qwest's current pricing continues to avoid conducting Fair Market Value studies. Qwest now advances Prevailing Company Price as an alternative means of avoiding a Fair Market Value study and of evading this Commission's affiliate transaction rules.

27. Qwest's interpretation of "Fair Market Value" appears confined to the perspective of the selling entity, i.e., the BOC in this case. Qwest argues that a service cannot have a "Fair Market Value" where its nature is so unique that it cannot be "taken to market." This entirely one-sided approach ignores the "Fair Market Value" from the perspective of the *purchasing entity*, i.e., the Section 272 affiliate, specifically, the purchaser's "willingness-to-pay." Suppose that Qwest's costs for a particular service are $1.00 but that the affiliate's cost, were it required to perform the service on its own or acquire it from a nonaffiliated source, would be $5.00. In that situation, the affiliate would be willing to pay close to $5.00 for the service and, in an arm's length transaction, that is precisely how a "Fair Market Value" price would be determined. Qwest and other ILECs certainly have extensive experience with "willingness-to-pay" pricing of tariffed and non-tariffed services, such as premium central office features (e.g., call waiting, caller ID) whose "costs" are at or near zero but whose prices are set a many multiples of that cost, billing and collection service furnished to interexchange carriers, and (going back to the 1970s and 1980s) customer premises inside

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26. *Minnesota 272 Proceeding, Findings of Fact, Conclusions of Law and Recommendations of Administrative Law Judge Luis*, March 14, 2002, ("*Minnesota ALJ Report*") at para. 100.

wire sold in-place to the customer. In all of these cases, "price" was and is based upon the customers' perceived willingness-to-pay and was and continues to be entirely unrelated to Fully Distributed Cost. By selectively relying upon Fully Distributed Cost for services provided to its Section 272 affiliate while applying a non-cost-related willingness-to-pay standard when pricing services to customers and competitors, Qwest discriminates in favor of, and cross-subsidizes, its Section 272 affiliate.

28. ***

*** Qwest's flawed financial records would make it impossible for Qwest to certify that those Fully Distributed Costs are accurate. As explained in the Declaration of Prof. William W. Holder, Fully Distributed Cost is based upon historical, i.e., accounting costs as reflected on Qwest's books. Qwest's inability to certify its historical costs necessarily means that it cannot accurately develop FDC-based prices or apply the "greater of FDC/FMV" pricing standard for non-tariffed, non-PCP inter-affiliate transactions. Since the Commission's affiliate transaction requirements, as normally applied, would require Qwest to compare FDC rates with FMV rates to determine the appropriate transfer price, QLDC would be unable to contract for any services from QC until QC was able to certify its finances.

29. Qwest's PCP designation of FDC prices is an attempt to avoid every aspect of the arm's length requirement of Section 272(b)(5). By this device, Qwest not only avoids performing a Fair Market Value study and charging its affiliate accordingly, Qwest also seeks

to sweep under the rug its inability to develop and to certify legitimate Fully Distributed Costs by portraying those Fully Distributed Costs that it has assembled as "Prevailing Company Prices."

30. In an “arm's length” transaction between non-affiliated entities, the price at which a particular asset or service is sold would be based upon what the *buyer* of that asset or service would be *willing to pay* to acquire it, not what the seller incurs to produce it. That amount, in turn, will be dictated not by the seller's cost, but by what the buyer would have to spend to acquire the item in some alternative manner. In an “arm's length” transaction, the seller would base its price to the buyer not on the seller's cost, but on the buyer's willingness to pay. Acceptance by QC of a payment from QLDC (or QCC) that is anything less than QLDC’s (or QCC’s) “willingness to pay” amounts to nothing short of an outright cross-subsidy flowing from the BOC to the 272 affiliate.

Qwest affiliate contracts and supporting documents show numerous errors in the establishment and application of Qwest’s own affiliate transaction policies.

31. Affiliate transaction contracts posted on the Qwest website and the back-up detail provided by Qwest indicate that numerous procedural and billing errors have occurred in just the first few weeks of QLDC’s existence. Despite the expectation that the Commission and interested parties would be carefully scrutinizing the proffered practices of QC and QLDC, and despite the obvious advantage of no history to overcome, Qwest has still engaged in practices that violate various Section 272 requirements.

32. In the Space and Furniture Work Order, QLDC has contracted with QC for QC to provide space and furniture rental as well as perform certain project management services for events such as personnel moves and building remodeling. The Pricing Addendum prices these services on an hourly basis. Charges related to setting up the offices of QLDC inside the offices of QC in Denver, Colorado were charged on a ***

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33. Qwest is apparently aware that there are un-billed services related to QC's setup of QLDC office space. Notes on the Project Description read, ***

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27. *Project Description: MRW68 - Qwest LD Corp,* Qwest Document No. 002627, provided in Exhibit 2.

28. *Id.*

29. *Brunsting Declaration*, at para. 22.

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34. Qwest's Methods for Affiliate Transactions ("MAT") provided as Exhibit MES-QC-17C outlines the steps taken by the QC Regulatory Accounting Review of these services.[31] ***

*** Although the magnitude of the error is small, the

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30. *Project Description: MRW68 - Qwest LD Corp,* Qwest Document No. 002627, provided in Exhibit 2.

31. *Schwartz Declaration*, at Exhibit MES-QC-17C.

32. *MAT*, at 22.

existence of the error indicates that Qwest's procedures for ensuring compliance with posting rules are ineffective.

