BEFORE THE ILLINOIS COMMERCE COMMISSION

Docket No. 02-0864

Rebuttal Testimony of Timothy Dominak
On Behalf of SBC Illinois

SBC Illinois Exhibit 17.0

January 20, 2004

**** PUBLIC VERSION****

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DIRECT TESTIMONY OF TIMOTHY DOMINAK

ON BEHALF OF SBC ILLINOIS

I. INTRODUCTION AND PURPOSE OF TESTIMONY

Q1. Please state your name and business address.

A1. Timothy Dominak, 2000 West Ameritech Center Drive, Hoffman Estates, Illinois 60196.

Q2. By whom are you employed, and in what capacity?

A2. I am employed by SBC Services as the Director of Regulatory Accounting responsible for ensuring that the financial operations of the five regulated companies in the SBC Midwest region (Illinois Bell Telephone Company, Indiana Bell Telephone Company, Michigan Bell Telephone Company, The Ohio Bell Telephone Company, and Wisconsin Bell, Inc.) are maintained in accordance with the Federal Communications Commission Part 32 Uniform System of Accounts and for affiliate transaction compliance for these companies, as well as The Southern New England Telephone Company. Additionally, I provide accounting support for state regulatory issues for the five SBC Midwest regulated telephone companies.

Q3. What is your education and business experience?

A3. I graduated from Cleveland State University in 1973 with a Bachelor of Science degree in accounting. I am a Certified Public Accountant and a member of the American Institute of Certified Public Accountants and the Illinois CPA Society.

I joined The Ohio Bell Telephone Company in 1974 as an Internal Auditor where I had responsibility for a variety of financial audits. In 1977 I transferred to the Independent

Company Settlements group where I was responsible for auditing and authorizing independent telephone company cost settlements in the Ohio territory. In March of 1979, I was promoted to Manager – Corporate Accounting, with the responsibility of developing mechanized general ledgers including associated methods and procedures. During the next seven years I had responsibility for many aspects of the Company's financial transactions as I assumed various jobs in the Corporate Accounting area. In October of 1986 I was promoted to Director - Accounting Standards at Ameritech Services, Inc., where I became responsible for establishing the new FCC Uniform System of Accounts and creating the Ameritech Cost Allocation Manual along with the mechanized Part 64 Cost Allocation System (PCAS) in response to the FCC's Part 64 requirements. During this time I represented the five SBC Midwest regulated telephone companies on many United States Telephone Association (USTA) task forces concerning FCC accounting issues. In April of 1991 I was appointed to the position of Director – Corporate Budgets at Ameritech Services, Inc., where I coordinated the consolidation of local departmental budget groups into a centralized organization. Effective in August, 1993, I was appointed to the position of Financial Management Systems Accounting Director responsible for the Ameritech Services corporate books and budgeting along with the corporate books closing process of the five SBC Midwest regulated telephone companies including the Benefit and Labor Rate Clearances, and the Affiliated Transaction methods and billing. I continued to serve in this capacity with increasing accounting responsibilities until my appointment as Director – Regulatory Accounting in April, 2000.

In April of 2003, the scope of my responsibilities was expanded to include oversight of affiliate transaction federal and state regulatory compliance for the following regulated telephone companies:

- Illinois Bell Telephone Company
- Indiana Bell Telephone Company, Incorporated
- Michigan Bell Telephone Company
- The Ohio Bell Telephone Company
- Wisconsin Bell, Inc.
- Southern New England Telephone Company ("SNET")

Q4. What is the purpose of your testimony?

A4. The purpose of my testimony is to respond to assertions on accounting issues in the testimony of Michael Starkey and Warren Fischer, which was submitted on behalf of AT&T, MCI, McLeodUSA, Covad, TDS Metrocom, Allegiance Telecom, RCN Telecom Services, Globalcom, XO Illinois, Forte Communications, CIMCO Communications and Z-Tel (the "Joint CLECs"), and the testimony of Staff witness Thomas Q. Smith, in which they propose changes to the SBC Illinois Shared and Common (S&C) study. I also address certain aspects of the Loop Installation Factor concerns raised in the testimony of Brian F. Pitkin and Steven E. Turner, which was submitted on behalf of AT&T Communications of Illinois.

II. COMMON COSTS

Q5. Messrs. Starkey and Fischer (pp. 27-44) allege that SBC Illinois made no effort to exclude non-overhead entries from the 67XX account balances used in its Shared and Common (S&C) cost study. Is this allegation valid?

A5. No. The booking of expenses to 67XX accounts is dictated by the FCC Part 32 Uniform System of Accounts For Telecommunications Companies. These rules specify that all entries booked to any 67XX account fall into two general categories: Executive and Planning, and General and Administrative expenses. SBC scrupulously abides by the Part 32 rules, auditing and ensuring that all entries are booked in full compliance with the rules. The Part 32 categories comprising all 67XX accounts are, by definition and Part 32 rules, corporate operations expenses or “overhead " functions. Breaking out the Part 32 67XX accounts by type of service/product would destroy the functionality principle that is the cornerstone of the Uniform System of Accounts. Part 32 specifically states that the financial accounts should not reflect “a priori allocation” (Part 32.2 (c)). The entirety of these account balances, again as specified by Part 32 accounting standards, are properly considered expenses related to overhead functions. Therefore, Part 32 rules obviate any need to exclude particular entries from 67XX account balances.

Q6. Messrs. Starkey and Fischer (pp. 28-30) contend that certain entries for some 67XX accounts are not overhead expenses but, rather, are direct expenses. Is their contention correct?

