

BEFORE THE ILLINOIS COMMERCE COMMISSION

Docket No. 02-0864

**Rebuttal Testimony of John Sneed
On Behalf of SBC Illinois**

SBC Illinois Exhibit 20.0

January 20, 2004

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**REBUTTAL TESTIMONY OF JOHN SNEED
ON BEHALF OF SBC ILLINOIS**

1 **I. INTRODUCTION**

2 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

3 A. My name is John W. Sneed. My business address is One Bell Center, 38-B-1, St. Louis,
4 Missouri, 63101.

5 **Q. BY WHOM ARE YOU EMPLOYED AND WHAT IS YOUR POSITION?**

6 A. I am employed in the Cost Analysis division at SBC Services, Inc., as Executive
7 Director—Cost Analysis and Regulatory.

8 **Q. WHAT ARE YOUR RESPONSIBILITIES AS EXECUTIVE DIRECTOR—COST
9 ANALYSIS AND REGULATORY?**

10 A. I am responsible for general oversight of the cost analysis division, supervision and
11 review of cost studies for consistency, and evaluation of cost study results.

12 **Q. PLEASE OUTLINE YOUR WORK EXPERIENCE.**

13 A. I began my career with SBC in May of 1991 in the Internal Audit organization. In 1997,
14 I transferred to the finance organization. I have held various finance positions with SBC
15 from 1997 to the present. In these positions, I was responsible for audits of various
16 Southwestern Bell Telephone Company (“SWBT”) entities, SWBT cost allocation rates,
17 and analysis of financial results for the SWBT network finance group.

18 **Q. WHAT IS YOUR EDUCATIONAL BACKGROUND?**

19 A. I received my Bachelor's degree from the University of Missouri in St. Louis, Missouri in
20 1985. I also received my Certified Public Accountant certification that same year.

21 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

22 A. The purpose of my testimony is to respond to AT&T witness' Brian Pitkin's and Steven
23 Turner's position on recurring UNE loop prices and make a high level comparison of the
24 positions being presented by SBC Illinois and the CLECs. Mr. Pitkin and Mr. Turner
25 claim that SBC Illinois failed to provide any reasonable support for the alleged reversal in
26 loop cost trends that its cost study contemplates¹ and they have advocated lowering
27 current UNE rates. I will demonstrate that information outside the four corners of the
28 Company's TELRIC studies supports a higher SBC Illinois loop rate and that, in fact, the
29 rates proposed by SBC Illinois are very reasonable in comparison with this benchmark
30 data. My testimony will also present a high level summary of SBC Illinois' position with
31 respect to the importance of this proceeding and the setting of reasonable loop prices by
32 this Commission. Key points of my testimony are as follows:

¹ Direct Testimony of Mr. Brian Pitkin and Mr. Steven Turner Regarding Recurring Cost Studies, ICC Docket No. 02-0864 (May 6, 2003) at 8.

- 33 • SBC Illinois’ proposed investment of \$701 per loop is reasonable compared to
34 other network providers.

	SBC²	LD³	Wireless⁴	Cable⁵
Investment Per Loop	\$701	\$1,049	\$1,076	\$1,076

- 35 • SBC Illinois’ proposed cost of capital of 12.19% is less than other
36 commissions have recently ordered and less than AT&T itself proposed in ex
37 parte filings with the FCC, as the following table illustrates:

	SBC	VZ-VA⁶	AT&T⁷
Cost of Capital	12.19%	12.95%	15.00%

² This figure (weighted statewide) is derived from SBC Illinois’ LoopCAT (Rebuttal).

³ AT&T 2002 Annual Report (available at <http://www.att.com/ar-2002/docs/ar2002.pdf>) at 1 and 53.

⁴ Sprint Corporation 10K Report for the fiscal year ended Dec. 31, 2001 (available at <http://www.sprint.com/sprint/ir/fn/10q10k/10k01.pdf>) at 31 and F-19.

⁵ Comcast Communications 10K Report for the fiscal year ended Dec. 31, 2002 (available at http://www.irconnect.com/comcast/annrep2002/pages/10k_2002.pdf) at 38 and 42.

