

**BEFORE THE  
ILLINOIS COMMERCE COMMISSION**

ILLINOIS BELL TELEPHONE COMPANY

Filing to Increase Unbundled Loop and  
Nonrecurring Rates

Docket No. 02-0864

**REBUTTAL TESTIMONY**

of

**HARRY GILDEA**

on behalf of

**THE UNITED STATES DEPARTMENT OF DEFENSE AND  
ALL OTHER FEDERAL EXECUTIVE AGENCIES**

**ROBERT N. KITTEL**  
Chief

Regulatory Law Office  
Office of The Judge Advocate General  
U.S. Army Litigation Center  
901 N. Stuart Street, Suite 700  
Arlington, Virginia 22203-1837

by

**PETER Q. NYCE, JR.**  
General Attorney

February 20, 2004

ILLINOIS  
COMMERCE COMMISSION  
2004 FEB 20 A.M. 5.  
CHIEF CLERK'S OFFICE

## Table of Contents

	<u>Page No.</u>
I. Introduction .....	1
II. Capital Structure .....	2
III. Fill Factors .....	4
IV. Avoided Advertising Costs .....	5



1 **II. Capital Structure**

2 Q. What recommendations did you make in your Direct Testimony  
3 concerning the capital costs to be used in setting the charges for UNEs?

4 A. I addressed capital structure, which refers to the proportions of debt and  
5 equity to be employed in determining the overall cost of capital.<sup>1</sup> I recommended that  
6 the Commission employ a capital structure of at least 35 percent debt.<sup>2</sup> My  
7 recommendation contrasts sharply with the company's proposal to use a capital  
8 structure of about 14 percent debt and 86 percent equity in setting UNE charges.<sup>3</sup>  
9 While the debt ratio that I recommend is well above the company's proposal, it is very  
10 conservative in view of the 40 percent actual debt ratio on the company's books at the  
11 end of last year.<sup>4</sup>

12 Q. What criticism does SBC Illinois witness Avera express concerning your  
13 recommended capital structure?

14 A. Witness Avera criticized my reliance on "book value" rather than "market  
15 value."<sup>5</sup> He also asserts that my recommendation is not consistent with my statement  
16 that it is important to reflect values that should be anticipated when the rates at issue in  
17 this case are in effect.<sup>6</sup>

18 Q. Is your recommendation to use a capital structure of at least 35 percent  
19 debt inconsistent with expectations for the period when the rates at issue in this  
20 proceeding would be in effect?

---

1 Direct Testimony of Harry Gildea, pp. 15–19.

2 *Id.*, p. 16.

3 *Id.*

4 *Id.*, p. 18.

5 Rebuttal Testimony of William E. Avera, p. 71.

6 *Id.*, citing Direct Testimony of Harry Gildea, p.17.

1           A.     No. As I explained in my testimony, on a book basis the debt ratio has  
2 ranged consistently above 40 percent.<sup>7</sup> Significant shifts in capital structure take a long  
3 time to accomplish for a firm of SBC's size.<sup>8</sup> It is not practical for the debt ratio to  
4 decline to 35 percent, even if the rates at issue in this case were effective for the next  
5 five years. Moreover, there is no evidence in this case — and indeed no claim by SBC  
6 Illinois as rebuttal — that the company's steps to issue and/or retire debt and equity  
7 over the next few years will even incrementally reflect a mix of 35 percent debt and 65  
8 percent equity.

9           Q.     What authority does SBC witness Avera cite for the proposition that  
10 capital structure should be based on market values?

11          A.     He cites a Memorandum and Order released by the FCC on August 29,  
12 2003.<sup>9</sup> That document, called the *Virginia Arbitration Order*, was a Preemption of the  
13 Jurisdiction of the Virginia Corporation Commission Interconnection Dispute concerning  
14 Verizon of Virginia.<sup>10</sup> In the *Virginia Arbitration Order*, the FCC stated “[t]he use of a  
15 capital structure based on market values, rather than book values, represents a  
16 departure from traditional ratemaking, but one that is entirely appropriate under the  
17 Act.”<sup>11</sup>

18          Q.     Does the position expressed in the *Virginia Arbitration Order* represent the  
19 FCC's final say on this point?

20          A.     No. First, I note that this order was issued in settlement of a particular  
21 arbitration, and there is no indication that I can see that the FCC meant it to be a  
22 general rule that would binding on state regulators, or even on the FCC itself. Indeed,

---

7     Direct Testimony of Harry Gildea, pp. 18.

8     *Id.*

9     Rebuttal Testimony of William E. Avera, p. 68.

10    Federal Communications Commission, CC Docket Nos. 00-218 and 00-00-251,  
    *Memorandum Opinion and Order* released August 29, 2003.

11    *Id.*, para. 102

1 less than a month later, on September 15, 2003, the FCC issued a Notice of Proposed  
2 Rulemaking ("NPRM") on a wide range of rules and procedures concerning the pricing  
3 of UNEs and the resale of services by incumbent local exchange carriers.<sup>12</sup> The NPRM  
4 seeks comments and replies on dozens of topics to help the FCC in forming its policies  
5 concerning pricing and costing of UNEs. On the subject of capital costs, the NPRM  
6 asks parties to address questions such as "How should the cost of debt and the cost of  
7 equity be weighted?" and "How should states determine the appropriate capital  
8 structure?" as well as "Is incremental investment typically funded through debt or  
9 equity?" and "Should the cost of capital reflect this?"<sup>13</sup>

10 Q. In this view, what is your recommendation for the Commission on this  
11 matter?

12 A. I urge this Commission to come to its own conclusions, and not be  
13 swayed by the FCC's finding that a low debt ratio is appropriate for arbitration of a  
14 Virginia case. To account for competition faced by SBC Illinois, I urge this Commission  
15 to consider that a carrier in a competitive environment needs to minimize its costs.  
16 Equity funding portions as high as 75 or 80 percent clearly do not minimize costs.  
17 Indeed, with the high cost of equity (including its income tax burden) the cost-  
18 minimizing firm will make considerable use of debt capital.

