BEFORE THE ILLINOIS COMMERCE COMMISSION

Docket No. 02-0864

SURREBUTTAL TESTIMONY OF DAVID J. BARCH
On Behalf of SBC Illinois

SBC Illinois Exhibit 7.2

PUBLIC VERSION

March 5, 2004

[NOTE: Struck-through language indicates material that was stricken as part of order on motion to strike issued on March 16, 2004.]

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1. Schedule DJB-S01 (Confidential)
Recalculated SBC Illinois Shared & Common Cost Study

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Sales, General, and Administrative Expense Analysis of Telecommunications Companies

3. Schedule DJB-S03 (Confidential)
Analysis of SBCI's ACFs Adjusted for Expensed Cost of Removal

I. PURPOSE AND OVERVIEW

Q1. PLEASE STATE YOUR NAME.

A1. My name is David J. Barch.

Q2. ARE YOU THE SAME DAVID BARCH WHO PRE-FILED DIRECT AND REBUTTAL TESTIMONIES IN THIS DOCKET ON BEHALF OF SBC ILLINOIS ("SBCI")?

A2. I am.

Q3. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A3. The purpose of my surrebuttal testimony is to address certain statements and conclusions from the following witnesses, who filed rebuttal testimony on behalf of intervening parties or Staff in this proceeding: Karen Chang, Mark Hanson, Thomas Smith, Harry Gildea, Susan Baldwin, William Dunkel, Michael Majoros, Robert Flappan, Steven Turner, joint witnesses August Ankum and Sidney Morrison, and joint witnesses Michael Starkey and Warren Fischer. My surrebuttal is not intended to be the sole response on behalf of SBCI to the rebuttal testimonies of the above witnesses; rather, it should be reviewed in conjunction with all of the relevant SBCI witnesses filing surrebuttal testimony.

Q4. PLEASE PROVIDE AN OVERVIEW OF HOW YOUR SURREBUTTAL TESTIMONY IS STRUCTURED.

A4. The sequence of topics I cover in my surrebuttal is outlined as follows:

- Shared and Common Cost Factor

Common Factor

Shared Factor

- Labor Rates

- Support Assets

- Annual Cost Factors, Productivity, Regulated/Nonregulated Accounting Data, and Depreciation

- Switch-Related Nonrecurring Costs

SBCI witnesses Tim Dominak and William Palmer serve as primary supplement to my cost factor testimony, which is and has been the majority of my direct, rebuttal and surrebuttal testimony.

II. SHARED AND COMMON COST FACTOR

Q5. IS THE RESULT OF STAFF'S RESTATEMENT[1] OF SBCI'S SHARED AND COMMON FACTOR REASONABLE?

A5. No. Staff's proposed percentages for Shared and Common costs (and uncollectibles) are too low, in large part because they ignore costs that SBC Illinois will incur and that should be included in a reasonable shared and common cost recovery mechanism. The factors proposed by the Joint CLECs are absurdly low and bear no resemblance to the appropriate forward-looking Shared and Common (and uncollectible) costs of SBCI.

Q6. OTHER THAN SIMPLY COMPARING INTERVENING PARTIES' S&C RESTATEMENTS TO SBCI'S, ARE THERE OTHER AVAILABLE DATA TO ASSESS REASONABLENESS OF S&C RESTATEMENTS?

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[1] Chang Surrebuttal Testimony at 10, including Schedules 1 and 2. Staff's proposal is **[BEGIN CONFIDENTIAL]***********************[END CONFIDENTIAL]** for Shared and Common costs and a **[BEGIN CONFIDENTIAL]***********************[END CONFIDENTIAL]** uncollectible factor (admittedly based on revenue, not cost). The Joint CLECs' proposal is **[BEGIN CONFIDENTIAL]***********************[END CONFIDENTIAL]** for Shared and Common costs, including uncollectibles. This amount is not reflective of their recommendation, given in their rebuttal testimony, to transfer support assets to common costs.

A6. Yes. One practical measure of reasonableness is an understanding of sales, general, and administrative (SG&A) costs compared to "other" (*i.e.*, direct or non-SGA) costs for major telecommunications companies, including AT&T. SBCI was able to obtain information from Securities and Exchange Commission 10K and 10Q reports and has presented summaries of this data in Schedule DJB-S02. These reports yield estimates of AT&T's SG&A cost *as a percentage of other or direct costs*[2] = **<u>28%</u>**. This is AT&T's average over roughly a ten year period. Although Worldcom/MCI only reported data for three years in the mid-90s, their percentage is about **<u>22%</u>**. The SG&A analysis, while not precisely identical, is analogous to the broad conceptual framework underlying SBCI's S&C factor. The SG&A analysis, relying solely on public data, shows over an extended period that the proposed reductions to SBCI's S&C factors produce patently unreasonable results.

Common Factor

Q7. MR. SMITH OF ICC STAFF AND MESSRS. STARKEY AND FISCHER REAFFIRM THEIR POSITIONS ON SBCI'S TRANSITION BENEFIT OBLIGATION ("TBO") AS A NON-FORWARD LOOKING COST THAT SHOULD NOT BE INCLUDED IN THE <u>COMMON COST NUMERATOR</u>.[3] ADDITIONALLY, MESSRS. STARKEY AND FISCHER CONTINUE THEIR

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2 Direct costs were approximated by taking filed revenues less operating expenses less SG&A costs, plus return and tax. This is conceptually similar to SBCI's common cost denominator without its forward-looking adjustments.

3 Smith Surrebuttal Testimony at 2-3, 8-9; Starkey/Fischer Surrebuttal Testimony at 29-35.

CRITIQUE OF SBCI'S REMOVAL OF WHAT IT CONSIDERS NON-FORWARD LOOKING PENSION SETTLEMENT GAINS.[4] PLEASE RESPOND.

A7. SBCI witness Mr. Dominak continues in his surrebuttal to be the primary source of SBCI testimony on the appropirateness of TBO as a forward-looking common cost and 2001 pension settlement gains as anomolous and therefore, non-forward looking.

Q8. MR. SMITH REPEATS HIS CRITICISM OF SBCI NOT REFLECTING HEADCOUNT REDUCTIONS ATTRIBUTABLE TO MERGER SAVINGS IN THE <u>COMMON COST NUMERATOR</u>.[5] PLEASE RESPOND.

A8. Mr. Smith misunderstands the point I was making in my rebuttal testimony. I agree that if common wage expense were to decrease, and nothing else changed, then the common cost allocation to UNEs would be lower. However, one cannot assume that "nothing else changes". The same decreases in SBCI employee headcount (a decrease that does not necessarily translate into lowered common expense, as Mr. Dominak explained in his rebuttal), would logically impact *both* the shared/common category *and* the direct category because payroll expense is a component of both of them. Given that the rationale for recent SBC headcount reductions has been to adjust force to load (*i.e.*, to account for decreased customer demand), it is likely that reductions have been directed primarily at network-related functions. These would reduce direct costs. The direct category serves as an input into both the TELRIC studies and the denominator to the Shared and Common cost study. Therefore, it is improper to flow through a change in the numerator only. Again, it is likely that changes in the numerator *and* denominator of

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4 Starkey/Fischer Surrebuttal Testimony at 35-39.

5 Smith Surrebuttal Testimony at 14.

SBCI's proposed Shared and Common factors will largely offset one another, resulting in a negligible change, or no change at all, to the overall Shared and Common factor.

Q9. MESSRS. STARKEY AND FISCHER CRITICIZE SBCI'S <u>COMMON COST NUMERATOR</u> AS NON-FORWARD LOOKING BECAUSE OF RELATIVELY FEW "ADJUSTMENTS."[6] PLEASE RESPOND.