35. In several cases, affiliate contracts between QC and QLDC have effective dates prior to the execution dates. Although most of the billing made available by Qwest contains only the aggregate September billing, in at least one instance QC provided services to QLDC prior to the contracts being signed. The Master Services Agreement itself was signed on September 20, 2002, and it indicates an effective date of September 11, 2002. The National Consumer Markets Joint Marketing Planning Work Order, provided pursuant to the MSA, contains the same September 20 approval and September 11 effective dates. Billing for this service, *** [33]*** Since there were only 10 days (including weekends) remaining in September after the September 20 approval date, *** *** during the portion of September following the date at which the contract was signed.

36. Although back-dating contracts may often be a common business practice, the specific requirements of Section 272(b)(5) and Section 272(c)(1) preclude QC from back-dating affiliate contracts. First, the understanding that the contract would be back-dated constitutes a term or condition that is not included in the MSA or any other documentation. Second, it is doubtful that QC would begin to provide services for a nonaffiliated competitor

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33. *Planning for Joint Marketing Service - Long Distance: Estimated Hours for September*, October 8, 2002, Qwest Document No. 002645, provided in Exhibit 2.

prior to signing a contract with that competitor (particularly a mere shell company) and, in fact, there is no indication on Qwest's website that such a procedure would be allowed.

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37. Qwest is not only back-dating contracts, it appears to be back-dating the back-up materials as well. In two cases, Qwest's "Affiliate Pricing Form" ("APF") establishing the service provided, purchasing companies, pricing methodology and valuation contains a

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*** It is unclear if this discrepancy is due to error or indicates that the documents provided were somehow altered from when first completed.

38. ***

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34. *MAT*, at 35.

35. *Affiliate Pricing Form: Tariff Support Services*, Qwest Document No. 0003021, provided in Exhibit 2.

36. *Affiliate Pricing Form: Operations and Marketing*, Qwest Document No. 002798, provided in Exhibit 2.

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QLDC's use of QC employees to support the overwhelming majority of its operations violates the separate employees requirement of Section 272(b)(3).

39. Section 272(b)(3) requires that the Section 272 affiliate "shall have separate officers, directors, and employees from the Bell operating company of which it is an affiliate." Yet Qwest's proffered Section 272 affiliate that is to provide retail in-region interLATA services throughout nine states, QLDC, has no more than *** *** physically located within the offices of QC in Denver. Indeed, based upon the fact that the total cost for the build-out of this postage-stamp size corporate headquarters is only *** ***,[39] it is extremely unlikely that a demising wall has been erected separating QLDC's area from the

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37. *MAT*, at p. 16.

38. *See* Exhibit 3, Letter dated October 10, 2002, from Blair A. Rosenthal of Qwest to Richard S. Wolters of AT&T.

39. *Project Description: MRW68 - Qwest LD Corp*, Qwest Document No. 002627, provided in Exhibit 2.

space occupied by QC employees. On the basis of these facts and from the extent QCC has contracted with QC for QC's services, it is clear that Qwest intends to use QC employees to perform virtually all of the business functions of QLDC,[40] taking the position that the "separate employees" requirement is fully satisfied so long as the QC personnel that are performing services for or on behalf of QLDC are legal "employees" of QC and are carried on QC's payroll. It is difficult to imagine why Congress would have bothered to include in the 1996 *Act* a "separate employees" provision that could so trivially be circumvented by Qwest's extraordinarily narrow legal interpretation.

40. The Qwest BOC has already contracted for BOC employees to perform services for QLDC. These services require some activity by BOC employees on a daily, weekly or monthly basis. These "services" would include, *inter alia*, joint marketing planning, billing inquiry services, payroll, finance and accounting. The *effect* of this arrangement is *full functional integration* of the Qwest BOC and 272 Affiliate entities. If it were Congress' intention to sanction the level of functional integration that Qwest has described in its Affidavits, no purpose would be served by requiring the BOC to "go through the motions" of Section 272(b) at all.

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40. Affiliate transactions between QC and QCC can be found on Qwest's website: http://www.qwest.com/about/policy/docs/qcc/overview.html; The Minnesota ALJ found, "The integration that Qwest contemplates between its Qwest BOC and the 272 Affiliate requires the former to provide an extensive array of services for an on behalf of the latter." *Minnesota ALJ Report*, at para. 69.

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41. It is unrealistic to believe that QLDC can function as a switchless reseller of long distance services throughout the nine-state region covered by Qwest's application with such a tiny staff and office. As many services as possible will be performed by the BOC for its Section 272 affiliate on a contract basis. Qwest BOC and long distance affiliate employees will occupy the same Qwest buildings and in some cases will be located on the same floors, perhaps in adjacent space not even separated by partitions or demising walls. At best, their specific corporate affiliation (insofar as which payroll they are on and *not* insofar as the nature of their work functions vis-a-vis QLDC) will be identified by colored dots on their security badges.[41]

42. In Qwest's view, an employee of one entity may be assigned to perform "services" on behalf of the other entity under an affiliate agreement entered into between the two entities without such employee being considered to have been "shared" by the two entities.[42] This can include BOC employees spending any portion of their time (up to and including 100%) performing services for the Qwest 272 Affiliate. Additionally, employees of Qwest Service Company ("QSC," a parent corporation) may provide services to both the BOC and the 272 affiliate.[43] Although this Commission has previously approved the sharing of services

41. *Brunsting Declaration*, at para. 22.