⁶ Memorandum Opinion and Order, In the Matter of Petition of WorldCom, Inc. Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc. and for Expedited Arbitration (CC Docket No. 00-218); In the Matter of Petition of AT&T Communications of Virginia Inc., Pursuant to Section 252 Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc.(CC Docket No. 00-251), DA 03-2738 (rel. August 29, 2003) at ¶ 104.

⁷ Marsh letter at 14; Exhibit JWS-1R.

- 38 • The depreciation lives proposed by SBC Illinois, related to loop investment,
39 are in fact longer than the CLECs use for their own financial reporting and are
40 more conservative than the updated lives that Technology Futures Inc (TFI)
41 calculated as proposed in SBC Illinois witness Dr. Lawrence Vanston's
42 testimony, as the following table illustrates:

	SBC⁸	TFI⁹	AT&T¹⁰	WorldCom¹¹
Depreciation Lives	15	12	10	7

43 **Q. ARE YOU SPONSORING ANY SCHEDULES?**

44 **A. Yes. I am sponsoring five Schedules:**

- 45 • Schedule JWS-R1 - Marsh Letter
- 46 • Schedule JWS-R2 –ARMIS Loop Investment
- 47 • Schedule JWS-R3 – CLEC Proposal
- 48 • Schedule JWS-R4 – SBC Proposal
- 49 • Schedule JWS-R5 – Replacement Cost Analysis

⁸ This figure represents the average economic life (weighted method) as calculated in SBC Illinois' LoopCAT (Rebuttal).

⁹ This figure represents the average economic life (weighted method) based on the TFI Analysis presented in the Direct Testimony of SBC Illinois witness Dr. Lawrence K. Vanston as calculated in SBC Illinois' LoopCAT (Rebuttal). Direct Testimony of Lawrence K. Vanston, ICC Cause No. 02-0864 (Dec. 23, 2002) at 38, 46 and Attachment LKV-2b at 5.

¹⁰ This average life is calculated based on the following formula (1 / Depreciation Rate), drawing the inputs from Table 4 of the Direct Testimony of SBC Illinois witness Dr. Lawrence K. Vanston, which illustrates the comparison of estimated depreciation rates. Direct Testimony of Lawrence K. Vanston, ICC Cause No. 02-0864 (Dec. 23, 2002) at 52, Table 4 (Comparison of Estimated Depreciation Rates).

¹¹ *Id.*

50 **II. TOTAL INVESTMENT AND OPERATING EXPENSES SERVE AS**
51 **IMPORTANT DATA POINTS FOR EVALUATING THE REASONABLENESS**
52 **OF COST RESULTS**

53 **Q. WHY ARE INVESTMENT AND OPERATING EXPENSES SIGNIFICANT IN**
54 **DETERMINING APPROPRIATE LOOP RATES?**

55 A. Ultimately, the investment required to construct a loop (that is, to physically build a loop
56 in the network) and the cost of operating and maintaining that loop on an annual basis are
57 the numbers that the final monthly UNE loop rate is designed to recover. The following
58 chart compares these crucial elements of SBC Illinois' and AT&T's proposals in this
59 proceeding:

	Investment per Loop¹²	Monthly Operating Expense per Loop¹³
SBC's Proposal	\$701	\$3.64
CLECs' Proposal	\$247	\$1.15

60 Clearly, the parties have widely divergent recommendations. Since the monthly loop rate
61 represents the amount required to compensate SBC Illinois for the costs it incurs in
62 providing the loop network, I have included a simple discounted cash flow analysis
63 which demonstrates the impact of each major input item (investment, cost of capital,
64 depreciation lives, and monthly operating expense). See Schedules JWS-R3, JWS-R4,
65 AND JWS-R5.

¹² This figure (weighted statewide) is derived from SBC Illinois' LoopCAT(Rebuttal) and the CLECs' restated LoopCAT.