A9. The CLECs' criticism is largely a repeat of what was presented in a prior round of testimony; namely, they argue that SBCI's numerator is deficient because it is largely based on historical 2001 ARMIS data. As I have explained previously, these data are a reasonable estimation of the common costs SBCI will incur in the future. Thus, there is no "mismatch" between numerator and denominator and Starkey/Fischer have presented no evidence that supports their position.

Q10. MESSRS. STARKEY AND FISCHER CONTEND THAT SBCI IS TRYING TO SHIFT THE BURDEN OF PROOF ON THE 67XX ACCOUNTS.[7] PLEASE COMMENT.

A10. As SBCI explained in its rebuttal testimony, costs such as those seen in the 67xx accounts are traditional "common overhead" accounts and are not economically attributable to individual or shared *direct* services and UNEs. As I understand their testimony, Messrs. Starkey and Fischer want to allocate some of these costs out of the proverbial common bucket based largely on bare assertions that more precise allocations can and should be made to retail services. Since this methodology is being proposed by the Joint CLECs and not SBCI, they should bear some responsibility for justifying it. In other words, the

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6 Starkey/Fischer Surrebuttal Testimony at 9-10.

7 *Id.* at 15-16.

burden should not fall exclusively on SBCI to disprove it. I demonstrated in my rebuttal testimony that the specific examples presented by Starkey/Fischer in support of their allocation proposal did not prove their point and they present no additional examples here.

Q11. MESSRS. STARKEY AND FISCHER CONTINUE TO ARGUE THAT COSTS MUST BENEFIT THE CLECS TO BE INCLUDED IN THE SHARED AND COMMON COST ALLOCATION.[8] PLEASE COMMENT.

A11. Messrs. Starkey and Fischer and I disagree on this point; however, it does not *matter* in the context of this proceeding. Their apparent obsession with Senate Bill 885 continues despite the fact that, (1) since all lobbying costs are booked to below-the-line accounts (as I explained in my rebuttal testimony), there are *no* such costs in the S&C factor; and (2) any legislative activities associated with Senate Bill 885 occurred in *2003*, well after the 2001 period I used to develop my factor. (In fact, legislative activity in 2001 resulted, *inter alia*, in Section 13-801 of the PUA, which I understand the CLECs supported). In short, there is no basis for their assertion that the majority of the costs in Account 6722 (External Relations) protect the Company's retail operations.

Similarly, Messrs. Starkey and Fischer rail against the fact that this UNE proceeding even exists. However, TA96 requires TELRIC-compliant rates, regardless whether any required rate changes are increases or decreases. Furthermore, since this case is taking place in *2003* and *2004*, there are *no* costs associated with it in my common cost factor. As I understand it, the regulatory proceedings in 2001 were more to the

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[8] *Id.* at 21-24.

CLECs' liking, since they involved lowering ULS/shared transport rates (Docket No. 00-0700), implementation of Section 13-801 (Docket No. 01-0614) and adoption of a wholesale remedy plan (Docket 01-0120).

Q12. ARE OTHER RECOMMENDATIONS BY MESSRS. STARKEY AND FISCHER CONSISTENT WITH THEIR INSISTENCE TO DRIVE COMMON COSTS DIRECTLY TO ELEMENTS?

A12. No. The primary example of this inconsistency relates to their proposal to shift support asset costs, which SBCI's TELRIC studies treat as direct costs, to the common cost numerator. Although not recommended in their direct testimony, Messrs. Starkey and Fischer did recommend this transfer of costs in the January 20, 2004 rebuttal testimony. As I've heretofore explained in direct and rebuttal testimonies (and will address later in this surrebuttal), support assets costs directly enable labor functions included in SBCI's direct cost TELRIC studies. SBCI's treatment of support asset costs as direct costs is in harmony with the Joint CLECs' oft-cited FCC directive to assign as many costs as possible directly to elements. That is what SBCI has done with its treatment of support asset costs as direct rather than common. The only perceivable reason the Joint CLECs give for its contradictory position is that support asset costs are supposedly incapable of being reasonably allocated to any particular service or product. However, I've previously shown why support asset costs enable direct labor activities included in specific TELRIC studies.

Q13. MESSRS. STARKEY AND FISCHER ALLEGE THAT YOU WERE "OBVIOUSLY AWARE" OF A CERTAIN ERROR IN THE <u>COMMON COST</u>

_____________, WHICH COULD HAVE BEEN CORRECTED IN THE DIRECT PHASE OF THIS PROCEEDING BUT WAS NOT.[9] IS THIS TRUE?

A13. No. The error is described in a SBCI discovery response, which Messrs. Starkey and Fischer reproduce in their surrebuttal testimony. I was not aware of this accounting misclassification until *after* the discovery request was received by SBCI, which was much later than the date when SBCI filed its direct case. As noted in the discovery response, SBCI readily accepts this correction. I have attached the revised Shared and Common study as Attachment DJB-S01, which reflects a revised factor reflecting this correction and one another I discuss later herein.

Q14. IN MICHIGAN, SBC RECENTLY FILED A RESALE AVOIDED COST STUDY, WHICH MESSRS. STARKEY AND FISCHER POINT TO AS PROVIDING SUPPORT FOR THEIR POSITION OF USING AN AVOIDED COST PERCENTAGE TO REDUCE SBCI'S <u>COMMON COST NUMERATOR</u>.[10] PLEASE RESPOND.

A14. The purpose of a resale avoided cost study is to meet the requirement set forth in Sections 251(c)(4) and 252(d)(3) of the Telecommunications Act of 1996. The purpose is not to provide an allocation mechanism for a Shared and Common cost study.[11] The latter section referenced of the Act provides that resale rates shall be determined "on the basis of retail rates charged to subscribers for the telecommunications service requested,

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[9] *Id.* at 18-21.

[10] *Id.* at 25-28.

[11] The sole reason SBC Michigan filed an updated Avoided Cost study in Michigan is because Michigan Public Service Commission rules dictate that cost filings must be comprehensive. That is, Michigan rules preclude SBC Michigan from filing a subset of UNE studies. In fact, Michigan rules require the cost proceedings must examine all existing elements, wholesale and retail. The fact that SBC Michigan filed an updated Avoided Cost study in Michigan has no bearing on the Shared & Common costs in Michigan, much less in Illinois.

excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier." A resale avoided cost study fails to be applicable in supposedly removing retail costs from common costs because of the fact that this would double-assign common costs to retail. The very structure of SBCI's common cost factor already addresses Messrs. Starkey's and Fischer's concern that costs that are perceived to be related to retail services be assigned to them, by allocating *all* common costs to *all* (i.e., total) direct costs. In effect, to the extent that there are these unproven kinds of common costs, retail and wholesale each get a proportional share. Furthermore, by taking "retail-related" costs out of the numerator (which are then theoretically assigned to retail services) separately and then assigning everything else based on essentially the same, unadjusted denominator, then the Joint CLECs have a true mismatch. This would result in the inappropriate result of retail receiving a double dose of common costs.

In their direct testimony, the Joint CLECs proposed the avoided cost percentage only in the context of the numerator, omitting any discussion of what direct costs would be "avoided" in the denominator by SBCI serving only retail customers. In their surrebuttal testimony, the Joint CLECs finally concede, in principle, that there is some merit in adjusting the common cost denominator (direct costs); however, they provide for the possibility of only a very limited decrease (an assumption with which I disagree) and do not make one in any event. As I explained in rebuttal testimony, if "retail" costs are removed from the numerator of pooled common costs, then the portion of the plant or direct costs supporting those shared retail services must be removed from the denominator to avoid artificially reducing the S&C factor through a mismatch of the numerator and the denominator. It stands to reason that, given the scope of SBCI's retail operations, the portion of SBCI's network required to provide its retail services is a very sizable amount. There is no attempt made on their behalf to identify the substantial amount of network, plant, facilities, switching, circuit equipment and other direct costs that serves retail, and therefore would be "avoided." If one were to attempt to make the required adjustment to the denominator, the most likely result is a complete offset to the effect of their numerator adjustment and no net change to the S&C factor.

