STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois Bell Telephone Company	:	
	:	
Filing to increase Unbundled Loop and Nonrecurring Rates	:	**ICC Docket No. 02-0864**
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REPLY BRIEF ON EXCEPTIONS OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION

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Now comes the Staff of the Illinois Commerce Commission ("Staff"), by its undersigned attorneys, and pursuant to Section 200.830 of the Commission's Rules of Practice (83 Ill. Adm. Code 200.830) respectfully submits this Reply Brief on Exceptions in reply to the Brief On Exceptions of The People of The State of Illinois ("AG BOE"), Brief On Exceptions of AT&T Communications of Illinois, Inc., CIMCO Communications, Inc., Forte Communications, Inc., MCI, Inc., McLeodUSA Telecommunications Services, Inc., Mpower Communications Corp. d/b/a Mpower Communications of Illinois, RCN Telecom Services of Illinois, LLC, TDS Metrocom, LLC, and XO Illinois, Inc. (CLECs BOE"), Brief On Exceptions of The Citizens Utility Board ("CUB BOE"), Brief On Exceptions of SBC Illinois ("SBC BOE"), and Brief on Exceptions of TruComm Corporation, Data Net Systems, L.L.C., and the Illinois Public Telecommunications Association ("TruComm BOE"), all of which were filed in response to the Administrative Law Judges' Proposed Order issued by the Administrative Law Judges ("ALJs") on May 6, 2004 ("Proposed Order").

I. INTRODUCTION

The Staff observes, as it did in its Brief on Exceptions, that the *Proposed Order* constitutes a very successful effort in establishing rates consistent with TELRIC principles. The Staff, accordingly, has taken very limited exception to the *Proposed Order*, *see, generally*, Staff BOE, and recommends that the *Proposed Order*, incorporating Staff's exceptions, be adopted.

Other parties, specifically the Joint CLECs and SBC, took more extensive exception to the *Proposed Order*. *See* Joint CLEC BOE, SBC BOE. Given the fact that the schedule in this proceeding allows only one week for Replies to Briefs on Exceptions, the Staff has prepared its Reply to Briefs on Exceptions in such a way as to highlight its main points of contention with other parties. The Staff has made extensive arguments regarding virtually all of the matters at issue in this proceeding, and continues to advance those arguments unless otherwise clearly stated. The failure by Staff to address in this Reply to Briefs on Exceptions some argument raised by another party should therefore not be construed as an abandonment or waiver of a position previously articulated by the Staff; rather, it is indicative of the time constraints attaching to the preparation and filing of this Reply to Briefs on Exceptions.

II. RESPONSE TO EXCEPTIONS

A. [III.B.1] Fill Factors

SBC, Joint CLECs, CUB, and the AG disagree with the Proposed Order's conclusions with respect to fill factors. These parties simply revisit arguments previously made in their initial and reply briefs. These arguments were properly understood and rejected by the Proposed Order. Staff continues to disagree with these arguments for the reasons stated in its briefs previously filed in this matter. See Staff Initial Brief at 37-64; Staff Reply Brief at 5-45; Staff BOE at 2-10. The Commission should reject these arguments to revise the Proposed Order. Although Staff will not repeat its previous arguments, Staff does wish to address several comments made by the parties in their briefs on exceptions.

1. SBC Illinois

For its part, SBC Illinois seems intent on confusing the distinction between its historical embedded actual fills and forward looking efficient fills. Although Staff and the Proposed Order both conclude that SBC's actual fills are an acceptable starting point to project forward looking actual fills, the facts in the instant record do not support a finding that SBC's unadjusted actual fills are efficient, forward looking fills. Rather, the evidence supports – indeed, it seems to be uncontested – that actual events have rendered a number of SBC Illinois' deployment decisions inefficient (even if properly thought to be efficient and proper at the time of deployment). There is no basis to account for this known inefficiency in calculating forward looking TELRIC rates. In short, the Proposed Order properly concluded that use of such fill factors would not be TELRIC compliant.

SBC argues that Staff's methodology "has no support in either the FCC's rules or judicial authority." SBC BOE at 30. To the contrary, TELRIC is clearly premised on the FCC's adoption of a forward-looking, economic cost methodology and rejection of an embedded cost methodology. *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 and 95-185, First Report and Order, FCC 96-325 at ¶ 705, 11 FCC Rcd 15499; 1996 FCC LEXIS 4312; 4 Comm. Reg. (P & F) (released August 8, 1996) (hereafter, "*First Report and Order*" or "*Local Competition Order*"). The FCC's adoption of a forward looking, economic cost methodology instead of an embedded cost methodology has been explicitly upheld by the United States Supreme Court. *See Verizon Communications, Inc., et al. v. FCC, et al.,* 535 U.S. 467, 497-523, 122 S.Ct. 1646, 1665-1679, 152 L.Ed. 2d 701,729-745 (2002) ("*Verizon*")

SBC further argues that "[n]owhere has the FCC ever ruled that spare capacity due to imperfect forecasts or changes circumstances must be excluded from TELRIC studies." SBC BOE at 30. This may be a true statement, but it is irrelevant. Staff is unaware of any FCC orders using actual fills in the manner employed by LoopCAT, and SBC has cited to none. Thus, the only conclusion that can be drawn from SBC's statement is that the FCC has not previously considered this specific issue. Moreover, SBC's argument inappropriately mixes forward-looking and backward-looking concepts. Forward-looking costs do not contain costs for spare capacity that have proven to be inefficient in retrospect. Rather, this is an embedded cost concept, as correctly recognized by the Proposed Order. As explained in Staff's Reply Brief:

> . . . The inability of SBC to avoid forecasting error for its large and diverse service area compels the conclusion that its embedded network reflects some amount of capacity that would not be built today based on changed circumstances (i.e. innocent forecasting errors). Staff Ex. 25 (Liu Rebuttal) at 25-28, 32. These forecasting errors generally occur when demand does not develop as anticipated or there is an unexpected reduction in existing demand. The forward looking TELRIC environment does not and should not reflect these forecasting errors that have occurred in the past (i.e., the cumulative forecast errors). Thus, unless SBC can demonstrate that it has made no forecasting errors – which it has not – it cannot support the use of its unadjusted actual fills.