A6. No. First, as Mr. Barch explains in his Rebuttal Testimony, Messrs. Starkey and Fischer base their contention on an activity code manual for Southwestern Bell Telephone and not Ameritech**.** The correct Ameritech activity code manual does not include the same entries cited by Messrs. Starkey and Fischer. Moreover, knowing that SBC Illinois determines its journal entries in accordance with Part 32 rules, the claim that certain

67XX entries are not overhead expenses but, rather, are direct expenses amounts to an assertion that Part 32 rules mis-assign stated expenses**.** This allegation, in effect, calls into question the integrity of Part 32 rules, which have a long history of auditing scrutiny. The Commission should reject their proposed disallowance of a substantial portion of 67XX expenses.

III. TRANSITIONAL BENEFIT OBLIGATION (TBO)

Q7. Messrs. Starkey and Fischer (pgs. 52 to 54) and Staff witness Smith (pg. 8) call for the complete disallowance of SBC Illinois' on-going TBO expenses from the S&C study. Do you agree with this proposal?

A7. No I do not. These witnesses rely on a number of errors and invalid assertions to arrive at their conclusion. I will discuss these points in depth in this testimony.

Q8. Please describe the TBO.

A8. Prior to 1990, SBC Illinois accounted for post-retirement benefits other than pensions on a pay-as-you-go basis (cash). Postretirement benefits are benefits to be provided to employees after/during retirement. The types of costs included as postretirement benefits are health care, life insurance and any other welfare benefit. The Financial Accounting Standards Board (FASB) issued SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions," in December 1990. This statement requires recognition of the expected cost of post-retirement benefits on an accrual basis during the years that an employee renders the necessary service. In exchange for the employee's current service, the Company is providing current wages and benefits along with the promise to provide future health and welfare benefits after the employee retires. The FASB considers the promised benefits to be a form of deferred compensation that is earned as the employee renders services. SFAS 106 also requires the recognition in the

financial books of account of the amount that the Company would have accrued on its books as of the effective date of the accounting change if it had been operating under the accrual method all along. The transition from the pay-as-you-go method of accounting to the accrual method created a Transition Benefit Obligation ("TBO").

Q9. Did the FASB and the FCC allow for the deferred recognition of the TBO?

A9. Yes. Under the provisions of FAS 106, the FASB allowed for either of two methods to recognize the TBO – immediate recognition or deferred recognition. The deferred recognition was over the average remaining service period of the active plan participants. However, this recognition could not be less rapid than pay-as-you-go cost. Additionally, the FCC chose the deferred method in RAO 20[1], which is consistent with the FASB accounting recognition. Indeed, the FCC expressly required all subject carriers to use the deferred method of recognizing the transition benefit post-retirement expenses rather than taking these expenses as a one-time charge in order to avoid earnings distortions. Thus, the FCC's ruling explicitly directed the local exchange carriers to recognize TBO costs as a forward-looking expense to be incurred over an eighteen year period.

Q10. At page 51 of their testimony, Messrs. Starkey and Fischer state that the TBO "is an amortization of the write-off for regulatory books purposes of the entire amount charged on its financial books of account." Does this statement accurately reflect the regulatory accounting for this transaction?

A10. No it does not. In fact there is no "write-off" at all. Rather, pursuant to Generally Accepted Accounting Principles ("GAAP") and according to the FCC[1], the transaction

[1] FCC Responsible Accounting Officer Letter 20 (RAO 20), Uniform Accounting for Postretirement Benefits Other Than Pensions in Part 32, released May 4, 1992.

represents the recordation of a liability for costs, not previously recognized, of benefits that are provided to employees in exchange for the employee service. It is appropriate to recognize the expense related to the recordation of this liability during the period in which the employee provides the associated services (that is, over the average service life of the employees). The FCC recognizes that the TBO is a forward-looking benefit cost in RAO 20, and accordingly requires the same benefit accounting treatment as all other benefit costs such as medical, pension expense, and disability. Like these other forward-looking benefit costs, the TBO is spread over plant specific accounts based upon the work performed. This FCC-mandated benefit accounting treatment serves to further affirm the appropriateness of the TBO expense as a current and future benefit expense.

Q11. In support of his testimony Mr. Smith argues (p. 7) that the TBO "costs relate to past operations, not current, or future operations." Do you agree with his position?

A11. No, I do not. The TBO is a form of deferred compensation that SBC Illinois incurs and will continue to incur to cover the post-retirement medical benefits that retirees receive. It is a continuing obligation that is owed to employees today that has been earned during their employment with SBC Illinois. These post-retirement medical expenses will continue to be recorded (and paid) by SBC Illinois for years to come. As such, they are on-going expenses to SBC Illinois, legitimately recognized as a forward-looking cost. By inappropriately excluding TBO costs, SBC Illinois' post-retirement liability would be incorrectly understated, and consequently so would a significant stream of on-going expenses. Disallowing the TBO in the S&C study would preclude SBC Illinois from all opportunity to recover this forward-looking cost, created and mandated for SBC Illinois by the FASB and the FCC.

Q12. Has the Commission previously recognized the amortization of the TBO as a proper test year expense?

A12. Yes. In the first Alternative Regulation Order, Docket 92-0448/93-0239 (Consol.) (pgs. 114-115) released October 11, 1994 the Commission allowed as a test year expense, the normal one year amortization of the TBO. This decision was supported by the testimony of Staff witness Alan K Griffey , who testified that the amortization of the SFAS TBO is a normal operating expense which should be recognized in the year incurred. Other orders in which the Commission expressly recognized the TBO amortization as a proper test year expense for ratemaking purposes include Central Illinois Public Service Company, Docket 91-0193 (March 18, 1992) and Illinois Power Company, Docket 93-0183 (April 6, 1994).