Q15. MESSRS. STARKEY AND FISCHER PRESENT SEVERAL CRITICISMS OF SBCI'S <u>COMMON COST DENOMINATOR</u>.[12] PLEASE ADDRESS WHAT THESE ARE AND RESPOND.

A15. In summary, I understand the denominator criticisms of Messrs. Starkey and Fischer to be the following:

1) SBCI's proposed denominator is inconsistent with the numerator,

2) SBCI's proposed denominator is inconsistent with prior ICC cost orders,

3) SBCI's proposed denominator contains irreconciable, perhaps erroneous, loop counts that contribute to SBCI's forward-looking adjustment, and

4) SBCI's reliance upon the lesser costly variety of loops (*i.e.*, 2-wire analog loops) in the forward-looking adjustment understates denominator costs, thereby overstating the proposed S&C factor.

My response to each of the above is as follows:

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12 Starkey/Fischer Surrebuttal Testimony at 10-14.

First, I explained in rebuttal testimony the forward-looking consistency of SBCI's proposed numerator and denominator. I also explained why the common factor proposed by Messrs. Starkey and Fischer would create a true "mismatch" between the numerator and denominator.

Second, Messrs. Starkey and Fischer neither explain nor cite just exactly how SBCI's proposed S&C factor methodology, particularly the denominator, is inconsistent with prior ICC cost orders (namely, 98-0396). Indeed, it wouldn't be unreasonable to describe SBCI's forward-looking adjustment to the denominator as essentially nothing new to what the ICC already inherently approved (*i.e.*, the denominator of "extended TELRIC") regarding the current S&C factor for SBCI.

Third, Messrs. Starkey and Fischer observe that the "total loop count in the 2001 NECA USF data is approximately half a million loops higher than the number SBC used in its shared and common cost model."[13] The Joint CLECs misinterpret this data. As I understand it, the "2001" NECA loop count pertains to the *report* date, not the *data* date. The data in the Starkey/Fischer FCC-NECA-USF cite actually pertains to the period of 2000. Notwithstanding this misinterpretation, I understand that SBCI's working loop count of 7,172,021 (used in SBCI's previously submitted S&C study) was a preliminary number that was subsequently finalized to be 7,400,361. SBCI has revised its S&C study to reflect the final and correct figure. This, coupled with the accounting correction I mentioned earlier, reduces SBCI's proposed S&C factor to **[BEGIN**

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13 *Id.* at 13.

CONFIDENTIAL]*********[END CONFIDENTIAL]** as seen in Schedule DJB-S01.

Fourth, the vast majority of loops are 2-wire analog loops, as they comprise lines serving virtually all residential and small business customers in Illinois. Even acknowledging that other loop varieties (*e.g.*, 4-wire) are more costly to SBC, any such increase for these other loop varieties would be substantially diluted when proportionately weighted with the dominant 2-wire analog loops. Therefore, SBC's straightforward modeling assumption of relying upon 2-wire analog loops is reasonable.

Shared Factor

Q16. IN THEIR REBUTTAL TESTIMONY, MR. SMITH OF ICC STAFF AND MESSRS. STARKEY AND FISCHER CONTINUE DISCUSSION ON THEIR PROPOSALS FOR AN UNCOLLECTIBLE FACTOR THAT SHOULD REPLACE SBCI'S PROPOSED FACTOR.[14] PLEASE RESPOND.

A16. SBCI witness Mr. Dominak continues in his surrebuttal to be the primary source of SBCI testimony on the appropriateness of the amount of SBCI's wholesale uncollectible costs and forward-looking estimates. In addition to my rebuttal testimony, there is some further response warranted regarding the mechanism in applying uncollectibles to TELRICs.

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[14] Smith Surrebuttal Testimony at 9-11; Starkey/Fischer Surrebuttal Testimony at 46-54.

Staff's proposal for a revenue-based denominator is a disruption to SBCI's consistent use of cost-based denominators. Without regard for economic consistency, this proposal has the effect of producing a very low factor that diverges from a cost foundation. However, given that this is a cost proceeding for the purpose of determining forward-looking costs, the introduction of a revenue-based factor has not been justified, from a cost relevance perspective, in this proceeding.

Q17. WHY IS CONSISTENT USE OF COST-BASED DENOMINATORS TO CALCULATE THE S&C FACTOR NECESSARY AND CORRECT?

A17. As I explained in my prior testimony, the very nature of the S&C factor demands the use of cost-based denominators. Because the S&C factor is designed to identify a reasonable amount of shared/common *cost* for each dollar of direct *cost*, it follows that the factor must appropriately use cost-based denominators. Therefore, only by applying cost-based denominators does the S&C factor accurately identify a reasonable level of common cost associated with each dollar of direct cost. The S&C factor is applied to TELRIC study results for each UNE to derive its price. Applying a purely cost-based S&C factor to TELRIC cost results is the only economically proper way to account for S&C costs and to derive cost-based UNE prices. Using a revenue-based denominator for uncollectibles, as Staff and other parties propose, inflates the shared denominator in a manner divergent from underlying costs, thereby producing non-cost-based UNE prices. Thus, the proposal is economically incorrect, artificially inflating S&C factor denominators that reflect contribution above direct costs, all working to produce a lower overall S&C factor, based on an unsupportable theory.

Mr. Dunkel terms SBCI's uncollectible "rate" "inflated" because cost is the denominator and not revenue; unsurprisingly, he supports Staff's recommendation of a revenue-based factor.[15] Mr. Dunkel's criticism is upside down since the only inappropriate inflating occurring is found in this competing proposal of using a revenue-based denominator. Additionally, Mr. Dunkel's statement that SBCI uses total wholesale costs in calculating uncollectibles but "[SBCI] objects to anyone else discussing total wholesale numbers"[16] is clearly a misrepresentation of SBCI's position, which is simply that UNE costs are comparable to UNE costs and total wholesale costs are comparable to total wholesale costs. SBCI "objects" to nothing resembling what Mr. Dunkel is portraying.

Q18. CAN YOU FURTHER ELABORATE AS TO WHY A REVENUE-BASED UNCOLLECTIBLE FACTOR IS NOT AS SOUND AS A COST-BASED UNCOLLECTBLE FACTOR?

A18. Yes. There are many reasons why the percentage produced from uncollectibles compared to *revenue* is not applicable in TELRIC pricing. These include, but are not limited to, the following:

1) The pricing formula proposed by Staff (specifically, Patrick, Smith, Chang) is as follows:

UNE rates = TELRIC * (1 + S&C factor) * (1 + Uncollectible factor)

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15 Dunkel Surrebuttal Testimony at 17-18.

16 *Id.* at 15-18.

As seen, there are three components in Staff's view to arrive at "UNE rates." However, the three components are not compatible with one another since the first two (TELRIC, S&C) of the three are fundamental measures of cost, whereas the uncollectible "factor" is a factor strictly and solely providing a measurement with respect to revenue. It is not a cost factor in the sense that every other cost factor in discussed in this proceeding is. Interestingly, Staff does not propose (and appropriately so) measuring SBCI's common costs with respect to revenue, nor does Staff propose measuring SBCI's wholesale shared marketing costs with respect to revenue. Staff appropriately recognizes that costs, particularly *direct* costs, are the only applicable denominator for common and wholesale shared marketing. For example, given hypotheticals of $1 of direct costs, 10 cents for common costs and 5 cents for wholesale shared markeing costs, the result is that a TELRIC should bear 15 cents of common and wholesale shared marketing. These amounts would be quite different if measured with respect to revenue. Indeed, only a measure that corresponds with TELRIC itself, *direct costs*, can serve as the denominator.