19 **III. Fill Factors**

20 Q. Please address the question that SBC witness Randall S. White raises  
21 concerning your testimony on fill factors.

22 A. As I noted in my Direct Testimony, the utilization or "fill factor" for a facility  
23 is the proportion of the facility used to provide services.<sup>14</sup> The assumed fill has a

---

<sup>12</sup> Federal Communications Commission, WC Docket No. 00-173, Notice of Proposed Rulemaking released September 15, 2003.

<sup>13</sup> *Id.*, para. 85.

<sup>14</sup> Direct Testimony of Harry Gildea, pp. 19-23.

1 significant impact because all costs, including those of “unused” facilities, are allocated  
2 over the revenue-producing units of service to determine the total costs, and hence the  
3 proposed charges for UNEs.<sup>15</sup> In my Direct Testimony, I recommended using a target  
4 fill of 70 percent for cooper feeder and a target fill of 45 percent for the distribution  
5 plant. SBC Illinois witness White states that it is difficult to tell if I am recommending  
6 these fills for state wide use or only for use in SBC rate zone C.<sup>16</sup> In this connection, he  
7 notes that “there is variation between the zones using the actual fill factors” that the  
8 company proposes.<sup>17</sup>

9 Q. Would you please clarify this matter?

10 A. Yes. My recommendation is that the 70 percent and 45 percent target fills  
11 apply state wide. In the table on page 22 of my Direct Testimony, I explicitly recognized  
12 the variation in SBC Illinois’ fills among rate zones. My recommendation, which is to  
13 apply throughout the state, seeks to “balance of a number of factors” including these  
14 variations.<sup>18</sup>

#### 15 **IV. Avoided Advertising Costs**

16 Q. Does SBC Illinois dispute your position concerning inclusion of advertising  
17 costs in UNE charges?

18 A. Yes. SBC Illinois witness David J. Barch states that “more than one  
19 witness has suggested complete removal or a significant reduction” in the marketing  
20 costs included in the UNE charges.<sup>19</sup> Witness Barch cites my testimony and that of two  
21 witnesses for the Commission staff.<sup>20</sup>

---

15 *Id.*, p. 19.

16 Direct Testimony of Randall S. White, p. 11.

17 *Id.*

18 Direct Testimony of Harry Gildea, p. 23.

19 Rebuttal Testimony of David J. Barch, p. 38.

20 *Id.*, fn. 44.

1 Q. What objection did you express in your testimony concerning the  
2 company's treatment of marketing costs?

3 A. I explained that the procedure SBC Illinois uses to determine this factor  
4 overstates the costs of UNEs because it fails to account for costs that are avoided in  
5 providing services to other carriers on a wholesale basis.<sup>21</sup> The company's cost factor  
6 reflects "wholesale marketing costs" which include costs in Account 6613, Product  
7 Advertising.<sup>22</sup> According to SBC Illinois, this account includes "the costs of developing  
8 and implementing promotional strategies to stimulate the purchase of products and  
9 services."<sup>23</sup> The company also states that "this includes non-product-related  
10 advertising, such as corporate image, stock and bond issue, and employment  
11 advertisements, which should be included in the appropriate functional accounts."<sup>24</sup>

12 Q. Why do you believe such costs should not be reflected in UNE charges?

13 A. Advertising to promote demand by the ultimate users — the competitors'  
14 customers — should be the responsibility of the competitive LECs themselves. Indeed,  
15 competitors must advertise their own services. On the other hand, it is virtually certain  
16 (and understandable) that SBC Illinois would aim any advertising in order to promote  
17 use of the company's services, rather than to promote the activities of its competitors.  
18 Thus, by including advertising costs in its charges to carriers acquiring UNEs, SBC  
19 Illinois is asking its competitors to pay for activities designed to thwart their own  
20 interests.

21 Q. Does SBC Illinois witness Barch provide any support for including  
22 advertising costs in its charges for UNEs?

---

21 Direct Testimony of Harry Gildea, pp. 23–26.

22 Shared & Common Cost Study – Illinois, Tab 1, lines 26–28 and Tab 3, Lines 142–146,  
Column L.

23 SBC Illinois Response to Staff Data Request No. PL 1.32a.

24 *Id.*

1           A.     No. In the first place, witness Barch states that advertising is one of three  
2 components of marketing costs. He asserts that the other two components — product  
3 management and sales — are larger and are relevant to UNEs.<sup>25</sup> These statements  
4 are totally off the point, and provide no justification whatsoever for including advertising  
5 costs. Also, witness Barch asserts that to the extent advertising costs are included this  
6 is appropriate because they are not related to “advertised retail products” but rather to  
7 “wholesale–related trade shows and similar functions.”<sup>26</sup> However, participation at  
8 trade shows is just as irrelevant as retail advertising because the competitive LECs  
9 needing UNEs are well aware that there is only one source of supply within the service  
10 area — the incumbent LEC.<sup>27</sup>

11           Q.     Does that conclude your testimony?

12           A.     Yes, it does.

---

<sup>25</sup> Rebuttal Testimony of David J. Barch, p. 38.

<sup>26</sup> *Id.*

<sup>27</sup> Direct Testimony of Harry Gildea, p. 24.