Staff Reply Brief at 28.

Finally, SBC's reliance on the Seventh Circuit's opinion in *AT&T Communications of Illinois v. Illinois Bell Telephone Co.*, 349 F.3d 402, 2003 U.S. App. Lexis 22961 (7th Cir. 2003) is misplaced. *See* SBC BOE at 30. The language cited by SBC must be viewed in its proper context. The *AT&T Communications* decision upheld the District Court's decision to stay enforcement of 220 ILCS 5/ 13-408 (which had mandated use of actual fills), but rejected the district court's conclusion that "any use of actual fill factors . . . violates federal law." *Id*. at 21-22. More importantly, the language from *AT&T Communications* cited by SBC does not establish that actual fills are TELRIC compliant. Rather, that language simply indicates that actual fills are allowable under TELRIC if it is demonstrated that such fills are in fact the efficient fills that would be obtained using the most efficient technology. SBC has not met this burden with respect to its actual fills.

2. Joint CLECs

Joint CLECs take exception to the Proposed Order's summary of its position regarding fills. See CLEC BOE at 26-28. Staff has two points to make with respect to this argument. First, Staff strongly disagrees with Joint CLECs characterization of the record with respect to Staff's fill factor recommendation. Staff's position did change over time as properly recognized by the Proposed Order. See Proposed Order at 53. However, there is no "dichotomy" in Staff's position, which is fully reflected in its briefs. Staff witness Mr. Bud Green, Chief Engineer of the Commission's Telecommunications Division, reviewed Staff witness Dr. Liu's proposed proxy fill values and supported her recommendation. Staff Ex. 32 (Green Rebuttal) at 2. To the extent that Joint CLECs believed there was some disagreement among Staff witnesses concerning fill factors (which there was not), Joint CLECs could have crossed those witnesses (which they did not). Second, Joint CLECs make much of the fact that the Proposed Order does not contain a verbatim presentation of the summary filed by Joint CLECs. CLEC BOE at 27. Staff notes that notwithstanding anything that the parties may file (including draft proposed orders and summaries of positions), the order in the end is the Commission's order and the Commission should only include such summaries and statements as it deems relevant and proper.

With respect to the balance of the Joint CLECs' arguments, they raise issues that were already addressed in Staff's prior briefs and the Proposed Order itself. For the reasons stated in Staffs prior briefs and in the Proposed Order, Joint CLECs arguments lack merit and should be denied.

B. [III.B.2] Depreciation

The *Proposed Order* recommends the Commission adopt FCC-prescribed depreciation lives, rather than the financial reporting depreciation lives advocated by SBC. Proposed Order at 72-73. It correctly determines that SBC's proposal to use book lives "inappropriate", and its prognostications regarding the economic life of telecommunications plant as expressed by SBC witness Dr. Vanston to be "excessive", "extreme", and "unrealistic". Id.

SBC takes exception to the *Proposed Order* on three grounds. *See, generally*, SBC BOE at 18-27. First, SBC alleges that the *Proposed Order* rejects out of hand the use of financial lives as UNE depreciation lives, which -- according to SBC -- is forbidden by (i) the FCC's finding that financial lives are a permissible approach under

TELRIC and (ii) the Seventh Circuit's recognition that financial reporting lives are not foreclosed by TELRIC. SBC BOE at 21.

Staff agrees with SBC, the FCC and the Seventh Circuit Court, that financial reporting lives are a *permissible* approach under TELRIC. However, just because financial reporting lives are permissible under TELRIC, this does not mean that the Commission is required to, or even should, adopt financial lives for UNE rate setting purposes. The fact that an outcome is permissible does not make it a wise or proper one. Here, the use of FCC-approved depreciation lives is a better alternative, as the *Proposed Order* recognizes.

As the *Proposed Order* correctly observes, financial reporting lives are governed by the principle of conservatism, and consequently are inappropriate for the regulatory purpose of setting UNE rates. Proposed Order at 72. Use of financial lives protects the interests of shareholders by enabling investors to recoup their capital outlays in the shortest period of time possible, thereby reducing investor risk. Id. However, the *Proposed Order* then draws an important distinction: that in a TELRIC environment, the concerns of shareholders in recovering their investment quickly is not a priority, only that depreciation lives are reflective of a competitive environment. Id.

Staff agrees with this reasoning. TELRIC principles do not require the Commission to adopt depreciation rates that minimize investment risk for shareholders, as SBC would have it. Rather, the Commission must recognize only that depreciation rates reflect lives that would exist in a competitive environment. Since SBC has not shown that the type of competition that exists today, or will likely exist in the foreseeable future, is likely to shorten lives, there is no justification for adopting financial lives.

Moreover, financial lives do not fairly balance the interests of ratepayers and CLEC customers with those of shareholders. Instead, financial lives unduly protect the interests of shareholders at the expense of wholesale -- and ultimately retail -- subscribers who in effect will be asked to pay higher rates in order to eliminate any possible obsolescence or competitive risk to shareholders. TELRIC does not mandate that subscribers pay UNE rates consistent with the shortest possible lives imaginable. Moreover, contrary to SBC's claims therefore, the *Proposed Order* does not absolutely reject financial reporting lives. Rather, the *Proposed Order* examines SBC's rationale for shorter lives and finds it wanting. Proposed Order at 72-73. In other words, the Proposed Order determined – explicitly – that SBC did not meet its burden of proof. *See* Proposed Order at 73 ("SBC has failed to demonstrate that either competitive pressures or technological changes have caused the depreciation rates set forth by the FCC to be outdated"). This is why the *Proposed Order* opted for existing lives, which, as it notes, the Commission and FCC have previously approved. Proposed Order at 73. This finding is correct and should be adopted.

Second, SBC argues that when existing lives were developed a decade ago they were not designed to replicate the results of a competitive market. SBC BOE at 22-23. SBC further contends that the *Triennial Review Order* requires that the rate of depreciation must reflect the actual decline in value that would be anticipated in the competitive markets and that adoption of 1995 FCC projection lives does not account for growing competition. SBC BOE at 23.