2) Given the accepted fundamental formula that **Revenue = Price * Quantity**, when "Price" includes contribution over cost (which would be in Staff's proposal of "wholesale revenue"), "Revenue" fails to be directly linked to cost.

3) Given the accepted fundamental formula that **Revenue = Price * Quantity**, when "Quantity" represents fluctuating demand, such fluctuation can, but will not necessarily correspond with cost.

4) In the Act, the TELRIC pricing formula described at its highest level is the TELRIC of an element and "a reasonable allocation of forward-looking common costs." A "factor[s] that may not be considered" includes the following:

> 47CFR51.505 (d)(4): Revenues to subsidize other services. Revenues to subsidize other services include revenues associated with elements or telecommunications service offerings other than the element for which a rate is being established.

It is not unreasonable to conclude that the non-UNE wholesale revenues contained in Staff's wholesale revenue denominator for uncollectibles presents a likelihood for overall "subsidization", since UNE revenues without contribution are proportionately less than wholesale services (*e.g.*, special access) that do contain contribution.

5) Estimating uncollectibles as percentage of revenue, sales, and/or receivables is traditional and has its basis in financial accounting methodology and accounting standards. Such measures were not necessarily explicitly contemplated for forward-looking economic cost applications (*i.e.*, TELRIC); nor did the FCC describe *applying* uncollectible costs in such a manner.

6) None of the existing S&C factors in SBC's states break out and separate uncollectible cost as a function of revenue *separate and apart* from other shared and common costs. This includes SBCI's existing S&C factor derived in prior cost dockets in Illinois. The formula proposal by Staff here in Illinois, if accepted, would be unprecedented, at least for SBC.

7) In SBC's most recently completed cost proceeding in an SBC state (Indiana Utility Regulatory Commission Cause 42393), although a proposal mirroring ICC Staff's

proposal on uncollectibles was not explicity proposed, the IURC did *not* adopt another UNE *revenue*-based allocation proposed by Messrs. Starkey and Fischer to serve as the denominator for their proposal of shared costs.

Q19. MR. SMITH ACKNOWLEDGES THAT WHAT HE CONSIDERS "NON-MARKETING" EXPENSE COULD REASONABLY BE INCLUDED IN THE SHARED FACTOR.[17] PLEASE COMMENT.

A19. This continuing issue is perhaps best summarized as one of semantics. For instance, Mr. Smith notes that, in his view, marketing costs are only those for "promoting" a firm's product sales. As I described in my rebuttal testimony, SBCI's overall "marketing" expense (summary account 6610) is comprised of product management (account 6611), product sales (account 6612) and product advertising (account 6613), with product management comprising the lion's share of SBCI's overall marketing expense. Product management consists of substantial operational and support organizations/systems. This is not surprising given that both the business world and academia likewise define "marketing" as something considerably more encompassing and far reaching than mere "promot[ional]" activity.

Mr. Smith's concern appears to be that SBCI has not sufficiently disaggregated "promotional" expenses from the other functions that I enumerated. In fact, as Mr. Dominak explains, *nearly all* of the costs in these accounts fall into the informational, assistance and negotiating categories that Mr. Smith finds reasonable. Therefore, even

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[17] Smith Surrebuttal Testimony at 13.

under Staff's approach, there *is* a need for a shared cost factor and the marketing costs that I identified previously should be restored to the numerator of that factor.

Q20. WITH RESPECT TO THE <u>SHARED COST DENOMINATOR</u>, MS. KAREN CHANG OF ICC STAFF LISTS SEVERAL CRITICISMS OF SBCI'S WHOLESALE DIRECT COST PERCENTAGE, THE PERCENTAGE WHICH SBCI INCORPORATES TO IDENTIFY THE WHOLESALE PORTION OF TOTAL DIRECT COSTS.[18] MESSRS. STARKEY AND FISCHER MODIFY THEIR POSITION ON THE DENOMINATOR BY PROPOSING WHAT THEY PROPOSED IN A RECENT SBC MIDWEST PROCEEDING.[19] PLEASE RESPOND TO THESE WITNESSES.

A20. I have addressed Messrs. Starkey and Fischer's criticisms to the *total* direct costs denominator previously herein. To arrive at a wholesale portion (or percentage) of total direct costs, SBCI uses wholesale direct operations expenses as a reasonable estimate. Messrs. Starkey and Fischer propose revenue, which they acknowledge is not only related to costs both in a direct manner, but also in an "*indirect*"[20] manner. Given this, SBCI considers it far more reasonable to judge operations expenses as providing a direct relationship to plant and operating cost, than it is to diminish the relationship as merely an indirect one (which is what revenue, admittedly by both SBCI and the Joint CLECs, can provide). This proposal of using revenue was not recommended in their direct testimony; rather the Joint CLECs used SBCI's wholesale direct cost percentage (albeit applied to their embedded total direct cost denominator).

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18 Chang Surrebuttal Testimony at 8.

19 Starkey/Fischer Surrebuttal Testimony at 43-44.

20 *Id.* at 42, line 924 [emphasis added].

While the shift of the Joint CLECs to use revenue seems to “favor[s] SBC because it increases the shared cost factor,”[21] it is only a superficial benefit “because *UNE* revenue is less than SBC’s *wholesale* direct costs by almost 50%.”[22] This is not surprising since one would expect UNE revenue to be less than not only wholesale revenue, but also wholesale cost – since UNEs are only a subset of SBCI’s wholesale operations. Also, as made abundantly clear in SBCI’s proposed TELRIC studies and analyzed by SBC witnesses Dr. Aron and Mr. Sneed, current UNE revenues understate associated existing (*i.e.*, non-forward looking) costs by significant amounts. The fundamental problem SBCI would have in accepting this “increase” to its factor due to the UNE-specific (*i.e.*, UNE revenue) denominator is, among other things, that SBCI would also have to accept the uneconomic approach of conceding the existence of a UNE-specific numerator, which it cannot do for reasons previously explained.

With respect to the criticisms presented by Ms. Chang, I have, in fact, already responded to these in response to other witnesses except one, which is the last criticism by Ms. Chang that SBCI’s use of SBCI’s Local Operations Center (“LOC”) and Industry Markets is an unreasonable represenation of regional wholesale direct costs. This is because, in her opinion, it is “a small portion of the company operation that cannot and does not adequately reflect or represent the entire regional wholesale direct costs in proportion to the total direct costs.” However, that is where the critique seems to abruptly end. There is no explanation as to *why* it does not adequately reflect or represent

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[21] *Id.* at 43-44, lines 968-969.

the region. There is no suggestion as to what other SBCI wholesale or SBCI wholesale-related operations, systems, organizations, or accounts that may be a better approximation of wholesale direct cost. Unfortunately, Staff's discussion on this topic is unhelpful because it is simply dismissive as opposed to presenting a constructive alternative(s). As I explained in direct testimony, because SBCI cannot attribute capital investments exclusively to wholesale, the wholesale cost percentage needs to be based on operating expenses only. This wholesale percentage was obtained by taking the regional (*i.e.*, 5-state) SBC Midwest portion of total SBC relevant wholesale ("Industry Markets") direct expenses. Industry Markets direct expenses are exclusive to 2001, entirely consistent with the direct operating expense denominator. The numerator starts with the Industry Market's total expenses for 2001, less those for Marketing functions and uncollectibles expense, since these are already identified in the Shared Factor numerator as shared costs. This amount of regional SBC Midwest direct Industry Markets expenses was divided by total operating expenses (regulated, direct) drawn from 2001 ARMIS data for the Ameritech region.