42. *Id.*

43. *Minnesota 272 Proceeding*, Rebuttal Affidavit of Judith L. Brunsting, December 28, 2001, at para. 22.

between affiliates, it has never before been confronted with the level of integrated operations that the minuscule size of QLDC will necessitate.

43. There also appear to be anomalies between the statements of Qwest witnesses and Qwest's own policy. In her affidavit filed with the FCC on September 30, 2002, Ms. Brunsting states that it is the policy of Qwest that "[i]n order for an employee of the BOC or QLDC to obtain a position with the other company, he or she must apply for the job through a process similar to an external hiring process."[44] However, on the following page, Ms. Brunsting notes that "[f]or example if a QLDC director *is moved to* any position within the BOC, that person will not remain on QLDC's board."[45] Despite claims that an employee must *apply* for a position with the affiliate, Qwest clearly foresees *moving* employees between affiliates. Indeed, it is difficult to imagine that QLDC would have been able to hire ten employees in the space of just a couple of weeks without the benefit of moving employees from other affiliates. Moreover, Ms. Brunsting's statement refers solely to the process of *applying* for a position with a different Qwest affiliate, and is entirely silent on the matter of *recruitment*. For example, QLDC (or QCC) may post information on available positions on the Qwest intranet, on bulletin boards, or via e-mail. By contrast, non-affiliated firms would be required to advertise job openings in newspapers and/or via employment agencies or recruitment firms whose services often involve substantial fees.

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44. *Brunsting Declaration*, at 15.

45. *Id.*, at 16 (emphasis supplied).

44. Similarly, Ms. Schwartz states in her September 30, 2002 affidavit that "...no employees of QLDC have been hired from the BOC, no employees have been transferred between the BOC and QLDC, and company policy prohibits employees from transferring between the two entities."[46] Inasmuch as QLDC was only a few weeks old when Ms. Schwartz's declaration was filed and is not at present providing any revenue services to anybody, these representations are hardly surprising and are most certainly of little interest or relevance. Indeed, it is highly significant, in light of Ms. Schwartz's claim, that Ms. . Brunsting, a former employee of both US West and QCC, has sponsored testimony in this matter *on behalf of QLDC.* Ms. Schwartz makes no statements regarding the transfer of employees from QCC to QLDC (i.e., between the "first" and "second" Section 272 affiliates). Insofar as many employees have already been transferred from the BOC to QCC, it is not surprising that no employees had, in the last three weeks of September 2002, been transferred from the BOC to QLDC. When considering movement of employees, however, also relevant is the number of employees transferred from the BOC to QCC, and then on to QLDC. Qwest has already or is in the process of transferring a large number of BOC employees to QCC. According to a Qwest response to an information request propounded in the Minnesota state 272 proceeding, 110 employees were transferred from the BOC to QCC, while QCC transferred only 39 employees to the BOC.[47] Qwest's policy prohibiting employees from transferring between QC and QLDC has no effect upon the type of "laundering of employees"

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46. *Schwartz Declaration*, at 15.

47. *Minnesota 272 Proceeding*, Qwest response to interrogatory DOC 15039S1.

that is likely to be happening among QC, QCC and QLDC, for example, via another Qwest entity, such as Qwest Services Corporation.

QLDC gains the benefit of QC-provided financing of its operations, in the form of the lag in payment by QLDC for QC-provided services until well after QC incurs the costs, in violation of Section 272(b)(4).

45. The specific functional integration that Qwest contemplates as between its BOC and QLDC entities requires the former to provide an extensive array of services for and on behalf of the latter. QLDC will have few employees of its own, relying upon BOC employees for a wide variety of sales, marketing, human resources, payroll, accounting, finance, real estate, and other support activities. Indeed, QLDC could hardly be said to have even the minimum number of employees it would need to function as a long distance reseller. QLDC avoids hiring these employees by contracting with QC to provide these functions. According to billing records, in the first few week's of QLDC's existence, *** *** BOC employees have provided services to QLDC. QC will be compensated via intercompany transfer payments flowing from QLDC to the BOC entity. The timing of these payments relative to the dates at which the BOC's services are actually furnished is critical to the determination of compliance or non-compliance with Section 272(b)(4). Specifically, if the BOC entity maintains a net account receivable from the Section 272 Affiliate, it is in effect providing capital to finance the affiliate's operations, which will be reflected as an account payable on the 272 Affiliate's balance sheet. In the event of default on the part of the 272 Affiliate, the BOC will be left with a potentially uncollectible receivable, which is the financial equivalent in all material respects of an "arrangement that would permit a creditor

[the BOC in this case], upon default [by QLDC], to have recourse to the assets of the Bell operating company." Indeed, were the BOC effectively forced to write-off QLDC's obligations in the event of default, the accounting effect of such a write-off would be the same as an uncompensated transfer of funds from the BOC entity to the 272 affiliate; while having no net effect on the Qwest consolidated financial statements, the transaction would constitute a "forgiveness of indebtedness" by the BOC to the benefit of the 272 affiliate, and would be recorded as a gain on the 272 affiliate's books.[48]

46. Although Qwest's Section 272 witnesses assure the Commission that the BOC will not guarantee any credit extended to QLDC, neither witness addresses the extent to which the BOC's provisioning of an extensive array and quantity of services to QLDC (for which it will be paid at a later date) will itself have the effect of the BOC providing permanent capital (in the form of an essentially permanent account receivable financing) to QLDC, or what happens in the event of default on the part of QLDC with respect to such receivables. It is difficult to imagine, in any "arm's length" dealings between nonaffiliated firms, whereby one firm would willing provide an extensive array of services to a three-week old entity with zero history and no access to the capital of its existing affiliates. A recent *Wall Street Journal* article indicated that such financing is already occurring. The article quotes Bruce McDowell, a Qwest employee and union official, as stating that "Qwest has been milking the cash cow for keep them in the game... If Qwest didn't have US West, they'd be in bankruptcy." The