Q13. Mr. Smith asserts on page 6 of his testimony that the TBO was essentially "recorded as an asset to be amortized over an 18 year period." Do you agree with this accounting representation?

A13. No I do not. SBC Illinois did not record the TBO as a deferred asset and subsequently amortize it over 18 years as Mr. Smith states. SBC Illinois recorded a liability and corresponding expense each year since the adoption of SFAS 106 in accordance with GAAP and the FCC. Each year SBC Illinois records one-eighteenth (which is attributable to the average remaining service life of the active employees) of the previously unrecognized liability.

Q14. On page 6 of his testimony, Mr. Smith asserts that "the financial liability of IBT was the same prior to the adoption of SFAS 106 as it is subsequent to the adoption." Is Mr. Smith correct?

A14. No. Once again Mr. Smith mischaracterizes the true nature of the financial accounting impact of the TBO. Prior to the adoption of the TBO, and in accordance with GAAP and

FCC rule, there was not a recognized liability on the books of account for the post retirement benefits. The liability did not exist since the Company used the pay-as-you-go method of accounting for retirement benefits. It was only upon the adoption of SFAS 106 that the recognition of the liability on the books of account began. Therefore, any financial measurement of the liability for post retirement benefits would be substantially different subsequent to the adoption of SFAS 106.

Q15. In support of their testimony, Messrs. Starkey and Fischer (p.51) argue that "it is a mistake on SBC's part to refer to its TBO as an expense." Do you have any comments in response to this argument?

A15. Messrs. Starkey and Fischer's position obfuscates the FCC's application of generally accepted accounting principles (GAAP) in RAO 20. Specifically, the TBO costs are not only current expenses, but they are also forward looking. These costs will continue to be incurred through 2008, which extends beyond the TELRIC study periods (i.e., 2003-2006) in this proceeding and certainly merits the quality of being forward-looking. The TBO is an ongoing liability, a liability in which the corresponding income statement expenses have not yet been recognized.

Q16. At page 53 of their testimony, Messrs. Starkey and Fischer assert that even if SBC Illinois used 1991 (the first year of TBO adoption) as its test year it would be inappropriate to include the TBO as it is an anomaly. Do you have any comments with respect to this assertion?

A16. Yes I do. The TBO is not an anomaly in any sense. Rather, the exclusions of these amounts would be an anomaly. As I have previously discussed, the Commission has recognized the TBO amortization as a normal test year expense in a number of cases, including Docket 92-0448/93-0239 (Consol.). In that case, the test year was the twelve months ended August 31, 1992. Therefore, it would not matter if 1991 were the test year:

the TBO liability and expenses would be properly recognized in this transition year as well as 2001.

Q17. Is the TBO comparable to similar pension accounting costs?

A17. Yes, the accounting for the TBO is comparable to the recognition of FAS 87 pension accounting for the recognition of prior service cost. Specifically, when a defined benefit plan is adopted or amended, the projected benefit obligation is usually greater than it was before. In many cases, the increase in the projected benefit obligation or "catch-up" cost can be substantial. The Financial Accounting Standards Board (FASB) has determined that the full expense for these increased costs and liability should not be recognized at the time of the plan's adoption or amendment. As a result, the retroactive benefits are not recognized as pension expense entirely in the year of adoption, but are required to be recognized during the service periods of those employees who are expected to receive benefits under the plan; that is, the costs are recognized over the average service life of the employees. This same type of treatment for prior service cost is inherent in FAS Statement No. 106, "Employers' Accounting for Post Retirement Benefits Other Than Pensions." In fact, the FASB used Statement No. 87 pension accounting as a reference for the accounting prescribed in statement No. 106. The FASB Statement 106 allows for the prior service cost to be recognized over the average service life of the employees, which is precisely the method that was chosen by the FCC for the TBO.

Q18. What are your conclusions related to the TBO?

A18. Contrary to the arguments of Messrs. Starkey and Fischer and Mr. Smith, the TBO is both a current period expense as well as a forward looking cost that SBC Illinois will continue to incur well beyond the planning period of the cost studies at issue in this

proceeding. Consequently, there is no basis for disallowing the TBO cost in this study. Had the liability and corresponding expense not been recognized over the 18 year period required by the FCC (as one of the alternatives granted by the FASB in FAS 106), these expenses would still have been recognized as future expenses under the former pay-as-you-go recognition method.

IV. PENSION SETTLEMENT GAINS

Q19. Please describe the pension settlement gain dispute.

A19. In calculating its expenses by using 2001 data as a starting point and then making forward-looking adjustments, SBC removed from the data its 2001 pension settlement gain of **[Begin Confidential]********** **[End Confidential]** because it would be inappropriate to include this large negative expense in a baseline for a forward-looking study. Messrs. Starkey and Fischer argue that the pension settlement gains occur on a regular basis and therefore a normalization of the settlement credit should be added back into the data, so that it is assumed that on a going-forward basis SBC will experience pension settlement gains.

Q20. Beginning on page 54 of their testimony, Messrs. Starkey and Fischer describe pension settlement gains. Do you agree with their description?

A20. No I do not. Once again there are certain inaccuracies and invalid assertions that need to be addressed.

Q21. Please describe these inaccuracies and invalid assertions.