Ms. Chang contends that the numerator mismatches the denominator in developing this proxy percentage because the numerator is "presumably forward-looking" and the denominator is "existing." However, both the numerator and the denominator are confined to 2001 data and both are, therefore, in harmony with one

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[22] *Id.* at line 970.

another.[23] Ms. Chang misunderstands why SBCI did not rely upon ARMIS for the numerator. It is simply that Industry Markets is neither an ARMIS account nor subaccount, nor a collection of ARMIS accounts, nor subaccounts. Therefore, SBCI had to rely upon internal data.

This calculation compares direct wholesale expenses for 2001 to direct total operating expenses for 2001, thereby rendering a valid percentage to apply to total SBCI company direct costs. The result is the wholesale portion of total company direct costs. Additionally, even if one were to remove depreciation expense (direct, regulated) from the denominator, to bring the numerator and denominator more in line with one another, the impact on the ratio would be negligible.[24] As explained, Staff's critique of the wholesale direct cost percentage falls short and should not be given merit.

Q21. MS. BALDWIN STATES THAT THERE IS "INSUFFICIENT EVIDENCE TO SUPPORT SBC'S POSITION THAT IT IS ACTIVITY [SIC] MARKETING UNE SERVICES…"[25]. PLEASE COMMENT.

A21. To be clear, SBCI's "position" is that is incurs many costs beyond common costs, direct costs and uncollectible costs in providing wholesale services as well as unbundled network elements. These are aptly termed wholesale shared costs since they are attributable, and only attributable, to wholesale as a group (*i.e.*, the Industry Markets

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[23] This "mismatch" critique is in the context of the wholesale direct cost calculation percentage and is therefore not the same "mismatch" as alleged by parties of SBCI's overall numerator and denominator for its S&C factor.

[24] This is due to the fact that there is very little depreciation expense in the ARMIS categories of direct, regulated that is contained total operating expenses used to derive SBCI's ratio.

[25] Gildea Surrebuttal Testimony at 6-7; Baldwin Surrebuttal Testimony at 4, 33-34.

entity within SBC). They are neither attributable to the broader company as a whole (*i.e.*, common costs), nor are they attributable to individual unbundled network elements (*i.e.*, TELRIC direct costs).

Q22. MESSRS. STARKEY AND FISCHER REAFFIRM THEIR CRITICISM OF SBCI'S <u>SHARED COST NUMERATOR</u> IN STATING THE SBCI'S WHOLESALE MARKETING INCLUDES LITIGATION COSTS THAT OUGHT NOT TO BE BORNE BY CLECS.[26] PLEASE RESPOND.

A22. This is fundamentally the same issue I addressed before in connection with certain 67xx accounts. Starkey/Fischer err in that context and they are wrong here for the same reasons.

Q23. MR. DUNKEL STATES THAT SBCI IS THE ONLY PARTY IN THIS PROCEEDING USING TOTAL WHOLESALE COSTS, AND MESSRS. STARKEY AND FISCHER CRITICIZE SBCI FOR NOT ATTEMPTING TO IDENTIFY UNE-ONLY COSTS AS OPPOSED TO ALL OF WHOLESALE FOR THE <u>SHARED COST NUMERATOR</u>.[27] PLEASE RESPOND.

A23. SBCI has already responded to this criticism insofar as I have explained, at length, and in conjuction with Mr. Dominak, why SBCI models total wholesale costs as opposed to the economically untenable and practically infeasible subset of UNE-only wholesale costs.

III. LABOR RATES

Q24. WITH RESPECT TO <u>BASE WAGES</u>, MR. FLAPPAN NOTES THAT FIRST, YOUR CLAIM OF USING 2002 WAGE DATA IS CONTRADICTED BY A DISCOVERY RESPONSE AND, SECOND, THAT CONTRACTUAL

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[26] Starkey/Fischer Surrebuttal Testimony at 45.

[27] Dunkel Surrebuttal Testimony at 18; Starkey/Fischer Surrebuttal Testimony at 40-43.

COMPARISONS BETWEEN SBC AND AT&T ARE OUT OF CONTEXT.[28] PLEASE RESPOND.

A24. ~~First, SBCI stated in its rebuttal testimony that it had responded to Mr. Flappan's testimony that the wage rates were old and had adjusted its studies to use 2002 wage data. This has been explained, largely at AT&T's request, multiple times. It is unclear why Mr. Flappan argues that this is "contradicted" by SBCI data request responses, as those data request responses were prepared last year following the filing of SBCI's direct testimony, when the Company *did* use 1999 labor rates as a cost input.~~

Q25. WITH RESPECT TO <u>MANAGEMENT HOURS</u>, MR. FLAPPAN STATES SBCI IS DOUBLE RECOVERING PAID ABSENCE BY CONFUSING PAID AND PRODUCTIVE HOURS IN RELEVANT AREAS OF SBCI'S DEVELOPMENT OF MANAGEMENT LABOR RATES.[29] PLEASE RESPOND.

A25. In addition to my explanation on this very topic that I provided in rebuttal, SBCI's correct calculation can be demonstrated in the following snapshot of the formula to calculate the labor rate for management basic wages (line 1 in SBC's labor rates):

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[28] Flappan Surrebuttal Testimony at 2-3.

[29] *Id.* at 5-14.

SBCI's Line 1 of Labor Rates =

Annual Mgmt Basic Wages (paid absence and other non-basic dollars not included)

2,080 Annual Productive Hours (no paid absence [vacation, holidays, sick days] included: but extra management hours worked implicitly included)

Therefore, no double counting exists given that line 1 is measuring productive dollars to productive hours, whereas SBCI's paid absence factor, as described in my direct testimony and supporting materials, measures paid absence dollars to paid absence hours.

Q26. WITH RESPECT TO <u>NON-PRODUCTIVE TIME</u>, MR. FLAPPAN STATES THAT YOU ACKNOWLEDGE THAT AT&T PROPOSES MORE BREAK TIME THAN DOES SBC AND PROVIDES A CITATION TO YOUR REBUTTAL TESTIMONY. DID YOU STATE SUCH AN ACKNOWLEDGMENT?

A26. No. I stated the following in Mr. Flappan's citation:

> Oddly, Mr. Flappan introduces a "95% fill factor" to account for *paid break time*, not just for nonmanagement employees (as SBC Illinois does), but for management employees as well.

The only conclusion one can draw from this statement in my testimony, and the explanation that follows it, is that his introduction of a "[labor] fill factor" is odd, since it seems to produce similar results as my approach. I neither state nor infer that AT&T's proposal is higher or lower than SBCI's. Indeed, Mr. Flappan still has not explained (much less convincingly) why his approach should be adopted in lieu of SBCI's if it in fact produces much the same result. The point of my rebuttal testimony was that SBCI's methodology of identifying forward-looking non-productive time (or "break time") is straightforward and verifiable and there is no need to introduce a duplicative, confusingly labeled, and methodologically suspect, "[labor] fill factor."

Q27. CONTINUING ON BENEFITS, MR. FLAPPAN CLAIMS SBCI HAS PROVIDED NO EXPLANATION ON ITS PENSION COST FACTOR DEVELOPMENT.[30] IS THIS TRUE?

A27. No. Mr. Flappan's statement does not fairly describe this cost modeling of pension cost as an input into SBCI's labor rates. There are at least several sources of information SBCI has provided to AT&T to describe its pension cost calculation for labor rates. These include, but are not necessarily limited to, the following:

1) Barch Direct Testimony at 58, 60-61; see also "Labor Rates and Labor Rate Development Application" Version 1.0 (provided as accompaniament to labor rates) at 6, 8.