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48. It is my understanding that in the event of default on the part of QCC, the Qwest BOC would be placed in the same position as any other unsecured creditor insofar as its ability to "collect" the debt from the 272 affiliate.

article also notes that "[former Qwest Chief Executive Joseph P. Nacchio] dismisses talk of bankruptcy and says he's 'not ashamed' that USWest is propping up Qwest, saying it's part of his 'long term strategy.'"[49]

47. Despite these risks, the Master Services Agreement provides for payment by the Affiliate 30 days after *receipt* by QLDC of the invoice from the BOC, creating in excess of 30 days' of effectively permanent financing of QLDC's purchases of BOC services, i.e., the time between the Affiliate's receipt of the services and the BOC's receipt of compensation. In addition, to the extent that the Qwest BOC must pay its employees for their time spent on behalf of QLDC before receiving payment from QLDC for those services, the Qwest BOC is advancing cash for QLDC's benefit for which it will not be reimbursed until a later date. Put another way, were the individuals performing services for QLDC themselves employed by QLDC, QLDC would be required to pay these people sooner than it is required to reimburse the Qwest BOC for the use of the BOC's employees. Assuming that affiliate services are ongoing in nature (as is indicated by the affiliated agreements), QLDC will have a permanent liability for BOC services that, would likely run into the millions of dollars. For example, for less than two weeks of services, QLDC owes QC more than *** .***[50] If QLDC continues to buy the same amount of services from QC, QLDC will owe QC more than a *** *** each month. The amount of services provided by QC for

49. Deborah Soloman, "Bad Connection: How Qwest's Merger with a Baby Bell Left Both in Trouble," *Wall Street Journal*, April 2, 2002, at A1.

50. *Qwest Corporation September, 2002 Journal Entries: Qwest LD Corp. Accruals*, October 8, 2002, Qwest Document No. 002625, provided in Exhibit 2.

QLDC is likely to increase should QLDC being providing service. QLDC has not yet contracted for Billing and Collections services provided by the BOC, nor has QLDC contracted for actual "joint marketing" services (not just "marketing planning services") both of which the Commission can expect that QLDC will do the moment it receives in-region authority. Billing from QC to QLDC for these and other services QLDC will require to provide in-region service will likely to quickly push billing from QC to QLDC to over a half million dollars a month.

Uncompensated transfers of assets, know-how and business opportunities from Qwest's original to its current Section 272 affiliates, QCC and QLDC, work to perpetuate cross-subsidies inherent in the original QC/QCC transactions.

48. For more than a year, QCC has been purchasing services such as joint marketing planning from QC as it prepares (ultimately) to enter the in-region long distance business. Since QCC is no longer the designated Section 272 affiliate in-region, any BOC services previously purchased by QCC relating to this joint marketing are no longer useful to QCC, but are potentially highly useful and valuable to QLDC. Any product resulting from contracts between QC and QLDC that is subsequently transferred from QCC to QLDC at less than the price that QCC had paid for it enables QLDC to avoid what would otherwise be a start-up expenditure. In this manner, Qwest can launch its in-region long distance venture through an entity whose books have been cleansed of all previously-incurred start-up costs, thereby eliminating the need for QLDC to amortize such start-up outlays or recover them in its retail service prices. Since, by its own admission, Qwest cannot certify the financial integrity of any of the pre-September transactions between QC and QCC, to the extent that such

transactions were discriminatory and/or had the effect of creating a cross-subsidy of QCC's operations from the Qwest BOC entity, those conditions are simply perpetuated into QLDC when the *value* of the prior work is gifted over to QLDC. Accordingly, Qwest cannot escape or avoid whatever taint may have characterized QCC by its recent creation of QLDC so long as any value, in the form of intellectual or other assets, acquired by QCC is transferred to QLDC without a corresponding Fair Market Value payment to QCC or QC.

Conclusion

49. Qwest has not provided this Commission with evidence sufficient for the Commission to conclude that Qwest has satisfied the requirements of Sections 272(a) and (b) of the 1996 *Act*. Instead, Qwest has described an operating arrangement between the BOC and 272 Affiliate entities that amounts to functional integration of their operations that cannot be overcome by nonsubstantive facial "compliance" measures such as nominally "separate" employees that in fact "act" simultaneously as employees of both entities in direct violation of Section 272(b)(3). QC and QLDC are in no sense dealing with each other "at arm's length" as required by Section 272(b)(5), and by virtue of the extensive array and quantity of "services" that QLDC will be "purchasing" from QC, the BOC entity is contributing to the capital financing and extending unsecured credit to QLDC, in violation of Section 272(b)(4).

50. This concludes my Declaration.

Declaration of Lee L. Selwyn
FCC WC Docket No. 02-314
October 15, 2002

VERIFICATION

I declare under penalty of perjury that the foregoing Declaration is true and correct to the best of my knowledge, information and belief.