This argument is unconvincing. The basic shortcoming of SBC's BOE argument is that little facilities-based competition exists today, and there is no evidence that the level of facilities based competition will increase substantially in the years to come. If facilities-based carriers were to make significant inroads into the local access market using their own facilities,[1] this might strand existing SBC plant, thereby reducing its economic value. However, as the Proposed Order correctly finds, this is unlikely, as SBC's competition forecasts are "unrealistic". *See* Proposed Order at 72. In fact, the *Proposed Order* labels these predictions as "extreme". Proposed Order at 73. Staff agrees with this assessment. About 75% of local access lines served by SBC competitors are UNE or resale based, which does not typically strand the incumbent's plant. In terms of facilities-based competition, the number of lines served by cable telephony changed little during the latest six month period, while the number of lines served by non-cable facilities based carriers actually declined, according to data provided by the FCC. Moreover, there is simply no evidence that households are switching from wireline to wireless in great numbers. Although there have been improvements in wireless quality and reliability in recent years, these remain markedly below wireline, and consequently poses a very limited threat to SBC's existing customer base. To contend as SBC has that 20% of subscribers will become entirely wireless by the year 2006 is, to put it mildly, a stretch. The *Proposed Order* correctly describes SBC's forecasts in this regard as "extreme" and "excessive". <u>Proposed Order</u> at 72-73.

SBC maintains that there is no reason to conclude that recent growth trends for facilities based carriers will remain constant. <u>SBC BOE</u> at 25. This is true – growth rates for facilities based carriers could <u>decline</u> further. Staff notes that the number of

[1] It is important to remember in this context that the rates at issue are for the use of loop plant, the least economically reproducible network element.

narrowband access lines served by facilities-based carriers actually declined between December 2002 and June 2003, the most recent period for which data is available. Staff Ex. 22.0 at 22. SBCI has not articulated any rationale that would justify the Commission assuming a sudden revival of fortune for facilities-based competitors.

SBC next takes exception to the *Proposed Order's* view that technological advancement as set forth by SBC Illinois witness Dr. Vanston is "excessive". SBC BOE at 24. In addition, SBC takes exception to the *Proposed Order's* finding that it is unrealistic to conclude that the circuit-switched, copper network will begin to become obsolete in five years. Id. at 26. Finally, SBCI maintains that technological innovation will continue to grow and contends because of this growth economic lives should be shorter. Id. at 25.

The *Proposed Order* concluded, for good reason, that Dr. Vanston's growth of broadband customers is "excessive". Proposed Order at 72. Dr. Vanston's broadband forecast assumes that 90% of subscribers will opt for broadband service by the year 2020 -- i.e., virtually all households who can subscribe to broadband will do so.[2] This broadband forecast is unwarranted, given the fact that only 70% of households currently subscribe to cable TV, which has been around for over forty years, and which has much broader appeal than broadband.

More to the point, new technologies allow DSL services to be provided over existing copper lines. That is, SBC does not have to replace copper loops with fiber facilities to provide broadband. So there is no reason that copper will become obsolete within five years, as Dr. Vanston suggests.

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[2] For some rural households broadband may not be available.

Staff also notes that current FCC-approved economic lives for SBC reflect the rapid rate of technological change that has occurred historically for telecommunications carriers. To justify shorter economic lives, SBC would have to demonstrate that the pace of technological change has accelerated relative to the past. This SBC has failed to do. SBC simply refers recent technological advances, (broadband, packet switching etc), and asserts that technological change in and of itself will lead to shorter lives. However, this would only be true if there had been no technological change in telecommunications historically. Since there has been rapid technological change for telecommunications in the past (analog to digital, direct distance dialing, etc.) recent advances are simply a continuation of a long trend and not a reason to shorten (already short) lives further.

More fundamentally, much of the technological change SBC refers to is used to serve customers that have specialized needs or, in the case of broadband, can be served by alternative providers such as cable companies. Low-income telephone subscribers, and low-volume users who subscribe to basic service and nothing else, should not be required to pay higher rates for telephone service in order to subsidize the provision of advanced services which are purchased predominantly by higher income subscribers. The *Proposed Order* properly recognized this. Proposed Order at 73.

The *Proposed Order's* findings and conclusions regarding the issue of depreciation are correct. SBC's exceptions should be dismissed and the *Proposed Order's* conclusions adopted.

C. [III.B.3.] Cost of Capital

The Commission should disregard SBCI's and AT&T/MCI's exceptions to the *Proposed Order* with regard to the cost of capital. Both parties' general arguments have been fully refuted previously in Staff's Initial and Reply Briefs. Nevertheless, Staff will briefly address several statements from those parties' Briefs on Exceptions.

1. SBCI

SBCI's primary exception concerning cost of capital is the *Proposed Order*'s adoption of a capital structure that SBCI claims contains too little equity. *See, generally,* SBCI BOE at 10-21. That exception should be disregarded. First, Staff has demonstrated that SBCI's continued insistence that the FCC requires UNE rates to reflect "full" competition is erroneous. *See, e.g.,* Staff RB at 51-52, 55-56. Indeed, in its Reply Brief, Staff accurately quoted the passage from an FCC decision that SBCI cited as the basis for its claims; in that passage, the FCC did not once indicate "full" competition. Staff RB at 55-56. SBCI's repetition of its mischaracterization of the FCC order would be of modest importance if the results were not so serious. Moreover, even if one were to reflect "full" competition in UNE rates, which would be improper, establishing the precise position of "full" competition along the spectrum between monopoly and perfect competition is a matter of interpretation. Id. at 51-52. SBCI's mischaracterization of the FCC order's conclusion regarding the degree of competition States are to reflect in UNE rates should not lead the Commission to abandon the *Proposed Order's* well-reasoned opinion on this issue.

Second, SBCI continues to cite the FCC Wireline Bureau ("Bureau") and other state regulatory agencies to support its claims for a higher equity ratio. SBCI BOE at 7-

12, 17-19. Again, the Commission is not bound by the Bureau staff's conclusions or those of other state regulatory bodies.