A21. Beginning at page 54 of their testimony, Messrs. Starkey and Fischer assert that "when SBC experiences expenses different from those it actually incurs in managing its pension benefits, it is allowed by SFAS 87 and 88 to account for those differences on an

accelerated basis." This statement is simply incorrect. Differences between anticipated costs and what actually occurs are maintained as a side record in an Unrecognized Gain or Loss account for pension accounting and are not recorded on an accelerated basis, but are subsequently amortized, typically over the average service life of the covered employees. This is an important distinction of pension accounting because it allows a company to control the volatility swings that could be caused by such events as sudden and large changes in the market value of plan assets or changes in actuarial assumptions. If these gains or losses were allowed to impact the financial statements in the period of incurrence via immediate and full recognition, substantial fluctuations in pension expense would occur. Thus, smoothing techniques are used to avoid substantial fluctuations in pension expense, which will minimize or even eliminate the pension expense volatility. For instance, the high market returns of the 1990s have reversed back to much lower returns today. Rather than immediately recognize losses and gains from these short term swings, the smoothing techniques drive the volatile impacts back to an average recognition. Therefore, the pension differences are not accelerated at all, but rather are deferred.

Q22. If recognition of losses or gains, like the investment gains SBC experienced in the 1990s, is typically delayed and amortized over several years, why did SBC experience such large "pension settlement gains" in 1999-2001?

A22. Under accounting rules, a company is required to accelerate recognition of deferred pension losses or gains and immediately recognize those losses or gains via its "pension settlement" reporting when certain triggering events occur. A pension settlement can occur when the employer settles a pension obligation through lump-sum cash payments in exchange for the liability (the right to receive specified pension benefits in the future).

When the amount of these lump-sum cash pension payments made by a pension plan in a given year exceeds a given threshold (established by the FASB), that triggers a requirement that the company accelerate the unamortized balance of any transition assets and immediately recognize its net gain or loss in its earnings. Such an occurrence is not directly related to the operation of the pension plan and not in the ordinary course of business. This is what occurred with respect to SBC in 1999-2001. The gain that SBC recognized in 2001 is the accelerated recognition of the market return on the invested assets. That accelerated recognition was required because enough of SBC's workforce left the business and elected to receive lump-sum pension payouts such that the FASB's triggering threshold was met.

Q23. Is the pension settlement gain credit booked in 2001 an anomaly?

A23. Yes. The credit is an anomaly not only in terms of the size of the gain, but because pension settlement gains are not a part of the normal on-going operation of SBC's business, and accordingly it should not be normalized in the cost study as if they were.

Q24. SBC Illinois experienced pension settlement gains in years 1999 through 2001. How then can you determine that these gains are an anomaly?

A24. SBC Illinois did experience pension settlement gains for years 1999 through 2001 as noted in the response to Staff Discovery TQS 1.01. However, to determine whether such gains are likely to be repeated in the near future, one must look further, to the business causes that triggered the recognition of those settlement gains. The pension settlement gains realized during the period of these cost studies is primarily related to the large amount of investment gains SBC experienced in earlier years that are now being recognized. Pension accounting typically contains various cost components that are

amortized over the average service life of the covered employees and are therefore unrecognized in the accounts of the financial statements until future years. Examples are interest changes and gains and losses on plan asset investments. The basis for the delayed recognition is the possibility that gains or losses occurring in one period would be offset by losses or gains in subsequent periods. There were two such primary events. First, during 1998 and 1999, many people left the business as a result of a number of factors, such as: the uncertainties of their job, the potential elimination of duplicate job functions, an aged work force of retirement eligible personnel, a robust economy and job market, and the potential negative impact of federal law changes on interest rate/mortality assumptions attributable to lump sum pension calculations. The lump-sum pension payments attributable to these events caused the recognition of the 1999 settlement gains. Secondly, in September of 2000, the Company introduced an Enhanced Pension and Retirement program (EPR). This was a one-time, voluntary offer that provided pension and benefit enhancements to eligible management employees in order to further streamline the organization. This event caused the accelerated recognition of the 2000 and 2001 settlement gains as a large amount of lump sum cash pensions were paid. But it is unlikely that an event such as the unusual economic factors or an early retirement offer of the magnitude of EPR would occur in the near future. Additionally, the dismal market returns have negated much of the favorable returns of the 1990s, thereby further reducing the likelihood of realizing settlement gains. Indeed, SBC has furnished 2002 data that shows that there were no pension settlement gains in that year. Further, in 2003, there has also been no pension settlement gains reflected on the books of SBC Illinois.

Q25. What adjustment did Messrs. Starkey and Fischer make to the SBC Illinois 2001 pension settlement gain it removed from its analysis?

A25. Messrs. Starkey and Fischer calculated an average pension settlement gain credit of **[Begin Confidential]**********[End Confidential]** using pension settlement gains from the past 14 years (1987-2001) (Starkey/Fischer Attachment MS/WF-4). They removed the **[Begin Confidential]********** [End Confidential]** calculated normalized average from the SBC Illinois 2001 booked pension settlement gain of **[Begin Confidential]********** [End Confidential]** to arrive at a final adjusted 2001 pension settlement gain of **[Begin Confidential]**********[End Confidential].**. The net effect of the Starkey/Fischer adjustment is to reduce the level of pension expense reflected in the Company's calculation of shared and common costs by **[Begin Confidentia**l]********** **[End Confidential]** .

Q26. Do you agree with the proposed adjustment of Messrs. Starkey and Fischer?

A26. No, I do not. For the reasons that I previously discussed, , the entire 2001 pension settlement gain should be removed from the shared and common model. However, even if the Starkey/Fischer adjustment is considered (which it should not) the adjustment needs to reflect a balanced approach since it only considers pension settlement gains from 1987 to 2001, while overlooking the pension settlement losses that have also resulted from the same events. For example, in year 2000, a significant employee termination of services earlier than actuarially expected generated losses of **[Begin Confidential]********** **[End Confidential]** which are not reflected in the Starkey/Fischer proposed adjustment.