Executed on October 15, 2002

Lee L. Selwyn

Exhibit 1

Statement of Qualifications

DR. LEE L. SELWYN

Dr. Lee L. Selwyn has been actively involved in the telecommunications field for more than twenty-five years, and is an internationally recognized authority on telecommunications regulation, economics and public policy. Dr. Selwyn founded the firm of Economics and Technology, Inc. in 1972, and has served as its President since that date. He received his Ph.D. degree from the Alfred P. Sloan School of Management at the Massachusetts Institute of Technology. He also holds a Master of Science degree in Industrial Management from MIT and a Bachelor of Arts degree with honors in Economics from Queens College of the City University of New York.

Dr. Selwyn has testified as an expert on rate design, service cost analysis, form of regulation, and other telecommunications policy issues in telecommunications regulatory proceedings before some forty state commissions, the Federal Communications Commission and the Canadian Radio-television and Telecommunications Commission, among others. He has appeared as a witness on behalf of commercial organizations, non-profit institutions, as well as local, state and federal government authorities responsible for telecommunications regulation and consumer advocacy.

He has served or is now serving as a consultant to numerous state utilities commissions including those in Arizona, Minnesota, Kansas, Kentucky, the District of Columbia, Connecticut, California, Delaware, Maine, Massachusetts, New Hampshire, Vermont, New Mexico, Wisconsin and Washington State, the Office of Telecommunications Policy (Executive Office of the President), the National Telecommunications and Information Administration, the Federal Communications Commission, the Canadian Radio-television and Telecommunications Commission, the United Kingdom Office of Telecommunications, and the Secretaria de Comunicaciones y Transportes of the Republic of Mexico. He has also served as an advisor on telecommunications regulatory matters to the International Communications Association and the Ad Hoc Telecommunications Users Committee, as well as to a number of major corporate telecommunications users, information services providers, paging and cellular carriers, and specialized access services carriers.

Dr. Selwyn has presented testimony as an invited witness before the U.S. House of Representatives Subcommittee on Telecommunications, Consumer Protection and Finance and before the U.S. Senate Judiciary Committee, on subjects dealing with restructuring and deregulation of portions of the telecommunications industry.

In 1970, he was awarded a Post-Doctoral Research Grant in Public Utility Economics under a program sponsored by the American Telephone and Telegraph Company, to conduct research on the economic effects of telephone rate structures upon the computer time sharing industry. This work was conducted at Harvard University's Program on Technology and Society, where he was appointed as a Research Associate. Dr. Selwyn was also a member of the faculty at the College of Business Administration at Boston University from 1968 until 1973, where he taught courses in economics, finance and management information systems.

Dr. Selwyn has published numerous papers and articles in professional and trade journals on the subject of telecommunications service regulation, cost methodology, rate design and pricing policy. These have included:

"Taxes, Corporate Financial Policy and Return to Investors"
National Tax Journal, Vol. XX, No.4, December 1967.

"Pricing Telephone Terminal Equipment Under Competition"
Public Utilities Fortnightly, December 8, 1977.

"Deregulation, Competition, and Regulatory Responsibility in the Telecommunications Industry"
Presented at the 1979 Rate Symposium on Problems of Regulated Industries - Sponsored by: The American University, Foster Associates, Inc., Missouri Public Service Commission, University of Missouri-Columbia, Kansas City, MO, February 11 - 14, 1979.

"Sifting Out the Economic Costs of Terminal Equipment Services"
Telephone Engineer and Management, October 15, 1979.

"Usage-Sensitive Pricing" (with G. F. Borton)
(a three part series)
Telephony, January 7, 28, February 11, 1980.

"Perspectives on Usage-Sensitive Pricing"
Public Utilities Fortnightly, May 7, 1981.

"Diversification, Deregulation, and Increased Uncertainty in the Public Utility Industries"
Comments Presented at the Thirteenth Annual Conference of the Institute of Public Utilities, Williamsburg, VA - December 14 - 16, 1981.

"Local Telephone Pricing: Is There a Better Way?; The Costs of LMS Exceed its Benefits: a Report on Recent U.S. Experience."
Proceedings of a conference held at Montreal, Quebec - Sponsored by Canadian Radio-Television and Telecommunications Commission and The Centre for the Study of Regulated Industries, McGill University, May 2 - 4, 1984.

"Long-Run Regulation of AT&T: A Key Element of A Competitive Telecommunications Policy"
Telematics, August 1984.

"Is Equal Access an Adequate Justification for Removing Restrictions on BOC Diversification?"
Presented at the Institute of Public Utilities Eighteenth Annual Conference, Williamsburg, VA - December 8 - 10, 1986.

"Market Power and Competition Under an Equal Access Environment"
Presented at the Sixteenth Annual Conference, "Impact of Deregulation and Market Forces on Public Utilities: The Future Role of Regulation" Institute of Public Utilities, Michigan State University, Williamsburg, VA - December 3 - 5, 1987.

"Contestable Markets: Theory vs. Fact"
Presented at the Conference on Current Issues in Telephone Regulations: Dominance and Cost Allocation in Interexchange Markets - Center for Legal and Regulatory Studies Department of Management Science and Information Systems - Graduate School of Business, University of Texas at Austin, October 5, 1987.

"The Sources and Exercise of Market Power in the Market for Interexchange Telecommunications Services"
Presented at the Nineteenth Annual Conference - "Alternatives to Traditional Regulation: Options for Reform" - Institute of Public Utilities, Michigan State University, Williamsburg, VA, December, 1987.

"Assessing Market Power and Competition in The Telecommunications Industry: Toward an Empirical Foundation for Regulatory Reform"
Federal Communications Law Journal, Vol. 40 Num. 2, April 1988.