Third, SBCI maintains that a 51.00% equity ratio is insufficient for it to maintain a reasonable credit rating. SBCI BOE at 8, 13-18. SBC claims that "analysts have said that SBC could lose its investment rating altogether if it actually operated at 51% equity." Id. at 8. That statement wrongly attributes such a conclusion to "analysts" when, in fact, it was the discredited conclusion of SBCI's cost of capital witness. Moreover, that conclusion is based on a single financial ratio (the debt ratio). Ironically, SBCI objected to Staff's alleged reliance on a single financial ratio to develop Staff's capital structure recommendation. In contrast to the two interest coverage ratios Staff employed, the debt ratio upon which SBC would have the Commission rely is a very imprecise measure of financial strength that does not adequately incorporate earnings, cash flows, or interest costs; consequently, debt ratio benchmarks are nothing more than very flexible guidelines – not prerequisites for given ratings, as SBCI implies they are. Staff RB at 96-97. The interest coverage ratios resulting from Staff's recommendations (i.e., 5.6x EBIT and 7.9x EBITDA) demonstrate that the combination of capital structure and component costs Staff proposes would maintain a reasonable level of financial strength for a UNE provider. Id. at 55. Indeed, Staff's capital structure was specifically calculated to produce interest coverage ratios consistent with an A/A– rating. Staff IB at 99-100. Moreover, Staff's 51.00% proposed equity ratio is above the 47.3% three-year average equity ratio for the sample group that formed the basis of Staff's cost of equity, which has an average credit rating of A/A–. Id.

Fourth, SBCI continues to claim that TELRIC requires that a market value capital structure be used to set UNE rates. SBCI BOE at 10. As Staff demonstrated in its Initial Brief, there is no difference between the market value and book value of incremental capital issuances and thus, there is no difference between the market value and book value of a forward-looking capital structure. Staff IB at 102-103. Thus, the issue is not a matter of choosing a book value or market value capital structure, but rather, selecting a target capital structure that minimizes the cost of capital and maintains a reasonable level of financial strength – a capital structure that is efficient and forward-looking. Id. at 103. That is precisely what Staff did.

Furthermore, use of secondary market values of *pre-existing* capital is not appropriate. Staff RB at 54-55. SBCI argues that the only way investors will actually receive the authorized return on equity is if it is applied to a market value capital structure. SBCI BOE at 11-12; 19-21. As explained in Staff's Initial Brief, that argument is simply an appeal for fair-value rate making, which has been consistently rejected since 1944. Staff IB at 97-99. Nevertheless, if a pre-existing market value capital structure were used, then the cost of equity that Staff recommended and the *Proposed Order* adopted would need to be reduced significantly because, as AT&T/MCI correctly noted, "the parties' cost of equity and common equity ratio recommendations go hand-in-hand". Staff RB at 54; AT&T/MCI BOE at 105. All else equal, rising stock prices indicate a falling required rate of return. Thus, as rising stock prices increase the proportion of equity in the market value capital structure, the authorized rate of return on equity should be correspondingly reduced. Otherwise, an unnecessarily excessive cost of capital will result. Staff RB at 54-55.

Finally, SBCI asserts that, at a minimum, a 79% equity ratio should be adopted. SBC BOE at 18-21. SBCI claims that a 79% equity ratio reflects the average market value equity ratio of Staff's Telecom Sample. Id. at 3, 9, 13, 18-19, 21. SBC also claims that the average book value equity ratio of Staff's Telecom Sample is 66.7%. Id. at 8, 13. SBC is wrong. The capital structures SBCI cites are not the actual average capital structures for Staff's Telecom Sample, but rather, are Value Line's speculative projections of the Telecom Sample's average capital structure three to five years in the future. The 79% market value equity ratio on which SBCI proposes to base UNE rates is particularly dubious, as it is based on a prediction of future stock market values. Predictions of future stock market values are, perhaps needless to say, highly speculative. Clearly, Value Line cannot project future stock market values with any certainty; otherwise every Value Line subscriber would be guaranteed wealth. The Commission should not base UNE rates on such speculation. Moreover, a 66.7% book value equity ratio estimate overstates the Telecom Sample's actual book value equity ratio. As noted above, the three-year average book value equity ratio for Staff's Telecom Sample, which has an average credit rating of A/A–, was actually only 47.3%. Staff IB at 99-100.

SBCI also questions the consistency of using Staff's cost of equity estimate in conjunction with Staff's equity ratio. SBCI BOE at 19. SBCI cites the Bureau's decision in the *Virginia Arbitration Order* to change its adopted capital structure because it had originally selected an equity ratio that "would create a mismatch with the data [it had] use[d] to calculate the cost of equity." Id. That citation does not refute the use of both Staff's cost of equity and cost of capital; indeed, it supports it. Combining Staff's cost of equity estimate with Staff's equity ratio is perfectly consistent, since Staff's capital structure was established directly in conjunction with Staff's capital component costs to produce interest coverage ratios that would allow a UNE provider to minimize capital costs while maintaining a reasonable level of financial strength. Staff IB at 93-94. Thus, an ex-post change to one of Staff's cost of capital inputs "would create a mismatch" with the other inputs, similar to that in the *Virginia Arbitration Order*, necessitating adjustments to other inputs in order to produce similar coverage ratios. Indeed, Staff is the only party that presented evidence to demonstrate that its cost of capital components collectively produce reasonable returns. Staff showed that the implied EBIT and EBITDA interest coverage ratios using Staff's capital structure and capital component cost recommendations equal 5.6x and 7.87x, respectively, which indicate a high degree of financial strength. Id. In contrast, SBCI's capital structure and capital component cost recommendations produce needlessly excessive EBIT and EBITDA interest coverage ratios of 19.46x and 24.6x, respectively. Id. at 99.