66 **Q. WHAT WOULD BE ONE WAY FOR THE COMMISSION TO EVALUATE THE**
67 **REASONABLENESS OF THE COST RECOMMENDATIONS OF THE PARTIES**
68 **IN THIS PROCEEDING?**

69 A. Comparing forward-looking costs with actual costs is a useful way to consider the
70 reasonableness of competing TELRIC cost proposals. A forward-looking network must
71 start from somewhere. While TELRIC rules do not permit SBC Illinois to set prices for
72 the leasing of its unbundled network elements to recover its booked costs, it is perfectly
73 appropriate for the ICC to use SBC Illinois' actual booked costs to gauge whether
74 alternative cost proposals are within a range of reasonableness. As Dr. Aron states in her
75 rebuttal testimony,

76 "It is understandable that the UNE-P based CLECs would like to relegate
77 my testimony to "a sideshow," but in fact a comparison of purported
78 TELRIC cost estimates to actual, incurred costs, when performed as a
79 validity check, should be highly relevant to the Commission's
80 investigation. Such a comparison produces useful and analytically
81 meaningful insights. It is a well-established principle in economic and
82 financial modeling that projections and forecasts should be benchmarked
83 to reality to help guard against unreasonable results."¹⁴

84 In fact, Judge Easterbrook recently effectively stated as much in a decision out of the
85 United States Court of Appeals for the Seventh Circuit:

86 The district judge also thought that any use of actual fill factors (or asset
87 lives matching the company's financial reports) violates federal law
88 because TELRIC is forward looking, while depreciation looks to the past
89 and fill factors to the present. True enough, TELRIC calls for a

¹³ This figure (weighted statewide) represents SBC Illinois' LoopCAT (Rebuttal) and the CLECs' restated LoopCAT investment multiplied by the operating expense factors, based on the following formula: [Investment * (maintenance + other factors) / 12].

¹⁴ Rebuttal Testimony of Dr. Debra Aron, ICC Cause No. 02-0864 (January 20, 2004), at 5.

90 projection, but it does not demand that every ingredient be hypothetical.
91 *How could one know the long-run costs of the most efficient technology*
92 *without understanding the costs of today's most efficient producers?*¹⁵

93 **Q. IN LIGHT OF YOUR DISCUSSION ABOVE ABOUT USING ACTUAL COST**
94 **DATA, PLEASE EXPLAIN THE DATA YOU HAVE REVIEWED TO GAUGE**
95 **THE REASONABLENESS OF THE PROPOSALS IN THIS PROCEEDING.**

96 A. In order to examine the reasonableness of SBC Illinois' \$701 investment per loop
97 compared with AT&T's alternative investment proposal of \$247, I reviewed publicly
98 available numbers for gross plant investment of other telecommunications and network
99 service providers. The table below summarizes the relevant data that I reviewed.

Investment Comparison				
	SBC Illinois Proposed TELRIC¹⁶	Long Distance¹⁷	Wireless¹⁸	Cable¹⁹
Investment per subscriber	\$774	\$1,049	\$1,076	\$1,076

100 As the table shows, SBC Illinois proposed total investment is a conservative estimate
101 when compared with the investment-per-subscriber costs of cable, long distance, and
102 wireless services. This is a valid comparison since these investments represent the

¹⁵ *AT&T Communications of Illinois v. Illinois Bell Telephone*, Cause Nos. 03-2735 and 03-2766, at 13-14 (7th Cir. Nov. 10, 2003) (emphasis added).

¹⁶ The Total Proposed TELRIC investment is comprised of \$701 of statewide Loop investment, which was derived from SBC Illinois' LoopCAT (Rebuttal) and \$73 of statewide Port and Switching investment that was based on changes ordered by the ICC in Docket 00-0700.

¹⁷ AT&T 2002 Annual Report (available at <http://www.att.com/ar-2002/docs/ar2002.pdf>) at 1 and 53.

¹⁸ Sprint Corporation 10K Report for the fiscal year ended Dec. 31, 2001 (available at <http://www.sprint.com/sprint/ir/fn/10q10k/10k01.pdf>) at 31 and F-19.

¹⁹ Comcast Communications 10K Report for the fiscal year ended Dec. 31, 2002 (available at http://www.irconnect.com/comcast/annrep2002/pages/10k_2002.pdf) at 38 and 42.