"A Perspective on Price Caps as a Substitute for Traditional Revenue Requirements Regulation"
Presented at the Twentieth Annual Conference - "New Regulatory Concepts, Issues and Controversies" - Institute of Public Utilities, Michigan State University, Williamsburg, VA, December, 1988.

"The Sustainability of Competition in Light of New Technologies" (with D. N. Townsend and P. D. Kravtin)
Presented at the Twentieth Annual Conference - Institute of Public Utilities Michigan State University, Williamsburg, VA, December, 1988.

"Adapting Telecom Regulation to Industry Change: Promoting Development Without Compromising Ratepayer Protection" (with S. C. Lundquist) *IEEE Communications Magazine*, January, 1989.

"The Role of Cost Based Pricing of Telecommunications Services in the Age of Technology and Competition"
Presented at National Regulatory Research Institute Conference, Seattle, July 20, 1990.

"A Public Good/Private Good Framework for Identifying POTS Objectives for the Public Switched Network" (with Patricia D. Kravtin and Paul S. Keller) Columbus, Ohio: *National Regulatory Research Institute*, September 1991.

"Telecommunications Regulation and Infrastructure Development: Alternative Models for the Public/Private Partnership"
Prepared for the Economic Symposium of the International Telecommunications Union Europe Telecom '92 Conference, Budapest, Hungary, October 15, 1992.

"Efficient Infrastructure Development and the Local Telephone Company's Role in Competitive Industry Environment" *Presented at the Twenty-Fourth Annual Conference, Institute of Public Utilities, Graduate School of Business, Michigan State University, "Shifting Boundaries between Regulation and Competition in Telecommunications and Energy"*, Williamsburg, VA, December 1992.

"Measurement of Telecommunications Productivity: Methods, Applications and Limitations" (with Françoise M. Clottes)
Presented at Organisation for Economic Cooperation and Development, Working Party on Telecommunication and Information Services Policies, '93 Conference "Defining Performance Indicators for Competitive Telecommunications Markets", Paris, France, February 8-9, 1993.

"Telecommunications Investment and Economic Development: Achieving efficiency and balance among competing public policy and stakeholder interests"
Presented at the 105th Annual Convention and Regulatory Symposium, National Association of Regulatory Utility Commissioners, New York, November 18, 1993.

"The Potential for Competition in the Market for Local Telephone Services" (with David N. Townsend and Paul S. Keller)
Presented at the Organization for Economic Cooperation and Development Workshop on Telecommunication Infrastructure Competition, December 6-7, 1993.

"Market Failure in Open Telecommunications Networks: Defining the new natural monopoly," *Utilities Policy*, Vol. 4, No. 1, January 1994.

The Enduring Local Bottleneck: Monopoly Power and the Local Exchange Carriers, (with Susan M. Gately, et al) a report prepared by ETI and Hatfield Associates, Inc. for AT&T, MCI and CompTel, February 1994.

Commercially Feasible Resale of Local Telecommunications Services: An Essential Step in the Transition to Effective Local Competition, (Susan M. Gately, et al) a report prepared by ETI for AT&T, July 1995.

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Funding Universal Service: Maximizing Penetration and Efficiency in a Competitive Local Service Environment, Lee L. Selwyn with Susan M. Baldwin, under the direction of Donald Shepheard, A Time Warner Communications Policy White Paper, September 1995.

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Where Have All The Numbers Gone?: Long-term Area Code Relief Policies and the Need for Short-term Reform, prepared by Economics and Technology, Inc. for the Ad Hoc Telecommunications Users Committee, International Communications Association, March 1998.

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Dr. Selwyn has been an invited speaker at numerous seminars and conferences on telecommunications regulation and policy, including meetings and workshops sponsored by the National Telecommunications and Information Administration, the National Association of

Regulatory Utility Commissioners, the U.S. General Services Administration, the Institute of Public Utilities at Michigan State University, the National Regulatory Research Institute at Ohio State University, the Harvard University Program on Information Resources Policy, the Columbia University Institute for Tele-Information, the International Communications Association, the Tele-Communications Association, the Western Conference of Public Service Commissioners, at the New England, Mid-America, Southern and Western regional PUC/PSC conferences, as well as at numerous conferences and workshops sponsored by individual regulatory agencies.

Exhibit 2

Proprietary

Billing Records for Services Provided by Qwest Corporation for Qwest Long Distance Corporation

Exhibit 3

Proprietary

Letter Dated October 10, 2002 from Blair A. Rosenthal of Qwest to Richard S. Wolters of AT&T

Tab D

Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of **Qwest Communications International Inc., Consolidated Application For Authority To Provide In-Region, InterLATA Services In The States Of Colorado, Idaho, Iowa, Montana, Nebraska, North Dakota, Utah, Washington and Wyoming**	))))))))))	WC Docket No. 02-314

DECLARATION OF KENNETH L. WILSON

1. My name is Kenneth L. Wilson, and I am a senior Consultant and Technical Witness with Boulder Telecommunications Consultants, LLC. My business address is 970 11th Street, Boulder, Colorado, 80302. I am submitting this affidavit on behalf of AT&T.

2. My education and relevant work experience are as follows. I received a Bachelors of Science in Electrical Engineering from Oklahoma State University in 1972, and I received a Masters of Science in Electrical Engineering from the University of Illinois in 1974. In addition, in 1976, I completed the course work required to obtain my Ph.D. in Electrical Engineering from the University of Illinois. For 15 years before coming to Denver, I worked at Bell Labs in New Jersey in a variety of positions. From 1980 through 1982, I worked as a member of the network architecture and network planning team at Bell Labs for AT&T's long distance service. From 1983 through 1985, I was a member of the first AT&T Bell Labs cellular terminal design team. From 1986 through 1992, I led a Bell Labs group responsible for network

performance planning and assurance for AT&T Business Markets. From 1992 through 1993, I was a team leader on a project to reduce AT&T's capital budget for network infrastructure.