2. AT&T/MCI

AT&T/MCI's primary exception concerning cost of capital is the *Proposed Order*'s adoption of a capital structure that AT&T/MCI claims contains too little short-term debt. AT&T/MCI BOE at 114-115. AT&T/MCI claims that a capital structure that includes only 4.78% short-term debt is inconsistent with SBC's actual short-term debt usage. Id. As Staff explained, SBC's capital structure is not meaningful, as it receives all of its new capital, both debt and equity, from its corporate parent, SBC. Staff Ex. 12.0 at 25.

Therefore, Staff derived its short-term debt level from SBC's December 31, 2002 capital structure.[3] Id. at 26-27.

Staff has demonstrated that its capital structure recommendation represents a reasonable forward-looking capital structure for a UNE provider. More specifically, Staff's proposed mix of debt maturities, including 4.78% short-term debt, is a reasonable match for the lives of UNE assets. First, given Staff's calculation of SBCI's UNE depreciation and amortization rate of approximately 5.12%, one would expect approximately 5% of SBCI's UNE investment to be returned to the company in the form of depreciation and amortization cash flows annually. Staff Ex. 31.0 at 15. Thus, one would expect approximately 5% of SBCI's debt to come due within one year to match the annual recovery of SBCI's assets via depreciation and amortization. Id. Clearly, Staff's 4.78% proposed short-term debt balance more closely matches a 5% annual asset recovery than does AT&T/MCI's 22.35% proposal. Second, the 11.65 year overall weighted average maturity of debt included in Staff's cost of capital recommendations better corresponds to the 9.77 year average life of UNE assets. Staff IB at 100-101. Changing the *Proposed Order*'s capital structure to include 22.35% short-term debt and 26.65% long-term debt, as AT&T/MCI proposes, would produce a weighted average debt maturity of 7.05 years, which would be less representative of the average maturity of UNE assets. Thus, Staff's 4.78% proposed short-term debt balance is reasonable.

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[3] Regrettably, page 93 of Staff's Initial Brief erroneously indicated that Staff's short- and long-term debt calculations were based on SBCI's December 31, 2002 capital structure. They were actually based on SBC's December 31, 2002 capital structure. *See* Staff Ex. 12.0 at 27.

AT&T/MCI states, "the parties' cost of equity and common equity ratio recommendations go hand-in-hand" and "if the Commission adopts Staff's cost of common equity recommendation (12.44%), it should also adopt Staff's proposed common equity ratio (51.00%), as recommended by the Proposed Order." AT&T/MCI BOE at 105; 113. Staff agrees with AT&T/MCI's assertion that the Commission should adopt both the cost of equity and equity ratio of a single party, since the two are interrelated. More specifically, Staff agrees with the *Proposed Order*'s conclusion that the Commission should adopt Staff's cost of equity and equity ratio. Indeed, Staff contends that the Commission should adopt all of Staff's cost of capital recommendations. Staff's capital structure was developed from interest coverage ratios, which, in turn, reflect all of Staff's cost of capital recommendations. As noted previously, adopting any capital component costs higher than that which Staff recommends would produce interest coverage ratios that are higher than necessary. Without a corresponding adjustment to the capital structure, the net result would be UNE rates that are higher than required to achieve a sufficient degree of financial strength. Thus, in addition to the stand-alone merits of each of Staff's recommendations, the Commission should adopt Staff's recommendations in toto in order to maintain consistency with the manner in which those recommendations were developed.

D. [III.C.1] Cable and DLC Installation Costs/Factors

The arguments raised by SBC in its Brief on Exceptions with respect to cable and DLC installation factors clearly conflict with basic TELRIC cost principles and should be rejected. SBC objects to the Proposed Order's adoption of Staff's proposed method of deriving installation factors. SBC BOE at 56-60; Proposed Order at 92-93. SBC then presents a critique of the Proposed Order's decision on this issue that fundamentally deviates from any reasonable notion of TELRIC costs.

The starting point for SBC's objection is the conclusion expressed in the Proposed Order concerning a basic assumption of TELRIC. According to SBC:

> The Proposed Order . . . expressly rejects Staff's [underlying] argument, finding that "augmentations and reinforcements of SBC's network are realities that cannot be ignored by the Commission in attempting to set TELRIC rates" and that "even a forward-looking network requires replacements and augmentations from time to time".

SBC BOE at 57. Since augmentations and reinforcements are to be considered, SBC contends it is appropriate to develop installation factors using its historical cost relationships, which rely considerably on reinforcements rather than new construction. *Id*.

This argument amounts to improper conjecture on the Company's part. There is no question that a network -- even when constructed in an efficient manner -- will later require certain augmentation and reinforcement costs. However, there is no evidence in the record to indicate that the costs of an efficient, forward looking network should be based on – or would require -- the significant level of augmentation and reinforcement work that the Company performs on its existing network. Clearly, under TELRIC's assumption of current technology and knowledge, the costs of building an efficient, forward looking network would involve a much lower proportion of augmentation and reinforcement work than experienced on SBC's existing network and the Company's use of unadjusted historical costs clearly serves to inflate the resulting installation factors.

SBC then seeks to buttress its position by focusing on the Proposed Order's conclusions concerning key assumptions under TELRIC regarding construction of the network. Specifically, SBC quotes the following passage from the Proposed Order regarding NID and Drop Wire Installation Costs:

> We do not agree with CLECs and Staff that TELRIC requires that we base prices on the assumption that a new network will be built from the ground up. TELRIC requires that we assume that we are determining costs and rates for SBC's network as if it had been built using the most efficient, currently available technology. In other words, the customers are located in the same location and served by their existing wire centers. Moreover, augmentations and reinforcements of SBC's network are realities that cannot be ignored by the Commission in attempting to set TELRIC rates.