2) SBC Illinois Response to AT&T 1st Set of Discovery, RF-10 Attachment 4

3) SBC Illinois Response to AT&T 1st Set of Discovery, RF-21 (including Attachment)

The attachments SBCI provided in response to the two discovery requests listed above include a comprehensive set of guidelines to the Ameritech Pension Plan, as well as the actual derivation of management and non-management pension service cost percentages.

Q28. MR. FLAPPAN JUDGES SBCI'S LABOR RATE MODELING AND DEVELOPMENT TO BE A "BLACK BOX" WHILE HOLDING UP AT&T'S

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[30] *Id.* at 20.

LABOR "MODEL" TO BE OPEN, VERIFIABLE AND WELL DOCUMENTED.[31] PLEASE RESPOND.

A28. First, AT&T has not provided a "model" of its own in this proceeding. All AT&T has done is criticize the level of "loadings" SBCI contains in its labor cost modeling. (Indeed, AT&T even accepts SBCI's base wages, the foundation on which the other labor components are added). Therefore, claims by AT&T to the Commission that its own labor rate "model" is "open" and "well documented", implying that SBCI's actual labor rate modeling possesses neither of the two traits, is hollow.

Second, Mr. Flappan is at misapplying the term "black box." AT&T appears to be grasping for straws as the same Mr. Flappan made no such allegation that SBC's labor rate modeling process was a "black box" in current or recently completed UNE cost proceedings in California, Texas, Indiana, and Michigan. In reality, it is AT&T's recommended reductions to SBCI's labor rates that represent a black box approach. Mr. Flappan relies exclusively on BLS data for his recommended reductions to SBCI's benefits-related components. As I demonstrated in my Rebuttal, and which Mr. Flappan does not and cannot refute, the BLS data relied on by Mr. Flappan is impossible to audit and validate. Due to confidentiality arrangements with the BLS, no party can verify what companies were included in the BLS sample used by AT&T. Indeed, SBC does not file wage and benefits data with the BLS; therefore, SBC cannot be represented in the sample.

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[31] *Id.* at 20-22, 31-32.

Q29. APPARENTLY AS SUPPORT FOR HIS POSITION THAT SBC OVERPAYS BENEFITS, MR. FLAPPAN PRESENTS A BRIEF HYPOTHETICAL EXAMPLE OF SBC GIVING ALL EMPLOYEES 2004 CHEVROLET SUBURBANS BASED ON A "BUSINESS DECISION" AND CONCLUDES IT WOULD BE "HIGHLY UNUSUAL FOR AN EFFICIENT NEW ENTRANT TO ENGAGE IN SUCH BEHAVIOR."[32] IN YOUR OPINION, IS THERE ANY MERIT TO SUCH AN EXAMPLE?

A29. None whatsoever. Certainly, it would be not only "highly unusual" for *SBC*, but also for any rational firm, or even national government for that matter, to engage in such wasteful behavior – past, present, or future. Granted, hypotheticals need not be based in fact to be illustrative of a point of persuasion, but silly hypotheticals are just meaningless.

Q30. WITH RESPECT TO THE OTHER EXPENSES COMPONENT OF LABOR RATES, MR. FLAPPAN STATES THAT SBC HAS FAILED TO EXPLAIN LARGE DIFFERENCES BETWEEN ITS COSTS AND AT&T'S.[33] PLEASE RESPOND.

A30. The list I provided in rebuttal testimony provides straightforward and ample explanation of this component. These other expenses are necessary costs of labor. Mr. Flappan has not explained why each of these typical, labor-caused other expenses fails to be forward looking.

Q31. MR. FLAPPAN INFERS THAT LABOR UNIONS, OR THE CONTRACTS WITH LABOR UNIONS, ARE NOT FORWARD-LOOKING.[34] DO YOU AGREE?

A31. No. AT&T is well aware of the costs required to attract and retain qualified telecommunications industry employees and AT&T also employs CWA-represented

[32] *Id.* at 25.

[33] *Id.* at 25-26.

[34] *Id.* at 34.

employees. While AT&T apparently doesn't view itself as encumbered by any "monopoly"[35] legacy, the wage levels and benefit provisions in AT&T's labor agreements with the CWA are very similar to, if not more generous, than those of SBCI, which I demonstrated in my rebuttal testimony.

IV. SUPPORT ASSETS

Q32. MR. HANSON, REMAINING CONVINCED THAT SBCI MAY HAVE INAPPROPRIATELY CHARACTERIZED SOME SHARED/COMMON COSTS AS DIRECT SUPPORT ASSET COSTS, POINTS TO THE STARKEY/FISCHER PROPOSAL OF MIGRATING SUPPORT ASSETS TO COMMON COSTS AS THE MOST VIABLE PROPOSAL IN THIS PROCEEDING.[36] PLEASE RESPOND.

A32. Mr. Hanson's general critique of SBCI's Support Assets appears to be that because certain of these are "assets" in every sense of the word, they are depreciable and thereby qualify only as recurring costs to the extent they can even be considered direct. His focus is upon the seemingly more obvious examples of long lived assets of land/building as opposed to the not-so-long-lived personal computers. If I understand Mr. Hanson's preferred proposal correctly, SBCI would somehow assign Support Assets to recurring rates to the extent possible, and then, classify any residual amount of Support Assets as common costs thereby including it in the numerator of the common cost factor.

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[35] "Monopoly" is a term used in more than one instance by non-economist Mr. Flappan to describe SBCI. In addition to his direct testimony, see surrebuttal at 6, 27, 30, and 34.

[36] Hanson Surrebuttal Testimony at 1-2, 9-10.

Mr. Hanson's proposal is unfeasible, both methodologically and practically. I explained in my rebuttal testimony why SBCI's considers the vast majority of its Support Assets to be Direct and not Common costs. The support asset costs that are properly associated with functions addressed in the *recurring* cost studies are already in those studies, largely by virtue of the support asset component of the maintenance factor in SBCI's ACF. There is no logical way to assign support asset costs associated with functions addressed in the *nonrecurring* cost studies to recurring activities. They do not belong there. Even if SBCI were ordered to recover Support Assets in recurring rates (*i.e.*, completely excluding any and all Support Assets SBCI currently includes in nonrecurring costs), SBCI's models would have to be significantly reconfigured in some unknown manner to facilitate such a proposal.

Mr. Hanson then points to the Starkey/Fischer approach, in which these Support Asset costs would be assigned to the S&C category for recovery as the only "viable" option presented by parties in this proceeding. Although still grossly flawed methodologically, SBCI could at least comply with such an ordered change similar to what SBC Indiana was able to do when faced with a similar ordered change in Indiana Utility Regulatory Commission Cause 42393.

V. ANNUAL COST FACTORS, PRODUCTIVITY, REGULATED/NONREGULATED DATA, AND DEPRECIATION

Q33. MESSRS. STARKEY AND FISCHER CONTINUE TO CRITICIZE SBCI'S ALGORITHM THAT PREVENTS MAINTENANCE EXPENSES FROM

DECREASING SHOULD NETWORK UTILIZATION, OR "FILL", INCREASE.[37] PLEASE RESPOND.

A33. I explained this conservative construct in both my direct testimony and fully addressed concerns in my rebuttal testimony.

Q34. IN RESPONSE TO A REQUEST FROM THE JOINT CLECS, SBC ILLINOIS PROVIDED AN UPDATED SERVICE ORDER ACTIVITY ADJUSTMENT STUDY, YET THE CLECS STILL CRITICIZE SBCI THAT THE NEWER, STATE-SPECIFIC STUDY PROVIDES NEITHER SOURCE DATA NOR A DESCRIPTION OF HOW IT WAS PRODUCED FROM SBC'S UNDERLYING FINANCIAL DATA.[38] PLEASE RESPOND.