Q27. Have you developed a schedule to show how the Starkey/Fischer proposed pension settlement gain adjustment would be calculated if it were revised to reflected pension settlement losses as well as gains? ?

A27. Yes, I have adjusted the Starkey/Fischer Attachment MS/WF-4 (Adjusted pension Settlement Credits) to also reflect the pension settlement losses incurred during the same time period, 1987 to 2001, on SBC Illinois Proprietary Schedule TD-R1. This calculation yields an adjusted average pension settlement net gain/loss of **[Begin Confidential]*******************[End Confidential]**. Furthermore, I would point out that in 2002 there were pension settlement losses in the amount **of [Begin Confidential**] *****************[End Confidential]** and in 2003 there were**[Begin Confidential]***********[End Confidential]** pension settlement gains or losses. If we include these years, , the adjusted pension settlement net average gain/loss is **[Begin Confidential]*******************[End Confidential]** which is reflected on Proprietary Schedule TD-R2. Therefore, even if the Commission were to accept the Starkey/Fischer pension settlement gain adjustment in principle (which they should not) the balanced approach of averaging both the gains and losses should be reflected in this proposed adjustment.

Q28. Would it be appropriate to include any of the 2001 pension settlement gains in the cost study?

A28. No, it would be inappropriate to include the 2001 pension settlement gains in the cost study in any manner. As I have explained, the significant pension settlement gains SBC experienced in 2001 (and in 1999 and 2000) resulted from an anomalous confluence of events. Specifically, SBC had experienced a large amount of investment gain on its pension plan assets in the 1990s, when market returns were very high. Because certain triggers were met (due to significant lump-sum pension payments and buyouts), SBC

was required under accounting rules to immediately recognize a portion of these gains on an accelerated basis, as "pension settlement gains." I stress that the period of 1999-2001 was an unprecedented time for SBC Illinois, combining never-before-seen pension fund performance with a major force loss. It is highly unlikely that SBC Illinois will experience anything approaching this set of conditions generating such pension settlement gains in the near future. On the contrary, increasing pension expense characterize the SBC Illinois landscape going forward. Thus, the SBC Illinois 2001 pension settlement gain is not forward-looking and should not be included in its UNE cost studies. In fact, SBC Illinois experienced *no* pension settlement gain in 2002 or 2003. Based upon the lower market returns of recent years, if the similar events that triggered the pension settlement gains in 2001 occurred in 2003, SBC Illinois would have recognized pension settlement losses.

Q29. If pension settlement losses had occurred in 2001, would SBC Illinois remove them from the shared and common study as they did with the pension settlement gains?

A29. Yes, since neither the pension settlement gains or pension settlement losses are associated with the normal forward-looking operations of the business they would be removed in order to recognize a balanced approach to the treatment of this event.

Q30. What is your conclusion with respect to pension settlement gains?

A30. Pension costs are a part of the overall employee compensation and arise because people are hired to provide work and therefore produce revenues for the on-going operation of the business. Pension settlement gains, in contrast, have nothing to do with the company's regular or ongoing business. The size and timing of pension settlement gains are largely reflective of the skill of the portfolio managers engaged to manage the pension

plan and the insight of the pension plan sponsor in hiring the portfolio managers and establishing investment policies. Both the settlement gains and pension costs are the result of having pension plans, but the similarity ends there. As explained above, SBC's 1999-2001 pension settlement gains were anomalous events that are unlikely to be repeated in the near future and are thus not forward-looking. Therefore, it is appropriate that the pension settlement gains should be removed in their entirety from the 2001 S&C cost study for purposes of this proceeding.

V. UNCOLLECTIBLES

Q31. Please explain how SBC Illinois accounts for wholesale uncollectible expense.

A31. Proper matching of revenues and expenses dictates recording uncollectible expense in the period in which the revenue was earned, not in the later period in which accounts are written off. To achieve this objective, SBC Illinois uses the allowance method of accounting for wholesale uncollectibles. The allowance method serves two primary accounting objectives. First, it reduces the value of the receivables to the amount of cash expected to be realized in the future and second, it matches the uncollectible expense of the current period with the related revenues of the period. It is this emphasis on matching expenses with related revenue that makes the allowance method the preferred method of accounting for wholesale uncollectibles. The nature of wholesale customers is much different than retail customers due to the nature of the the services purchased and the dollar volume of the purchases. Past experience shows that wholesale customers are more prone than retail customers to going out of business or into bankruptcy while owing SBCI large amounts of money. Under the allowance method, SBCI reviews the wholesale accounts receivable by various risk categories such as the relative age of the receivables,

bankruptcies, high risk, and others. SBCI then determines the percentage of the ending accounts receivable in each risk category that is not expected to be collected (net of recoveries). This review takes into consideration the overall collection success of the outstanding accounts receivable (which includes recovered amounts). Following the review of the wholesale accounts receivable, a theoretical reserve is calculated. The theoretical reserve is analyzed and compared to current balances on the books and adjusted for known business events and forecasts of future activity to determine if additional uncollectible expense should be recorded or if reversal of a portion of the allowance for uncollectibles is needed. Additionally, through this process the uncollectible expense in account 5301 is naturally adjusted as it takes into account recoveries from prior periods.

Q32. On pages 8 to 12 of his testimony, Mr. Smith discusses Uncollectible Expense. Please describe the essence of his arguments.

A32. Mr. Smith disagrees with the SBC Illinois presentation of the Shared Cost Factor as a quotient of the combined wholesale uncollectible expense along with the wholesale marketing expense over the entire wholesale portion of SBC Illinois' total direct cost. Mr. Smith asserts that there is a relationship between revenues and uncollectible expense such that an uncollectible expense should be developed as a separate factor which is then applied to each UNE rate. Based upon this premise, Mr. Smith calculates a wholesale uncollectible expense factor on Staff Exhibit 9.0, Schedule 9.1.