Proposed Order at 27; SBC BOE at 58. That, in SBC's estimation, opens the door to consideration of historical costs. In support of its argument, SBC also cites to paragraph 53 of the FCC's recent TELRIC NPRM.[4]

As demonstrated in Staff's Brief on Exceptions with respect to NID and Drop Wire Installation Costs, one of the principle assumptions of TELRIC is that costs should be determined on the assumption that the network is constructed from scratch. *See* Staff BOE at 16-19. To the extent that the Proposed Order held otherwise, those rulings were in error and should be corrected as set forth in Staff's Brief on Exceptions. See Staff BOE at 15-22. The Proposed Order's adoption of Staff methodology with respect to cable and DLC installation factors, however, properly adjusts the over-weighting given by SBC's proposal to augmentations and reinforcements. In this regard, the Proposed Order's decision is completely in line with the FCC's decision in

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[4] *In the Matter of Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers*, WC Docket No. 03-173, Notice of Proposed Rulemaking,, FCC 03-224 (Rel. Sept. 15, 2003) ("TELRIC NPRM").

the Verizon 271 Order where the FCC determined that only a small percentage of costs could be based on the costs of augmenting existing switches under TELRIC:

> . . . While the Commission has not to date specified an appropriate split between new, replacement switches and growth additions, we strongly question an assumption of only growth additions, as proposed by Verizon and incorporated in the April 11 rates adopted by the Rhode Island Commission. Even if some growth additions may be used in a forward-looking network, the absence of any new switches is inconsistent with the assumption in TELRIC pricing of a forward-looking network built from scratch, given the location of the existing wire centers. Although an efficient competitor might anticipate some growth additions over the long run, rates based on an assumption of all growth additions and no new switches do not comply with TELRIC principles. We also note that the Rhode Island Commission determined that Verizon's assumptions for switch cost recovery in the new UNE rate proceeding will be based on a rebuttable presumption of 90 percent new switches to 10 percent growth additions.

In the Matter of Application by Verizon New England Inc., Bell Atlantic Communications, Inc. (d/b/a Verizon Long Distance), NYNEX Long Distance Company (d/b/a Verizon Enterprise Solutions), Verizon Global Networks Inc., and Verizon Select Services Inc., for Authorization To Provide In-Region, InterLATA Services in Rhode Island, CC Docket No. 01-324, Memorandum Opinion and Order, FCC 02-63 at ¶ 34 (rel. Feb. 22, 2002) (emphasis added) (footnotes omitted) ("Verizon 271 Order).

SBC's reliance on the TELRIC NPRM is similarly unavailing. Even accepting SBC's characterization of the TELRIC NPRM, it is clear that the propositions for which SBC cites the TELRIC NPRM reflect possible changes to the FCC's current rules rather than the current state of the law:

> 52. We tentatively conclude that our TELRIC rules should more closely account for the real-world attributes of the routing and topography of an incumbent's network in the development of forward-looking costs. **We seek comment on whether such an approach would address claims that our TELRIC rules currently distort a competitor's decision whether to invest in new facilities or to lease an incumbent's existing facilities.** Yet we also wish to ensure that a

> reformed TELRIC methodology does not swing in the other direction and give incumbents undue advantages. **We seek comment on this tentative conclusion** and, in particular, on how such an approach may differ from the practices of state commissions in UNE pricing proceedings.
>
> 53. We seek comment on proposals that would achieve these objectives. We seek comment on whether it is appropriate to assume that the cost of an existing element is the cost of that element if it were being replaced today. Under this approach, the cost to the incumbent LEC of using its existing facilities is the cost that would actually be incurred (including actual placement costs) to place new facilities in the same location. As discussed above, the UNE pricing methodology, while forward-looking, must be representative of the real world and should not be based on the totally hypothetical cost of a most-efficient provider building a network from scratch. To that end, the UNE cost study should be based upon the incumbent LEC's actual network topography and currently available, forward-looking technologies.

TELRIC NPRM at ¶¶ 52-53.

Further, as Staff has demonstrated in its BOE, the Proposed Order's assumption that the TELRIC network has been constructed over time leads to contradictory results. It suggests that that equipment based on current technology may have been installed on the network sometime in the past, in some cases as much as 30 or 40 years ago. The end-result is a meaningless mixture of forward-looking and historical costs that bear little resemblance to TELRIC principles.

SBC seizes on this assumption as further reason to justify its historical installation factors. The Company argues the Proposed Order's assumption that the network is constructed over time opens the door to the use of unaltered historical cost relationships between labor and materials to develop installation factors. Under that assumption, SBC argues that TELRIC costs would include the significant level of reinforcement costs reflected in the Company's historical labor and material costs. SBC BOE at 58. SBC's logic falls short. Even if the Proposed Order's assumption of constructing a TELRIC network over time is to be accepted, there is still no justification for the use of what is essentially an embedded cost methodology to develop installation factors for a forward-looking TELRIC study.

The Company seeks to dress up this backward-looking approach in forward-looking TELRIC terminology with the following contention:

> The installation factors were developed using actual audited accounting data from SBC Illinois' general ledger for a recent three-year period to develop a normalized, forward-looking relationship between equipment costs and installation costs.

SBC BOE at 56. Despite SBC's claim, there is nothing forward-looking about the Company's approach. As SBC admits, its installation factors are based on unaltered embedded cost relationships for a three-year historical period. However, to give its approach a TELRIC veneer, it suggests that this backward-looking approach somehow produces a "normalized, forward–looking relationship" between equipment and installation costs. This claim is clearly unsupported.

The unadulterated historical costs relied on by SBC are deficient in other respects. For example, SBC makes no effort to demonstrate that these historical costs meet the efficiency requirements for a TELRIC study. SBC simply assumes that it is an efficient operator, which ensures that its historical costs must be incurred in an efficient manner. Furthermore, there is no effort to demonstrate that costs incurred in the past are a meaningful guide for going-forward costs. The Company simply assumes this to be the case without providing any supporting evidence.

In sum, the Company's proposed method of developing installation factors is flawed under even the broadest interpretation of TELRIC. There is simply no justification for using unaltered historical, embedded costs as a foundation to develop installation factors for a forward-looking TELRIC study. Whether the TELRIC network is built today or was constructed over time, the methodology must still reflect forward-looking principles. The historical cost relationships employed by the Company clearly fall short.

Staff has developed a reasonable alternative that seeks to minimize the distortions resulting for SBC's historical cost approach. The reasons for the Staff alternative were understood and correctly accepted in the Proposed Order. The arguments presented by SBC provide no justification for changing this conclusion.