103 financial costs of the company's entire network in an industry that has true competition.
104 SBC Illinois is in direct competition with cable Voice over Internet Protocol (VoIP)
105 services, long distance internet-based phone service, and wireless substitution. The
106 CLECs' proposal of \$247 investment per loop represents a mere 24% of the lowest
107 comparative investment listed above.

108 As another data point, I also compared both proposals to actual ARMIS data. In
109 order to consider replacement costs for the loop network, I adjusted the ARMIS data to
110 consider current labor costs.²⁰ I selected two other states with similar line densities to
111 SBC Illinois.²¹ The table below summarizes this data.

²⁰ Developed from 2002 ARMIS 43-04 Data, specifically a combined total of row 1277 plus row 1460 divided by the total working loops per the SBC Access Line Report (December, 2002), Total Switched. Schedule JWS-R2.

²¹ According to Dr. Aron, line density is generally considered to be a cost driver for telecommunication networks. She calculated the line density in SBC Illinois to be 587 lines per square mile. Other states with similar line densities include Florida and Massachusetts (both of which have line densities in the 500's). Rebuttal Testimony of Dr. Debra Aron, ICC Docket No. 02-0864 (January 20, 2004), p. 77.

SBC Illinois and CLEC Proposals vs. SBC Illinois Actual Costs						
	CLEC Illinois Proposed TELRIC	SBC Illinois Proposed TELRIC	SBC Illinois ARMIS Data²²	SBC Illinois ARMIS Data (adjusted for wage increases)²³	Verizon Massachusetts ARMIS Data (adjusted for wage increases)²⁴	BellSouth Florida ARMIS Data (adjusted for wage increases)²⁵
Investment per loop	\$247	\$701	\$772	\$909	\$1,065	\$1,531

112 The SBC Illinois ARMIS data above represents historical costs as maintained on SBC
113 Illinois balance sheets. As explained by Mr. Smallwood, this investment was placed over
114 time and, since the majority of this cost is labor for trenching and splicing, those costs
115 would need to be increased from the time they were placed to consider labor rates to
116 place the loop plant today. Therefore, we adjusted the ARMIS data to reflect current
117 costs. As demonstrated in the table above, SBC Illinois' proposed loop investment is
118 actually a full **23%** less than ARMIS at current costs. This TELRIC investment reflects
119 forward-looking adjustments and efficiency gains. In order to evaluate whether SBC
120 Illinois' ARMIS costs were reasonable, we also compared the SBC Illinois loop
121 investment to Verizon Massachusetts' and BellSouth Florida's loop investment. This

²² Developed from 2002 ARMIS 43-04 Data, specifically a combined total of row 1277 plus row 1460 divided by the total working loops per the SBC Access Line Report (December, 2002), Total Switched. Schedule JWS-R2.

²³ *Id.*

²⁴ Developed from 2002 ARMIS 43-04 Data, specifically a combined total of row 1277 plus row 1460, divided by the total working loops per the SBC Access Line Report (December, 2002), Total Switched. Adjusted for wage rate increases using SBC data. [$\$905 * (\$909 / \$772)$]. Schedule JWS-R2.

²⁵ Developed from 2002 ARMIS 43-04 Data, specifically a combined total of row 1277 plus row 1460, divided by the total working loops per the SBC Access Line Report (December, 2002), Total Switched. Adjusted for wage rate increases using SBC data. [$\$1,300 * (\$909 / \$772)$]. Schedule JWS-R2.

122 comparison demonstrates that SBC Illinois' loop investment is in fact more economical
123 than Verizon Massachusetts' and BellSouth Florida's.

124 **Q. WHAT CONCLUSION SHOULD THE COMMISSION DRAW FROM YOUR**
125 **COMPARISON OF SBC ILLINOIS' PROPOSED FORWARD-LOOKING LOOP**
126 **INVESTMENT AND OPERATING EXPENSES WITH ACTUAL LOOP**
127 **INVESTMENT AND OPERATING EXPENSES OF SBC ILLINOIS AND OTHER**
128 **CARRIERS?**

129 A. The analysis performed indicates the SBC Illinois' proposed loop investments and
130 operating expenses reflect forward-looking productivity gains while AT&T's proposals
131 are only a fraction of what is required to operate a loop network.