3. From January 1994 through May 1995, I led a team at Bell Labs investigating the various network infrastructure alternatives for entering the local telecommunications market. From 1995 through the spring of 1998, I was the Business Management Director for AT&T in Denver, managing one of the groups responsible for getting AT&T into the local market in Qwest's 14-state territory. I was the lead technical negotiator for AT&T with US WEST (now Qwest), negotiating the terms of interconnection agreements in each of US WEST's 14 states. In addition, I was also the senior technical manager in Denver working on local network and interconnection planning, OSS interface architectures and the technical aspects of product delivery.

4. As noted above, I am currently a consultant and technical witness with Boulder Telecommunications Consultants, LLC. In this capacity, I have worked with several companies, including AT&T, on all aspects of interconnection, unbundled elements, collocation and resale issues, among other things. I was the lead technical witness for AT&T in the section 271 workshops in Qwest's region. In this capacity, I attended a total of 41 multi-day Qwest 271 workshop sessions and several hearings. My credentials are a matter of record in the Commission's prior proceedings regarding Qwest's request for authority under Section 271, including WC Docket No. 02-148.

5. I am qualified to analyze the agreements that Qwest engaged in with various CLECs over the past three years because of my familiarity with the Qwest SGAT and its

development, the process of negotiating interconnection agreements with Qwest and the workshops conducted by the state commissions.

6. The purpose of my testimony is to demonstrate that Qwest has not disclosed all of the secret interconnection agreements that are currently in effect in the nine states for which Qwest is seeking Section 271 approval. Additionally, a variety of these secret agreements included provisions that barred Qwest's secret deal partners from criticizing Qwest's interconnection performance in state and federal Section 271 proceedings. I have previously submitted testimony in this proceeding that supported the claim that Qwest's secret deals contained discriminatory terms, silenced secret deal partners causing a substantial impact on the state proceedings, and substantially skewed the results of the third party tests of Qwest's operations support systems.

7. Qwest has asserted that it is making all of its "unfiled" agreements in the nine states covered by its Application available for review by the Commission and competitive local exchange carriers ("CLECs") by posting those previously filed secret deals on its Internet website. My review of the secret deals that Qwest has posted on its website confirms that Qwest has not yet done so. Qwest's website contains twenty six (26) separate interconnection agreements (Qwest creates the impression that it has posted more than 26 agreements by posting multi-state agreements separately for each state in which those agreements are in effect). By contrast, the current active investigations into Qwest's secret deals (by three separate state commissions in Arizona, Iowa and Minnesota, and by Qwest's admissions in FCC ex parte filings) confirm that at least 105 separate arrangements between Qwest and various CLECs are available for review – some publicly available, but the majority available only through an agreement to review the documents under confidential seal. Based on my review of these

arrangements, I have determined that most of them are interconnection agreements that relate to the states in Qwest's pending nine-state Section 271 application. Thus, Qwest has not come close to disclosing all of the relevant interconnection agreements.

8. In order to assist the Commission in evaluating the claims concerning Qwest's practice of entering secret, discriminatory interconnection agreements, I have prepared a matrix, attached to this declaration, that identifies and catalogues Qwest agreements that are available in different venues. I used documents from the Minnesota proceeding on unfiled agreements, the Iowa proceeding on unfiled agreements, the Colorado proceeding on unfiled agreements, and the Arizona proceeding on unfiled agreements. I also utilized agreements that Qwest filed on its web site. I have limited the matrix to only those agreements that are interconnection agreements and have terms and conditions that have not to my knowledge been made available to other CLECs.

9. The first column in the matrix, "Company", lists the name of the CLEC with which Qwest made the agreement. The second column, "Date", lists the effective date of the agreement. The third column, "Agreement", lists the title of the agreement. The fourth column, "On Qwest Web Site", indicates whether or not the agreement is on the Qwest web site. The fifth column, "Public", indicates whether the agreement has been made available to the public, with notes when AT&T was given permission to use the contract even though it is not generally available to the public. The 6th column, "Expiration Date", lists any expiration that is shown on the agreement. However, subsequent agreements could serve to extend or replace an agreement before it expired. This column also lists situations where, to my knowledge or information, Qwest terminated the agreement by terms that were contained in a second agreement. The seventh column, "Should Have Been Filed", lists who has requested that the contract be filed. In

the Minnesota proceeding, the Department of Commerce and the Administrative Law Judge hearing the case have requested that the contracts be filed. In Arizona, the Arizona Commission Staff has requested that Qwest file many of the contracts (These agreements are marked as "AZ Staff"). There are a number of other contracts where AT&T has filed or will file requests that the contracts should be filed. The eighth column, "Jurisdiction", lists the states where the contract is effective. When the indication in that column is "all" the indication is that the contract is valid in all 14 Qwest states. The final column, "Discriminatory Terms", lists the type of discriminatory terms that are in the contract.

10. To determine whether a contract is an interconnection agreement, I have read the FCC's recent ruling on this issue. To determine whether a contract has discriminatory terms, I have relied on my extensive knowledge of Qwest's positions and policies on the issues as set forth in their SGATs, in testimony by Qwest witnesses in hearings and workshops, and on other information available on the Qwest web site in the form of product catalogues.