E. [III.C.3.(g)] Remote Terminal Investment Cost Allocation

SBC objects to the *Proposed Order's* adoption of Staff's proposal to reduce by 25% the cost of SBC's investment costs in DLC RT equipment because such costs are common to both voice and advanced services. SBC continues to assert that such investments are incurred solely as a direct result of voice services, not advanced services. SBC BOE at 60. To support its argument, SBC again notes that the LoopCAT cost study "does not include any of the incremental costs associated with the additional equipment that would be necessary to make the DLC system capable of providing DSL service." *Id*. Consequently, according to SBC, the *Proposed Order's* conclusion is inconsistent with cost causation principles. *Id*. SBC specifically objects to the Proposed Order's conclusion that "[b]y adopting a lower copper/fiber breakpoint in order to better accommodate advanced services, there are incremental costs in the form of additional DLC RTs." SBC BOE at 62-63. Staff disagrees with SBC. In fact, Staff again commends the ALJs for getting it right on this issue.

As Staff pointed out in its Reply Brief, the "crux of Staff's argument is that the *common* equipment in the RT is designed so that data services can ultimately be provisioned, and that forcing recovery of 100% of those joint costs solely on voice services is simply not appropriate." Staff Reply Brief at 68. SBC, moreover, acknowledges the *Proposed Order's* essential point that it adopted a low crossover point in order to better accommodate advanced services. SBC BOE at 62. SBC then appends to this acknowledgement the assertion that the same crossover point is also the most efficient design for voice services. *Id.* SBC is again attempting to have it both ways on this issue. Either it is designing a "forward-looking network capable of handling multiple needs, including voice and advanced services" or it is not. See SBC Ill. Ex. 8.0 (White Direct) at 28; SBC Ill. Ex. 8.1 (White Rebuttal) at 60. Forcing 100% recovery of what SBC acknowledges are joint costs solely on voice services is clearly inappropriate.

The *Proposed Order's* findings and conclusions regarding the issue of remote terminal cost allocation are correct. SBC's exceptions, accordingly, should be dismissed and the *Proposed Order's* conclusions adopted.

F. [III.C.4.(a)] NID and Drop Wire Installation Costs

With respect to the AG's discussion of this issue (AG BOE at 3-4), Staff is unclear about what specific changes the AG believes need to be made to Saff's installation factors in order to address this double-counting issue. Therefore, Staff is not able to support the AG's proposed revisions to the "Sundry and Misc." expense component of its installation factors.

G. [IV.] Non-Recurring Cost Studies and Rate Designs

1. [IV.C.1.] Provisioning (Loops and EELs) - Identification of Tasks

The Proposed Order states:

> We recognize that SBC's costs may differ based on whether it is provisioning EELs or standalone loops, but SBC has not adequately explained the difference. Although Staff recommends that SBC not

> charge anything for the work done by the SSC/LOC or the CPC/HPC, we require SBC to utilize whichever group has the lowest costs and is, therefore, the more efficient.

Proposed Order at 173.

The *Proposed Order* later states:

> CLECs argue that designed loops are not necessary for EEL applications nor are they required for standalone POTS loops. We agree with CLECs that because the loop is already working, SBC has given us no justification for SBC to do anything other than to simply migrate the working loop over to the CLEC collocation arrangement or the transport element.

Id.

SBC takes exception to this finding. With respect to these two passages, SBC asserts that

> The conclusion regarding designed loops reached in the Proposed Order is inconsistent with the conclusion reached several paragraphs above, where the Proposed Order instructs SBC Illinois to utilize the lower of the costs incurred by the SSC/LOC and CPC/HPC groups.

SBC BOE at 70.

Joint CLECs offer a similar analysis of the *Proposed Order*. Staff agrees with the assessment of both parties, although not perhaps for the same reason as either. That is, the *Proposed Order* contains a potential inconsistency that should be clarified.

It is not entirely clear what activities constitute "design" related activities. In initial testimony, SBC witness Chris Cass[5] indicated that the "only major difference" between the provisioning processes for standalone analog and 2-wire digital loops on the one hand, and EEL analog and 2-wire digital loops on the other, is that EEL loops are "designed", while standalone loops are not. SBC Ex. 6.0 at 26. Mr. Cass, however, did not explain precisely what work is necessary to "design" a loop that is not necessary

5 Mr. Cass' testimony was thereafter adopted by Dr. Kent Currie. *See* SBC Ex. 5.1.

when the loop is not "designed". *See, generally*, SBC Ex. 6.0. Nonetheless, as noted by Staff, SBC listed, in its initial cost study filing, activities performed by the SSC/LOC and CPC/HPC in support of its EEL analog and 2-wire digital loop cost estimates that it did not list in support of its standalone analog and 2-wire digital loop cost estimates. In its rebuttal testimony, SBC contended that standalone loops are designed and, therefore, it had erred in its initial costs studies by failing to include design activities for standalone loops. SBC Ex. 9.1 at 4; SBC Ex. 5.1 at 21. SBC corrected its studies by adding costs associated with SSC/LOC and CPC/HPC activities, which supports the notion that these activities are "design" activities. SBC Ex. 5.1 at 21. Therefore, while SBC has not specifically identified the activities necessary to "design" loops, it follows logically that these activities are the activities performed by its SSC/LOC and CPC/HPC groups.

The inconsistency in the *Proposed Order* likely arises because Staff, recognizing the potential ambiguity regarding what activities constitute "design" activities, elected to make recommendations with respect to particular activities or provisioning groups, rather than to refer to "design" related activities. Presumably, however, those activities performed by SBC's SSC/LOC and CPC/HPC groups are "design" activities. SBC Ex. 9.1 at 3-4; SBC Ex. 5.1 at 21. Thus, to the extent SSC/LOC and CPC/HPC activities are those that constitute "design" activities, the *Proposed Order* errs in providing separate and different guidance with respect to the treatment of SSC/LOC and CPC/HPC activities versus design activities. That is, to Staff's understanding the *Proposed Order* at one point permits SBC to include costs associated with the SSC/LOC and CPC/HPC groups in its NRC cost estimates for analog and 2-wire digital loops, and at another point requires SBC to eliminate seemingly identical design activity costs for these loop types. *See* Proposed Order at 173.