132 **III. OTHER KEY INPUTS FOR THE COST STUDIES ARE COST OF CAPITAL**
133 **AND DEPRECIATION LIVES.**

134 **Q. HOW IMPORTANT ARE COST OF CAPITAL AND DEPRECIATION IN**
135 **DETERMINING LOOPCOSTS?**

136 A. As demonstrated in the Schedules attached, the impact of these inputs is significant to the
137 monthly loop cost. For example, a 20% change in cost of capital results in an
138 approximately \$2 per month change in monthly loop cost. Depreciation lives determine
139 the time period over which the loop investment is recovered. A 20% change in the
140 depreciation life results in an approximately \$1 change in the monthly loop cost.

141 **A. COST OF CAPITAL**

142 **Q. WHAT IS THE APPROPRIATE TELRIC COST OF CAPITAL FOR USE IN THE**
143 **SBC ILLINOIS COST STUDIES?**

144 A. As explained by Dr. Avera, 12.19% is a conservative estimate of the cost of capital for
145 use in forward-looking cost studies and is appropriate for pricing SBC Illinois' UNEs.
146 The following chart compares SBC Illinois' cost of capital proposal to the CLECs' cost
147 of capital proposal (sponsored by CLEC witness Terry Murray) in this proceeding:²⁶

	CLEC	SBC Illinois
Cost of Capital	7.54%	12.19%

²⁶ Please note that all of these rates are net of tax.

148 Other relevant cost of capital rates include the following:

FCC ²⁷	Verizon- Virginia ²⁸	AT&T ²⁹	Average
11.25%	12.95%	15.00%	13.07%

- 149
- The FCC indicated in its 1996 First Report and Order that 11.25% should be a starting point for cost of capital.
- 150
- The FCC's Wireline Competition Bureau conducted an arbitration in the stead of the Virginia commission under 47 U.S.C. § 252(e)(6) and issued an order in 2003 in which the Bureau chose a higher cost of capital which considered the current risk in the industry.
- 151
- Cost of capital rates such as those proposed by AT&T³⁰ to the FCC in ex parte filings represents another valid comparison.
- 152
- 153
- 154
- 155
- 156

157 As illustrated above, SBC Illinois' proposed cost of capital, calculated to reflect the increased risk in the telecommunications industry today, is comparable (if not low) relative to the average of these cost of capital rates.

158

159

²⁷ *Report and Order and Order on Remand and Further Notice of Proposed Rulemaking*, In the Matter of Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers (CC Docket No. 01-338); Implementation of the Local Competition Provisions of the Telecommunications Act of 1996 (CC Docket No. 96-989); Deployment of Wireline Services Offering Advanced Telecommunications Capability (CC Docket No. 98-147), FCC No. 03-36, (rel. Aug. 21, 2003) (TRO) at ¶ 678; In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; Interconnection between Local Exchange Carriers and Commercial Mobile Radio Service Providers, CC Docket Nos. 96-98 & 95-185, First Report and Order, FCC 96-325, 11 F.C.C.R. 15499, 1996 FCC LEXIS 4312 (1996) (First Report and Order) at ¶ 702.

²⁸ Memorandum Opinion and Order, In the Matter of Petition of WorldCom, Inc. Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc. and for Expedited Arbitration (CC Docket No. 00-218); In the Matter of Petition of AT&T Communications of Virginia Inc., Pursuant to Section 252 Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc.(CC Docket No. 00-251), DA 03-2738 (rel. August 29, 2003) at ¶ 104.

²⁹ Marsh letter at 14; Exhibit JWS-1R.

160 **Q. IN WHAT CONTEXT HAS THE FCC COMMENTED THAT 11.25% SHOULD**
161 **BE A STARTING POINT FOR COST OF CAPITAL IN TELRIC**
162 **PROCEEDINGS?**

163 A. In the First Report and Order in 1996, the FCC stated that the “currently authorized rate
164 of return at the federal or state level is a reasonable starting point.”³¹ The Commission
165 also noted that 11.25 percent was the currently authorized rate of return at the federal
166 level, but held that states may “adjust the cost of capital if a party demonstrates to a state
167 commission that either a higher or lower level of cost of capital is warranted.”³² The FCC
168 more recently clarified in the Triennial Review Order (TRO) that:

169 To ensure that UNE prices set by the states appropriately reflect the risks
170 associated with new facilities and new services, we think it would be
171 helpful to clarify two types of risks that should be reflected in the cost of
172 capital. First, we clarify that a TELRIC-based cost of capital should
173 reflect the risks of a competitive market. The objective of TELRIC is to
174 establish a price that replicates the price that would exist in a market in
175 which there is facilities-based competition. In this type of competitive
176 market, all facilities-based carriers would face the risk of losing customers
177 to other facilities-based carriers, and that risk should be reflected in
178 TELRIC prices³³.Second, we clarify that a TELRIC-based cost of
179 capital should reflect any unique risks (above and beyond the competitive
180 risks discussed above) associated with new services that might be
181 provided over certain types of facilities.³⁴

³⁰ Marsh letter at 14; Exhibit JWS-1R

³¹ First Report and Order at ¶ 702; *see also* TRO at ¶ 678.

³² First Report and Order at ¶ 702.

³³ TRO at ¶ 680.

³⁴ TRO at ¶ 683.

182 **B. DEPRECIATION**

183 **Q. WHAT DEPRECIATION LIVES SHOULD APPROPRIATELY BE USED IN SBC**
184 **ILLINOIS' COST STUDIES?**

185 A. As explained by Dr. Vanston, the depreciation rates used by SBC Illinois, based on the
186 lives used for financial reporting purposes, are reasonable. In fact, if anything, they are
187 conservative based on his TFI analyses. The following chart compares various
188 depreciable lives for loop equipment as proposed in this proceeding:

Loop Depreciation Rate			
Source	CLEC³⁵	SBC³⁶	TFI³⁷
Average Life (Years)	22	15	12

189 As demonstrated above, the CLEC proposal is based on longer lives, which reduces
190 annual depreciation expense. In contrast, TFI's analysis would support shorter lives and
191 increased depreciation expense, which would result in higher UNE rates.

192 **Q. HOW DO SBC'S OVERALL DEPRECIATION RATES COMPARE WITH**
193 **THOSE OF OTHER TELECOMMUNICATIONS COMPANIES?**

³⁵ This figure represents the average economic life (weighted method) as calculated in the CLECs' restated LoopCAT.

³⁶ This figure represents the average economic life (weighted method) as calculated in SBC Illinois' LoopCAT (Rebuttal).

³⁷ This figure represents the average economic life (weighted method) based on the TFI Analysis presented in the Direct Testimony of SBC Illinois witness Dr. Lawrence K. Vanston as calculated in SBC Illinois' LoopCAT (Rebuttal). Direct Testimony of Lawrence K. Vanston, ICC Cause No. 02-0864 (Dec. 23, 2002) at 38, 46 and Attachment LKV-2b at 5.

194 A. As discussed in the testimony of Dr. Vanston, SBC overall depreciation rate is lower than
195 that of both AT&T and WorldCom. This comparison is illustrated in the following table:

Overall Depreciation Rate			
Company	SBC	AT&T	WorldCom
Depreciation Rate ³⁸	7.3%	9.6%	14.6%
Average Life (Years)	13.7	10.4	6.8

196 The average life in years is calculated as (1 / Depreciation Rate) for each company listed
197 above. Since SBC rate is lower, the average life used for depreciation purposes is longer
198 than the lives used by both AT&T and WorldCom. Notably, AT&T's average
199 depreciable life is less than half of what it proposed in this proceeding. Even more
200 remarkably, WorldCom's average depreciable life is less than one-third of what it
201 proposed in this proceeding.

202 **Q. WHAT DOES THIS HIGH-LEVEL OVERVIEW OF DEPRECIATION RATES**
203 **DEMONSTRATE FOR PURPOSES OF THIS PROCEEDING?**

204 A. This overview demonstrates that SBC's depreciation lives are conservative when
205 compared to the CLEC's own depreciation lives and when compared to the updated
206 analysis performed by TFI and supported by Dr. Vanston.