A34. The updated SOAA study, unlike its predecessor, provides noticably more financial explanation than Messrs. Starkey and Fischer suggest. Unlike the precedessor, it is specific to Illinois and contains visible SOAA percentage adjustments that vary by account and also varying by maintenance/repair reporting codes. The source system of the data was provided in SBCI's response to AT&T data request BFP 467.

Q35. MESSRS. STARKEY AND FISCHER HAVE REVISED THEIR PROPOSED BUILDING INVESTMENT FACTOR ADJUSTMENT FOR SPACE LEASED TO COLLOCATING ENTITIES DOWNWARD.[39] PLEASE RESPOND.

A35. SBCI agrees that the proposed new factor is more reasonable than the old factor. However, as it represents an absolute *decrease* of about 95 percent, this revised proposal simply proves my point that the factors are too variable to be reliable for use as a forward-looking input.

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[37] Starkey/Fischer Surrebuttal Testimony at 54-57.

[38] *Id.* at 57-58.

[39] *Id.* at 58-59.

Q36. WITH RESPECT TO SBCI'S POWER AND COMMON INVESTMENT FACTOR, MESSRS. STARKEY AND FISCHER CRITICIZE SBCI FOR COMMINGLING 2000 AND 2001 DATA WITHOUT ANY EXPLANATION.[40] PLEASE RESPOND.

A36. The main distribution frame investment (which was the source of double cost recovery that SBCI corrected in its rebuttal testimony) for 2000 for Illinois was not available. In contrast, the data for 2001 were available because I understand SBCI was able to identify and retrieve the data from another system. To remove the MDF dollars, SBCI assumed that the 2000 and 2001 investment dollars in MDF were similar. Therefore, the total investment dollars identified in 2001 were removed from the 2000 Power & Common development. The 2001 data were only used to identify the MDF investment dollars, and no other changes were made to the analysis.

Q37. IN YOUR REBUTTAL TESTIMONY YOU RELIED UPON THE SAME BUREAU OF LABOR STATISTICS CITE TO SUPPORT SBCI'S USE OF THE CONSUMER PRICE WAGE INDEX (CPI-W) AS DID MESSRS. STARKEY AND FISCHER IN THEIR CRITICISM OF ITS USE IN A TELRIC PROCEEDING. THIS RESULTED IN MESSRS. STARKEY AND FISCHER ASSERTING THAT YOU MISCONSTRUED THE CITE.[41] PLEASE RESPOND.

A37. First, it is worthwhile to note that there would not be a large impact on SBCI's studies if GDPPI were used instead of CPI-W. This seems to be a philosophical difference of views that does not have great practical significance. On the merits, I do not dispute that the broad CPI indicator measures inflation with respect to consumers and not producers. However, I have relied on CPI-*W*, which unlike GDPPI, measures price changes facing

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[40] *Id.* at 60.

[41] *Id.* at 61-62.

labor, specifically urban and clerical workers. Because labor drives much of the cost of SBCI's TELRICs, CPI-W does not present itself as incompatible in inflating SBCI's labor-related expenses on a forward-looking basis. I would also note that state commissions have variously relied on both GDPPI and CPI as measures of inflation for ILECs. For example, the Michigan Telecommunications Act[42] relies upon the CPI (not the PPI) as the primary instrument of annual percentage increase in calculating SBC Michigan's basic local exchange services rates. In other words, there is not necessarily one "right" answer and SBCI considers its use of CPI-W as reasonable.

Q38. THE CLECS REAFFIRM THEIR POSITION IN THE NEED FOR AN EXPLICIT PRODUCTIVITY FACTOR.[43] PLEASE RESPOND.

A38. Messrs. Starkey and Fischer observe that other Regional Bell Operating Companies apparently include explicit productivity factors in costs resulting from proceedings such as this one. They do not specify to what extent the factors were proposed by the BOCs as opposed to being imposed upon them. Nor do Messrs. Starkey and Fischer describe any readily discernable and reliable parallels in methodology amongst the BOCs and SBCI.

One known significant difference in annual cost factor methology between at least one BOC (Verizon) and SBC is the application of CC/BC ratios, which ratios I explained in my direct testimony. In short, Verizon, at least in a recent cost proceeding, did not rely upon CC/BC ratios whereas SBC does. The FCC's Wireline Competition Bureau

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[42] PA 295, §304(2)(b)

[43] Starkey/Fischer Surrebuttal Testimony at 62-72. See also Flappan Surrebuttal Testimony at 4, 37-38.

recognized not only that CC/BC ratios, once implemented, constitute a sufficient forward-looking adjustment in and of itself, but also that additional adjustments are for the most part unnecessary unless they can be proven with certainty. This is contained in the following excerpt:

> For all these reasons, we reject Verizon's forward-looking adjustments *and calculate plant-specific expenses by applying, to TELRIC investment, expense ratios based on 1999 expenses and 1999 investment, adjusted by CC/BC ratios*.[fn] The use of TELRIC investment, which assumes the most efficient technology, ensures that the cost calculated through and ACF based on current expenses and investment is forward-looking and that it reflects anticipated productivity gains. Although Verizon may be correct that expenses do not change in exact proportion to changes in the value of assets, *the Commission has used current expense ratios in the past,[fn] and we think it is reasonable to follow a similar approach in the calculation of UNE prices. Because we apply the expense ratios to forward-looking investment, additional adjustments generally should be unnecessary* unless we can anticipate with some certainty that the underlying relationship between investment and expenses will change in the future, i.e., that the relationship between expenses and investment in 1999 is not representative of what would be expected on a forward-looking basis.[fn] [44]

Q39. THE JOINT CLECS ARGUE THAT THE UNDERLYING ANNUAL COST FACTOR RELATIONSHIP BETWEEN EXPENSES AND INVESTMENT WILL CHANGE, BASED ON RECENT COMMENTS BY SBC EXECUTIVES REGARDING PRODUCTIVITY IMPROVEMENTS AND COST CUTTING MEASURES.[45] PLEASE COMMENT.

A39. First, the cost savings alluded to in these referenced comments are not subject to meaningful quantification. I cannot realistically reflect in my studies cost changes that have not taken place and, more importantly, cannot be measured. The CLECs' proposal

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[44] FCC *Memorandum Opinion and Order*. CC Docket Nos. 00-218 and 00-251. Adopted August 28, at ¶ 141 [emphasis added, footnotes excluded].

[45] Starkey/Fischer Surrebuttal Testimony at 67-71, including Exhibits MS/WF-20.

to apply a productivity measure reduces to little more than a guess as to what will happen. They have not established any link between their productivity offset (which is based on the most aggregate of measures) and the operational changes being contemplated, much less a quantification of what realistically could be expected. In my view, cost estimates should be based on facts and reasonable projections based on those facts, not guesswork. If SBCI becomes even more efficient as a result of these initiatives, these efficiencies will be captured in the next round of updated UNE studies.

The CLECs are also ignoring the fact that factors are (generally) *ratios* of expense to investment, and operational changes have to be limited to just *one* part of the ratio (*i.e.*, either expenses in the numerator or investments in the denominator) to effect a change in the overall factor. Notably, the SBC executive alludes to productivity improvements that are expected to save SBC $1.3 billion in annual *capital and expense* by 2006. If expected reductions to investments closely track expected reductions to expenses, SBCI's cost factors would change little, if at all. In fact, if annual investment reductions were to out-pace, or be proportionately larger than, annual expense reductions, related cost factors could actually *increase*. For instance, assume SBCI's current operating expense factor for switching was 0.05, meaning that SBCI incurs $5M in annual switching expense for every $100M in annual switching investment. If productivity savings resulted in a $500K reduction in annual switching expenses (10%) accompanied by a $10M reduction to annual switching investment (also 10%), then SBCI's operating expense factor would remain at 0.05 ($4.5M / $90M = 0.05). If, however, annual switching expense dropped $500K (10%), but annual investments decreased $15M (15%), the switching expense factor would actually increase ($4.5M / $85M = 0.053).