11. Qwest has agreed that it would consent to AT&T disclosing to this Commission the agreements that are subject to the state protective orders; AT&T would be required, however, to obtain consent from the other party to the agreement in question, or have some other basis for its disclosure. While AT&T has obtained consent from Eschelon to show the FCC the secret deal arrangements that it entered with Qwest, it has not had such success with certain other CLECs, who have withheld their consent or been beyond AT&T's reach. In order to abide by the protective order that covers a particular contract where a release was not available, I have blanked out information in the following columns: Expiration Date, Jurisdiction, and Discriminatory Terms. The fact that a particular contract exists, along with the date of the

contract and the contract title have been disclosed in the Arizona proceeding and so can be revealed here.

12. I have included only agreements that appear applicable in some or all of the nine states at issue in the Qwest III Application and that contain terms or conditions that I believe were not made available to other CLECs. Interconnection agreements that should have been filed but do not appear to contain discriminatory terms were excluded from the matrix. (Many of the agreements that were excluded from the matrix should have been filed as interconnection agreements). I have provided only information that is publicly available. AT&T expects that the Arizona Corporation Commission "ACC" proceeding will conclude during the 90-day period for considering the Qwest III application, forcing these parties to end their campaign of secrecy. Of course, the FCC has the authority to require the filing of these agreements on a confidential basis at the FCC for its own review if it so chooses.

13. The summary of my review is contained in a matrix of forty seven (47) discriminatory agreements that were at some point part of Qwest's practice of engaging in secret deals. While Qwest has posted sixteen (16) of these agreements on its website, numerous other agreements remain "secret" *to this day*-- either unfiled or otherwise unavailable. Those continuing secret agreements include seventeen (17) interconnection agreements that the ACC Staff has recommended be filed and made public, and fifteen (15) additional agreements that AT&T continues to argue also constitute interconnection agreements in the state proceedings.

14. As indicated above, Qwest has posted to its website 26 unique agreements for the nine states in its filing (of which 16 are in the matrix). The title of the web page is "Provisions Available for Opt In -V6.0 and the URL for the site is:

<http://www.qwest.com/wholesale/clecs/provisionoptin.html>. Qwest has been claiming that it is posting the agreements to its website so that other CLECs can take advantage of the terms that Qwest has provided to other, preferred CLECs in the past. The catch is that in these agreements Qwest is selecting the provisions that the CLEC can opt into. Qwest is only providing "selected" provisions from the 26 agreements:

> Selected provisions are available for all CLECs to review and request as Opt Ins. The selected opt in provisions are marked and bracketed.

Qwest selected the provisions that would be available without discussion with CLECs. Generally, opt in is applicable to an entire contract, not to selections that Qwest makes. In the agreements on the website, Qwest makes the following restrictions:

> A CLEC may request only those services that are being provided to another CLEC under the posted agreement on a going-forward basis. This offer does not apply to provisions of these agreements that have expired, that involved payments made in settlement of past disputes, or that involve matters unrelated to Section 251(b) and (c) of the Telecommunications Act.

Qwest has predetermined, without discussion, negotiation or state ruling, which sections of each contract Qwest thinks meets these restrictions. This is hardly the availability of provisions that I would have expected, especially given the limited number of agreements that Qwest has listed.

15. Moreover, Qwest has disgorged the agreements contained in the attached matrix very slowly and very reluctantly over the past nine months. The only state that is looking at the full complement of agreements is Arizona. Minnesota did an in-depth review of a dozen agreements out of a total of over one hundred and found all of them to be discriminatory on multiple issues. The nine states in the current filing looked at a minimal number of agreements in a very perfunctory manner. Qwest's assurances that they were divulging every relevant

agreement have proven, politely speaking, to be inaccurate. To the extent states believed this message from Qwest, their review of the issues is woefully incomplete.

16. In a previous declaration I spent some time reviewing the discriminatory issues that impacted CLECs and the 271 workshops. My review in that declaration was limited to a mere handful of the 47 agreements contained in the matrix that I present here. Moreover, that review (and the review catalogued in the matrix) does not consider the impact of Qwest's practice of entering secret oral agreements and connecting disparate written agreements through oral understandings that provide, in the aggregate, discriminatory treatment to CLECs. There is no doubt in my mind, having attended over 41 Qwest 271 workshops, that if the content of these agreements had been known, the workshops would have included numerous additional issues and the outcomes could easily have been very different. While we cannot turn back the clock, Qwest can be required to divulge all of the agreements and explain for each agreement why all CLECs should not be able to take advantage of any provision they choose. Only then will Qwest have made a clean break from its entry into numerous secret deals.

17. Although numerous other secret deals are not on the website and currently covered by protective orders, the staff of the Arizona Corporation Commission ("ACC") has determined that 28 of those confidential secret agreements should have been filed in Arizona as interconnection agreements. And I have identified 22 additional agreements that I believe should have been filed in Arizona as interconnection agreements. Filing of these agreements should be required by the ACC Staff as they complete their review process. I also can confirm that many of the agreements available for review in Arizona and other state proceedings are effective in the states for which Qwest currently is seeking Section 271 approval, including Colorado, Idaho, Iowa, Nebraska and North Dakota, Utah and Washington.

I hereby declare under penalty of perjury that the foregoing is true and accurate to the best of my knowledge and belief.

Executed on October 15, 2002

Kenneth L. Wilson

Kenneth L. Wilson