Q33. Please explain the calculation of Mr. Smith's proposed adjustment on Staff Exhibit 9.0, Schedule 9.1.

A33. Mr. Smith used the SBC Illinois response to Staff Data Request TQS 1.07 and TQS 3.7 to obtain Bad Debt Expense and Wholesale Revenues for the period 1998 through 2002. He

then calculated an average percent ratio of wholesale bad debt expense to wholesale revenues of **[Begin Confidential**]**********[**End Confidential**] for the five year period. Mr. Smith however proposes to use only the average of the most recent two years (2001 and 2002) or **[Begin Confidential]** *********[**End Confidential]** from his schedule reasoning that a five year average would be misleading due to the developing wholesale market conditions.

Q34. Do you agree with Mr. Smith's proposed adjustment?

A34. No, I do not. For all the reasons Mr. Barch discusses in his Rebuttal Testimony, the wholesale uncollectibles should not be bifurcated into UNE and non-UNE subsets. Additionally, there are several other inaccuracies in Mr. Smith's testimony regarding uncollectibles that I will address.

Q35. Please summarize the flaws in Mr. Smith's uncollectible analysis.

A35. Mr. Smith reaches an incorrect conclusion about what comprises the SBC Illinois bad debt expense by combining elements of three different uncollectible accounting methodologies: the Allowance Method, the Direct Write-Off Method, and the Income Statement approach. As I have discussed in this testimony and has been discussed in response to data requests, SBC Illinois uses the Allowance Method to determine wholesale uncollectible expense. Therefore, Mr. Smith's assertion that uncollectible expense is clearly a function of the underlying revenues and that, as revenues increase, bad debt and uncollectible expense also increase, is incorrect. Unlike regular retail customers, the wholesale uncollectibles are largely a function of the overall financial credit risk of the CLECs and are not related to the magnitude of the gross revenues themselves.

Another example of this mixture of methodologies appears on lines 196 to 200 of Mr. Smith's testimony, where he describes what is known as the Direct Write-Off Method of uncollectibles, i.e. when a specific account has been identified as uncollectible, the loss is recorded by crediting Accounts Receivable and debiting bad debt expense. SBC Illinois does not use this method to determine Wholesale Uncollectible expenses as explained in data request TQS 2.03.

Finally, Mr. Smith proposes an adjustment to modify the uncollectible factor by aligning it with the percentage of sales methodology (Income Statement method). This approach only has foundation when there is a fairly stable relationship between the previous years' sales and bad debts. However, this has simply not been the case as illustrated in Mr. Smith's Schedule 9.1. In his testimony, Mr. Smith asserts that the concept of competition in the local markets is not completely developed. Yet in spite of these statements, Mr. Smith is proposing an uncollectible factor based upon a methodology that only works when there are stable market conditions and a predictable relationship between sales and bad debts.

Q36. At pages 76 to 93 of their testimony, Messrs. Starkey and Fischer propose to reduce the uncollectible expense in the S&C study. In support of this proposal, Messrs. Starkey and Fischer (p.80) argue that "SBC does not explain how it was able to allocate specific uncollectibles to its ALDIS and or/Special Markets divisions" from its total wholesale services uncollectibles data. Do you have any comments in response to this argument?

A36. Yes. Wholesale revenues are billed from a completely different billing system than the regular retail and business customers. Therefore, the outstanding receivables data that SBCI uses for its cost study is specific to its wholesale (Industry Markets) unit. SBC Illinois maintains the uncollectible reserve on a wholesale basis, and it is not separable into specific product components (*e.g.*, wholesale UNEs and wholesale non-UNEs).

Contrary to the suggestion of Messrs. Starkey and Fischer, however, it is entirely reasonable to assume that the total wholesale uncollectible ratio is a good proxy for the hypothetical UNE-only wholesale uncollectible ratio. The primary cause of most of the wholesale uncollectibles is bankruptcies. When CLEC customers declare bankruptcy, they owe on their entire wholesale account balances, so there is little point in attempting the difficult task of maintaining an uncollectible structure at a product level.

Q37. Messrs. Starkey and Fischer (p.80) also argue that "SBC fails to even mention, let alone explain, why substantial variations in its uncollectibles data over time were not considered in deriving an uncollectible estimate." What is your response?

A37. Messrs. Starkey and Fischer pose a question as to why variations in uncollectibles over time were not used. This question has some merit worth exploring, yet the Joint CLECs do not follow their own advice and examine those variations. Perhaps that is because those variations show that SBCI's wholesale uncollectible expense has increased dramatically from 1998 to 2000 levels. The fact is that the number of bankruptcies and financially troubled carriers has dramatically increased. During this same time period, the demand for UNE products has also greatly increased. Messrs. Starkey and Fischer point to data for the period 1998 through 2000. That data does not reflect the reality of the current and future market place. During the period 1998 to 2000, the wholesale market was just developing, as indicated by the annual wholesale revenues. This market experienced robust growth beginning in 2000. . With this growth also came deteriorating business plans for some of the wholesale customers, along with the resultant economic credit risk, that gave rise to much higher uncollectibles. Further, SBCI has produced data in response to Staff Data Request TQS 1.07 that clearly shows wholesale uncollectible

expense rising, which is a direct result of the conditions cited. Not surprisingly, the Joint CLECs make no mention of this data.

Q38. Does Staff agree with your conclusion that the use of five year old data to compute a wholesale uncollectible expense is not appropropriate?