³⁸ These figures are based on the data in Table 4 of the Direct Testimony of SBC Illinois witness Dr. Lawrence K. Vanston, which illustrates the comparison of estimated depreciation rates. Direct Testimony of Lawrence K. Vanston, ICC Cause No. 02-0864 (Dec. 23, 2002) at 52, Table 4 (Comparison of Estimated Depreciation Rates).

207 **IV. A HIGH-LEVEL COMPARISON OF THE ALTERNATIVE COST PROPOSALS**
208 **THAT HAVE BEEN PLACED BEFORE THE COMMISSION DEMONSTRATES**
209 **THAT SBC ILLINOIS', AND NOT THE CLECS', ARE REASONABLE**

210 **Q. WHY, THEN, ARE THE PROPOSALS OF SBC ILLINOIS AND THE CLECS IN**
211 **THIS PROCEEDING SO DIFFERENT?**

212 A. Simply put, because the CLECs' proposals are demonstrably unreasonable. Consider the
213 following information obtained from 2002 Annual reports, which compares SBC Illinois'
214 and AT&T's actual monthly operating expenses with their proposals in this proceeding:

	AT&T	SBC
OPEX/Month (per customer-AT&T, per line - SBC)	\$52.00	\$50.00
Administrative costs per month (based on proposed shared & common costs)	8.88% or \$5.00	30.18% or \$15.00
Non-Recurring costs per month	\$19.00	\$14.00
Recurring costs per month	\$28.00	\$21.00
Loop Portion	38%	38%
Monthly OPEX / Month – Loop	\$10.64	\$7.98
Proposed OPEX/Month	\$1.15	\$3.64

215 The above information was calculated using publicly available operating expense
216 information and using each party's proposed shared and common cost factor to calculate
217 administrative costs. The remaining monthly operating expenses were split between
218 recurring (60%) and non-recurring (40%) activities. The percentage or portion of the
219 monthly operating expenses constituting loop expenses (i.e. 38%) is derived from the
220 SBC 2002 Annual report.³⁹

³⁹ SBC Communications, Inc. 2002 Annual Report at 44, Note 5 (Property Plant & Equipment).

221 Based on this analysis, SBC Illinois' proposed monthly operating expenses are only 55%
222 of what we actually incur today. This demonstrates that we have considered both
223 forward-looking efficiencies and productivity improvements in our proposal. AT&T's
224 proposal, on the other hand, comes in at only 17% of SBC Illinois' actual costs and is
225 therefore clearly unreasonable. AT&T's proposed monthly operating expense per loop of
226 \$1.15 is one third of SBC Illinois' proposal. In this regard, the observations of another
227 state commission faced with the same task are instructive . The Commission in New
228 Jersey had the task of evaluating similar CLEC proposals and concluded the following:

229 Chief among our concerns is a fact pointed out by Verizon NJ that
230 revealed that the HAI model assumes that Verizon's entire network could
231 be constructed for less than one-third of Verizon NJ's existing investment
232 and that it could be operated for approximately one-fifth of Verizon NJ's
233 current operating expenses. (VNJb at 25). Although we recognize that
234 forward-looking investment and operating costs are likely to be less than
235 embedded or current costs, the substantial nature of the difference between
236 the HAI cost estimates and Verizon NJ's actual experience is indeed
237 dramatic and suggests to the Board that the HAI Model may potentially
238 understate forward-looking costs.

239 Even though the CLECs did not introduce the HAI model in this proceeding, the
240 magnitude of the difference between AT&T's proposed investment and operating
241 expenses, compared to SBC Illinois' actual experience, are equally dramatic here.

242 **Q. CAN YOU PROVIDE THIS COMMISSION WITH A TOOL TO EVALUATE**
243 **THESE PROPOSALS IN MORE DETAIL?**

244 A. Yes. I have attached a very abbreviated cash flow analysis to my testimony that
245 calculates the monthly cost under each of these proposals listed above. This spreadsheet
246 calculates the net present value of cash outflows considering all the inputs listed above.
247 The monthly cost is the point at which the net present value of the cash flows over the

248 depreciation life is zero.⁴⁰ The following chart shows the sensitivity of the loop cost with
 249 a 20% variation in each key input.