Q40. MESSRS. STARKEY AND FISCHER INFER THAT SBC DOUBLE RECOVERS COST BY ACCOUNTING FOR "INFLATION TWICE" IN ITS ACFS.[46] PLEASE RESPOND.

A40. SBCI adjusts investment by a factor to bring a historical value to current cost or to take a current investment to projected investment amount. It does this primarily with Telephone Plant Index values, not some strict measure of inflation such as CPI. SBCI also adjusts maintenance expenses by a factor. The two adjustments are measuring completely different things: the former identifies existing and projected changes in the values of plant; the latter identifies changes in operating expenses. There is no double recovery. Additionally, although operating expenses are consistently projected to increase (labor expenses being the critical cost driver), plant investment is not necessarily increasing in amount. To term the factor applied to plant as a "capital cost inflation factor" is not as accurate as perhaps terming it a "capital cost inflation/deflation factor" given that plant investment can be projected to decrease in amount.

Q41. WITH RESPECT TO <u>DEPRECIATION AND NET SAVLAGE VALUE</u>, MR. MAJOROS CLAIMS SBCI IS PLAYING "FAST AND LOOSE" WITH ACCOUNTING REGULATIONS.[47] PLEASE RESPOND.

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[46] *Id.* at 64-66.

[47] Majoros Surrebuttal Testimony at 5-15.

A41. Mr. Majoros' testimony is misleading. The depreciation rates used in study were the depreciation rates in effect at time the study was prepared, which was prior to effective date of FASB 143 (1/1/03). Mr. Majoros claims to have been "following" FASB 143, yet did not discuss it in his direct testimony, submitted in May 2003, over four months after AT&T received SBCI's study. It is questionable why Mr. Majoros did not raise the issue then, which would have provided SBCI an earlier opportunity to address his concerns. In any event, Mr. Majoras ignores the fact that, if the depreciation rates are adjusted to eliminate the negative net salvage, a separate adjustment to recover negative net salvage would have to be made to the maintenance expense factor. The offsetting effects of changing the depreciation and increasing the maintenance factor would result in a very minor overall impact ACFs, and therefore, UNE loop costs.

Mr. Majoras overemphasizes the impact of the net salvage issue with his example of one account in which the negative net salvage is 75%. However, one must consider the broader context of FASB 143; namely, that FASB 143 does not affect all of the depreciation rates at issue in this docket and, for the rates that are affected, the overall variance would not be dramatic. As shown in Schedule DJB-S03 (Confidential), the offsetting effects of changing the depreciation and increasing the maintenance factor would result in a minuscule impact on ACFs, and therefore, UNE loop costs.

Conservatively, the service lives reflected in the Company's depreciation rates are equal to, or longer than, the lives supported by the TFI studies.

VI. SWITCH-RELATED NONRECURRING COSTS

Q42. ANKUM / MORRISON PRESENTED REBUTTAL TESTIMONY ON SBCI'S NONRECURRING COSTS. TO WHAT EXTENT WAS YOUR JANUARY 20, 2004 REBUTTAL TESTIMONY SPECIFICALLY ADDRESSED?

A42. Apparently, it was not addressed. I saw no mention in the Ankum / Morrison surrebuttal testimony of my rebuttal, topically or explicitly.

Q43. MR. TURNER CRITICIZES SBCI'S RELIANCE ON AVERAGE TECHINICAN ACTIVITY TIMES AS OPPOSED TO A TECHNICIAN WITH MORE EXPERIENCE AND/OR TRAINING.[48] PLEASE RESPOND.

A43. SBCI will, as will any rational firm, continue to be constrained by a labor pool consisting of a mix of skills, training, experience, aptitude and other related traits. There is no compelling cost efficiency argument to the contrary. Nor is there any reason to believe that in a "forward-looking" , efficient environment one must assume that only a fully trained/experienced technician would be performing the activities in the TELRIC study. However, as I alluded to in an earlier response herein to Mr. Flappan, entirely missing from this criticism is the accompanying increase in labor cost for such a workforce of über technicians. Certainly, SBCI's labor rates would have to reflect a substantial *increase* to compensate these technicians. But, SBCI's labor rates reflect an *average* technician, not a fully trained/experienced one. Therefore, SBCI's cost modeling of labor rates and the technician assumptions in its TELRIC studies are not only in harmony with one another (*i.e.*, both are average or typical), but they are also forward looking given that SBCI's workforce will always reflect, on a forward-looking basis, an average of

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[48] Turner Surrebuttal Testimony at 8-9, 13.

technicians with a variety of experience. If the Commission agrees with the CLECs that technicians of superior ability should be assumed in a forward-looking environment, then the Commission should also order SBC Illinois to adjust its labor rates upward to reflect the commensurately higher salary that such technicians earn. I would also note that the CLEC position is internally consistent. Typically, the CLECs point to all sorts of new technologies that have been developed recently, or that are on the horizon; yet, the CLECs inherently assume that technicians have several years of experience with such technologies. Clearly, as new technologies and equipment are developed, technicians need to be educated about how to operate, provision, maintain and repair the equipment, and must spend time gaining on-the-job, hands-on experience.

Q44. MR. TURNER BROADLY CLAIMS THAT SBCI SWITCH VENDORS LUCENT AND NORTEL CANNOT AFFORD TO HAVE DIFFERENT PERFORMANCE LEVELS.[49] PLEASE RESPOND.

A44. I am not sure what the basis of Mr. Turner's claim is. As I discussed in my rebuttal testimony, switch procurement decisions are based on a vast array of aggregated criteria. As Mr. Cunningham discusses in his surrebuttal testimony, each switch has its relative strengths and weaknesses. And despite Mr. Turner's apparent assumption, switches are not homogenous products. They are neither built identicially nor do they have perfectly identical functionality or performance. Economically, a switch vendor can indeed afford to best its rival in some areas of funtionality and come up short on others.

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[49] *Id.* at 12.

Q45. MR. TURNER STATES THAT YOUR CRITICISMS REGARDING THE SWITCH PORTS NONRECURRING STUDY(S) ARE INACCURATE.[50] PLEASE RESPOND.

A45. Mr. Turner states the following:

> Mr. Barch specifically claims that my adjustment regarding the removal of the log in and retrieval task times relates to the 'ports included in the Combination ULS Ports cost study.' [fn Barch Rebuttal, p. 73]

and continues by stating he did not revise the study in the way I claimed. This is confusing since a review of his revisions to SBCI's studies reveal that he indeed revised the Combination ULS Ports cost study log in and retrieval task time to zero minutes. This is seen twice on Tab 8.4 (cells E12 and E55) and twice again on Tab 8.5 (cells E12 and E49).

Q46. MR. TURNER MAINTAINS THAT LOG IN AND RETRIEVAL TASKS FOR THE LUCENT SWITCH ARE NOT VALID REQUIREMENTS.[51] IS THIS OBSERVATION ACCURATE?

A46. No. Plainly visible on Tab 8.3 of the Combination ULS Ports cost study, line 16 states "Prep time - <u>includes accessing systems</u> to obtain the necessary order information. Also includes reviewing the order for completeness and accuracy, as well as determining the work required and the specifics required for translating." (emphasis added). This "Prep Time" includes the same log in and retrieval tasks that were identified in Tabs 8.4 and 8.5, line 2, for Nortel and Siemens unbundled local switching trunk port provisioning.

Q47. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

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[50] *Id.* at 7-8.

[51] *Id.* at 11.

A47. Yes.