A38. Yes, on page 12 of his testimony concerning uncollectibles, Staff witness Smith concludes that "A five year history would be misleading because it would ignore the realities of the developing competition in the IBT local exchange market."

Q39. At pages 82-83 of their testimony, Messrs. Starkey and Fischer discuss their concern over the possible inclusion of billing disputes in calculating the bad debt expense, and assert that "SBC does not incur any real expense" in regard to billings that were in error. Please discuss how billing errors are managed in the uncollectible calculation.

A39. Billing disputes that result in incorrect billings to customers are not included in the calculation of uncollectible expense. Billing errors represent revenue that the Company is not entitled to collect and therefore is not actual revenue to SBC Illinois. Consequently, a billing that proves to be in error is removed from revenue as a billing adjustment and is not considered in the evaluation of uncollectible expense.

Q40. At page 84 of their testimony, Messrs. Starkey and Fischer suggest that SBCI provides an inaccurate portrayal of uncollectible expense because it fails to "account for the fact that some of that amount is ultimately recovered." Does this suggestion have merit?

A40. No. The current uncollectible expense is calculated with consideration for recoveries and thus is already a net amount (gross less recovery). Further reducing the expense to the account 5301 balance for recoveries as suggested by Messrs. Starkey and Fischer would serve to double count recoveries and understate the proper level of SBCI's true uncollectible expenses.

Q41. On page 86 of their testimony Messrs. Starkey and Fischer assert that the write-offs in account 1181 "represent SBC's true 'uncollectible cost.'" Do you agree with this assertion?

A41. No. As I previously mentioned, wholesale customers and products possess markedly different business and collection characteristics than retail. It may take years, through various court proceedings, to collect little if anything from CLECs declared bankrupt and/or gone out of business. No write-offs to account 1181 occur until these lengthy legal proceedings have concluded. Proper accounting dictates that current receivables be valued at the amount that the Company will ultimately realize, and therefore that uncollectible expense be recognized fairly. The Joint CLECs' proposal would make SBCI go back in time to recognize the 2001 bankruptcy uncollectibles in perhaps 2004, when the judicial process runs its course. Not only is this improper accounting, it is certainly not a forward looking, but rather a "backward looking ", view of costs. SBCI's true uncollectible costs for purposes of this proceeding are the account 5301 expenses which are directly related to the collectibility of the accounts of its current customers.

Q42. On pages 90-91 of their testimony, Messrs. Starkey and Fischer conclude that [BEGIN CONFIDENTIAL] [******] [END CONFIDENTIAL] of the expenses booked to account 5301 are ultimately recovered. Do you agree with this assertion?

A42. Absolutely not. The notion that SBCI collects or will collect almost **[BEGIN CONFIDENTIAL] ******** [END CONFIDENTIAL]** of the wholesale uncollectible expense is unrealistic. Much of this expense is caused by failed or near failed companies that are approaching or already in a bankruptcy proceeding. There are several flaws in the analysis of Messrs. Starkey and Fischer. First, they erroneously assume that the difference between the amount recorded in account 5301 as bad debt expense and the account 1181 write-offs represent the "amount of the originally-booked 'bad debt

expense' that was either recovered, or is anticipated to be recovered." In fact, the remaining credits in account 1181 largely represent amounts for which the Company is awaiting disposition from the courts, and most of those amounts will not be "ultimately recovered," as Messrs. Starkey and Fischer allege, but will be written off in the future. Second, the Starkey/Fischer analysis uses time periods (1998-2000) that are not truly representative of current and future activity. The real measure of the business failure begins with the 2001 and 2002 data, as the wholesale market matured. The following table presents a more accurate depiction of current uncollectible trends

All numbers $000				
	Year	**2001**	**2002**	**2 yr Total**
A.	**Account 5301** "Bad Debt Expense"	$32,529	$24,138	$56,667
B.	**Account 1181** "Write-Offs"	$12,978	$21,102	$34,080
C.	**Acct 5301 minus Acct 1181 "Write-offs"**	$19,551	$3,036	$22,587
D.	**% of Bad Debt Expense to be Written Off in the Future** (Row C divided by Row A)	60.10%	12.58%	39.86%

Q43. What can you conclude from this information?

A43. First, SBCI experienced significant write-offs in 2001 and 2002 as some of the bankruptcy and business failure cases are resolved. It also shows a more current view of the changing business conditions and the greater risk that the Company's receivables are under. Additionally, Row B shows that Uncollectible Write-offs lag Bad Debt Expense, but increase as insolvency cases are resolved. Finally, as row (D) shows, the difference

between Bad Debt Expense and Write-Offs in account 1181 is correctly labeled as the " % of Bad Debt Expense to be Written-Off in the Future," and not what is anticipated to be actually collected.

Q44. Beginning on page 91 of their testimony, Messrs. Starkey and Fischer explained their proposed uncollectible adjustment contained in Attachment MS/WF-4 to their testimony. Do you agree with this adjustment?

A44. No, for reasons discussed by Mr. Barch in his testimony on the appropriateness of a shared wholesale factor (i.e., derived from, and applicable to, all of wholesale) and for all the reasons previously stated, this proposed adjustment should be rejected in its entirety.

VI. REDUCTION IN COMMON EMPLOYEE LEVELS

Q45. In his testimony (pp. 13-14), Mr. Smith proposes an adjustment to the SBC Illinois employee level. Do you have any comments regarding Mr. Smith's proposal?