- 250 • A 20% change in the loop investment would result in a \$2.00 shift in monthly
 251 cost.
- 252 • A 20% change in the cost of capital would result in a \$2.00 variation in monthly
 253 cost.
- 254 • Adjusting the operating expense by 20% impacts the monthly cost by less than
 255 \$1.00.
- 256 • Adding 20% to the depreciation lives reduces the monthly cost by less than a
 257 dollar.

⁴⁰ See Schedules JWS-R3, JWS-R4 and JWS-R5.

258 **V. CONCLUSION**

259 **Q. WHAT WOULD BE SOME OF THE REAL WORLD IMPLICATIONS OF**
260 **AT&T’S RECOMMENDATION?**

261 A. SBC Illinois employs 13,888⁴¹ people in the state of Illinois. AT&T’s recommendation
262 for operating expense suggests that SBC Illinois should be able to reduce that employee
263 base and annual compensation by a remarkable 68%.⁴² This would result in SBC Illinois’
264 eliminating 9,444⁴³ employees from its payroll. Approximately two out of every three
265 employees in the state of Illinois would be affected by this reduction. The company
266 would be required to operate a network of almost 7 million lines⁴⁴ with a staff of 4,444
267 employees, or a mere 32% of the current employee base in Illinois.

268 As illustrated below, if all existing loops were leased at the AT&T-proposed UNE-P
269 rate, SBC Illinois would not receive enough revenue to cover even the reduced operating
270 expense necessary to maintain the network, much less to cover its forward-looking labor
271 costs or generate any cash to be used for future capital investments.

272 To illustrate, consider the projected results shown in the following table:

SBC ILLINOIS		
	Projected Results after 68% reduction (\$millions)	Projected Results based on current operating expense (\$millions)

⁴¹ ARMIS 43-02 (December, 2002), Row 830.

⁴² The 68% reduction in employee base was calculated by taking the percent difference between SBC Illinois’ proposed operating expense of \$3.64 and the CLECs’ proposed operating expense of \$1.15, or $[1 - \$1.15/\$3.64]$.

⁴³ The 68% reduction in employees would result in the elimination of 9,444 employees, which is equal to $[13,888 * .68]$.

⁴⁴ SBC Access Line Report (December, 2002), Total Switched.

Total Operating Revenues (if 100% UNE-P) ⁴⁵	\$532	\$532
Operating Expense	\$931 ⁴⁶	\$2,910 ⁴⁷
Net Operating Income	\$(399)	\$(2,378)

273 AT&T is asking the Commission to believe that SBC Illinois could, today, using
274 currently available equipment and engineering methods, operate the network with one-
275 third of the employees we have today. That claim is simply facially unreasonable. At the
276 end of the day, the Commission must ask itself if it believes that SBC Illinois could
277 improve its efficiency to such a degree in the forward-looking environment. The
278 Commission should also ask itself if it believes that the CLECs (or any carrier) could
279 build and operate a local exchange network at their proposed level of so-called
280 “efficiency”. Clearly the SBC Illinois proposal is the most reasonable of the alternatives
281 presented. If the CLECs truly believed the cost of loops was as low as they suggest, then
282 good business sense dictates that they would have been building loops based on a
283 statewide average of \$3.64 rather than paying SBC Illinois \$9.66 per month. Reasonable
284 UNE loop rates will allow SBC Illinois to maintain and continue to improve the SBC
285 Illinois network and simultaneously provide the right price signals to encourage the
286 CLECs to build their own facilities. That is the formula for stimulating healthy

⁴⁵ This figure represents the CLECs’ UNE-P rate of \$6.57 per month multiplied by the total working loops per SBC Access Line Report (December, 2002), Total Switched of 6,752,204, then annualized, which is equal to [(6.57*12) * 6,752,204].

⁴⁶ This figure is calculated by reducing total operating expense per ARMIS 43-02 (December, 2002), Row 720 by 68% of total operating expense, which is [2,910,029,000-(2,910,029,000*.68)].

⁴⁷ ARMIS 43-02 (December, 2002), Row 720.

287 telecommunications competition in accordance with the Telecommunications Act of
288 1996 and the FCC's directions.

289 **Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

290 **A. Yes.**