A45. Yes, Mr. Smith's proposal is discussed in Mr. Barch's Rebuttal Testimony. However, I do have some observations regarding the application of the headcount data by Mr. Smith. An analysis of the data used in Staff Exhibit 9.0, Schedule 9.3 shows that Mr. Smith simply used the difference in the SBC Illinois employee headcount at year-end 2001 and 2002. Mr. Smith removed the employees that left SBC Illinois, but ignored the fact that a significant number of these employees likely transferred to other SBC affiliates. As a result, Mr. Smith underestimated the impact of the force reductions on overall expenses, since SBC Illinois will incur higher offsetting affiliate expenses as a result of the higher level of work force there.

Q46. Please explain why SBC Illinois will incur higher affiliate expenses?

A46. When employees are transferred to shared services organizations such as Ameritech Services and SBC Services and continue to perform the same functions, their costs

continue to be recorded on the books of account of SBC Illinois. However, instead of appearing as SBC Illinois wages and salaries, the costs would be recorded from affiliated billing. Therefore, for these transferred employees, there would not be any overall cost reductions reflected on the financial books of SBC Illinois. The same would be true, although to a lesser degree, for work functions that are transferred to shared services subsidiaries without the incumbent work force. However, in these instances SBC Illinois would still be experiencing costs.

Q47. Were there transfers of employees from SBC Illinois to shared services companies in 2002?

A47. Yes. I cannot document all such transfers because the Company does not have a tracking system for each function transferred. However, I do know that 167 Procurement employees transferred from SBC Illinois to SBC Services and 139 employees performing various functions transferred from SBC Illinois to Ameritech Services in 2002. There undoubtedly have been other functions now being performed by transferred employees on behalf of SBC Illinois in other SBC affiliates for which some portion of cost is charged to SBC Illinois.

Q48. What is your conclusion regarding Mr. Smith's employee adjustment?

A48. For all the reasons discussed above and in Mr. Barch's testimony, Mr. Smith's proposed adjustment to common costs based on changed SBC Illinois payroll employee levels should be rejected in its entirety.

VII. LOOP INSTALLATION FACTORS

Q49. In their testimony (pp. 32-34), AT&T witnesses Pitkin and Turner question the accuracy and the verifiability of the data used by the Company to loop installation factors. Do you have any comments in response to their testimony in this regard?

A49. I provided the data that was used to develop the cable installation factors used by the Company in its loop cost study. I also provided the data that was used to develop revised DLC installation factors discussed by Mr. Smallwood in his Rebuttal Testimony. For the reasons that I will discuss, this data is accurate, verifiable and provides a reasonable basis for developing installation factors.

Q50. What was the source of the data used to calculate these factors?

A50. The source of this data was the underlying cost data of the SBC Illinois General Ledger. The Account, Sub-account and Transaction Category Code (TCC) data elements were analyzed. Three years worth of data from 1999, 2000, and 2001were used for the cable factors. For the DLC Installation factors, which have been revised in this rebuttal filing to address certain concerns raised by the Staff and AT&T witnesses, the most recent years (2000, 2001 and 2002) of cost data were used. A three year period was selected in order to accurately reflect a normal going-forward level of the relationship between installation costs and material costs**.**

Q51. Does the General ledger cost data undergo any type of financial controls to ensure its reliability?

A51. Yes. The General Ledger data is routinely audited by external auditors. Additionally, the data is the underlying support of the publicly filed ARMIS reports with the FCC. The ARMIS 43-03 and the underlying financial support is also audited by independent

external auditors. Additionally, all of the ARMIS reports, general ledger results, and internal controls are reviewed and certified by the financial management of SBC.

Q52. What types of costs were included for cable and DLC installation?

A52. The outside plant aerial, buried, and underground copper and fiber cable plant investment along with the circuit equipment activity was reviewed in conjunction with the Cost Analysis organization. We then produced the appropriate investment activity for the following categories of costs: telephone company labor, telephone company engineering, contract labor, and sundry and miscellaneous costs.

Q53. Were there investment costs that were excluded?

A53. Yes, costs were excluded that were not viewed as an integral part of the labor activity to construct new telephone plant. This includes plant retirements, transfers, billing to other telephone companies and general business expenses. The TBO was also excluded since it is recovered in the S&C factors.

Additionally, the cost of the aerial and buried cable drop wire was removed since it contains the cost of the NID and is used in another portion of the recoverable cost studies. The financial system separately identifies the cost of the aerial and buried drop activity which is reported through Field Reporting Codes 52C (Aerial Drop Wire) and 545C (Buried Cable Drop Wire).

Q54. Is the cost data used to develop the cable and DLC Installation Factors reconciled to the General Ledger?

A54. Yes, the cost data used in the Cable Installation Factor study for the years 1999, 2000, and 2001 and the DLC for years 2000, 2001 and 2002 was reconciled to the General Ledger and as such represents the actual costs incurred for the functions.

Q55. Messrs Pitkin and Turner criticize the use of Illinois General Ledger information for the use of developing the Loop Installation Factors (Pitkin/Turner Direct Testimony, page 38) . Do you have any reason to believe that this data is not forward-looking?

A55. No. As I already stated, the Cost Organization used three years of recent data as a conservative method in order to smooth out any irregularities in the data. Examination of the data shows that same type of costs occur from year to year and these costs are legitimate costs for installing cable. The data use were the most recent data available for use when the cost studies that are the subject of this case were developed and that can be used to develop a forward-looking relationship of labor to material.

Q56. Several intervener witnesses, including Pitkin/Turner, assert that loop costs should be declining. Do you have any comments in response to that assertion?

A56. Yes. Mr. Smallwood has testified that labor costs are a significant portion of the total loop costs. I have observed that labor costs have been increasing year over year and are continuing to increase due to such factors as wage increases attributable to union contractual obligations and rising benefit costs.

Q57. Mr. Dominak, does this conclude your rebuttal testimony?

A57. Yes, it does.