SBC recommends that the Commission clarify the *Proposed Order* by stating explicitly that all non-UNE-P unbundled loops, including those used in EELs, must be provisioned using the design loop process. SBC BOE, Appendix B at 20. Joint CLECs recommend that the Commission clarify the *Proposed Order* by stating explicitly that all non-UNE-P unbundled loops, including those used in EELs, do not need to be provisioned using the design loop process. Joint CLEC BOE at 192. Staff recommends the Commission adopt the latter course and, in particular, specify that SBC must not include costs related to its SSC/LOC and CPC/HPC activities in its analog or 2-wire digital loop cost estimates. Staff notes that this recommendation is included in the rates supplied by both Staff and SBC in response to the *Proposed Order's* direction that "a calculation of the rates adopted herein shall be provided by SBC and Staff with their Briefs on Exceptions". *Proposed Order* at 294; *see also,* SBC BOE, Appendix A; Staff BOE, Exhibit 2.

In Staff's view, this conclusion is appropriate because SBC has failed to produce evidence sufficient to answer the question of whether SBC must rely on its SSC/LOC and CPC/HPC groups to provision analog and 2-wire loops. In its Initial Brief, Staff demonstrated that the answer to this question is not readily apparent because SBC has, with respect to SSC/LOC and CPC/HPC activities, failed to provide evidentiary support for its position, leaving unanswered the question of when and if SSC/LOC and CPC/HPC activities need to be performed. Staff Initial Brief 156-159. The argument SBC raises in its BOE does little but highlight this point.

In its BOE, SBC cites to the testimony given on its behalf by Vivian Gomez-McKeon, who stated that SBC must provision all unbundled loop orders (including those loops included in EEL combinations) following a design loop process "…so that, for instance, SBC Illinois can verify the connecting facility assignment information and establish the circuits in the TIRKS database." *See* SBC BOE at 69. Neither SBC nor Ms. Gomez-McKeon, however, have explained which SSC/LOC and CPC/HPC activities are necessary in order to accomplish these objectives, why these objectives are necessary in order to provision non-UNE-P analog and 2-wire loops and not UNE-P loops, or why SBC's own witness Chris Cass testified that these activities need not be performed with respect to standalone analog and 2-wire loops. As Staff noted in its Initial Brief, it is certainly conceivable that some activities performed by SSS/LOC and CPC/HPC are consistent with TELRIC non-recurring cost estimates. Staff IB at 10. SBC, however, has failed to provide any evidence of what these activities might be.

For the reasons above, Staff continues to recommend that SSS/LOC and CPC/HPC charges be excluded from standalone analog and 2-wire digital loop cost estimates.

2. [IV.C.2.] Provisioning (Loops and EELs) – Activity Times

SBC asserts that the *Proposed Order* errs by adopting Staff's recommendation to replace DOG travel times for loop provisioning activities with CP&M travel times for loop provisioning activities. SBC BOE at 73. SBC argues that travel times associated with these two work groups differ for the simple reason that the groups cover geographic areas of different sizes and that "Staff's speculation that this necessarily means that one group is 'inefficient' (see Staff Init. Br. At 161-62) is nonsense". SBC BOE at 73.

SBC mischaracterizes Staff's statements. Staff did not say nor imply that differing provisioning group travel times alone "necessarily means" that one group is inefficient. Rather, Staff stated:

> SBC has offered no technological reason for the existence of this difference. Rather, it has argued that CP&M does the job more quickly due to the way CP&M is structured. Thus, based on its contentions, SBC has done nothing more than demonstrate that its DOG group is inefficient when provisioning UNE loops.

Staff IB at 161-162.

Certainly, there may very good reasons related to, for example, technical differences in the work these groups perform that would result in differing travel times. However, SBC failed to identify any such differences -- technical or otherwise -- or to explain how such differences would result in the differing travel times presented by the company. Thus, what SBC has shown is that one group does the same work that another does, but takes more time and costs the company -- and hence purchasing CLECs -- more money to do so. Absent any other mitigating factors, SBC has provided only enough information to demonstrate that the latter group performs the activity less efficiently than the first.

For all of these reasons the Commission should reject SBC's proposal to modify the *Proposed Order* with regard to this issue.

3. [IV.C.3] Provisioning (Loops and EELs) – Occurrence Probabilities

SBC asserts that the Work Group Occurrence Factor (WGOF) for the CP&M group with respect to standalone loops is "an overall average, reflecting the frequency with which outside plant technicians must be dispatched over all types of stand-alone UNE loop orders" and that "[t]he Proposed Order fails to recognize this." SBC BOE at

74. SBC appears to argue that the Proposed Order failed to accurately understand SBC's methodology in determining the CP&M WGOF. This argument is incorrect. The Proposed Order accurately summarizes SBC's approach and the flaws therein.

SBC uses a figure of ***BEGIN PROP XXXX% END PROP*** to indicate the percentage of the time it must dispatch a CP&M technician when provisioning a new UNE-P POTS loop, and a figure of 0% to indicate the percentage of the time it must dispatch a CP&M technician when provisioning a UNE-P POTS loop migration. *See* Staff IB at 166-167. When estimating the costs of provisioning standalone POTS loops, SBC does not differentiate between standalone loops that are and are not migrated from existing loops. SBC uses the single figure of ***BEGIN PROP XXXXX% END PROP***, apparently applicable to non-migrations, to indicate the percentage of the time it must dispatch a CP&M technician when provisioning standalone POTS loops resulting both from non-migrations and migrations. The *Proposed Order* determines that this approach is problematic because migrations that are 100% DOP'd have the occurrence factor for performing cross-connects applied to them. Proposed Order at 189.

SBC does not estimate NRCs using separate CP&M WGOF for migrated and non-migrated standalone POTS loops, but instead uses a single CP&M WGOF for both migrated and non-migrated standalone POTS loops. Therefore, this single CP&M WGOF figure SBC uses in its estimate is very clearly an average. However, because the CP&M WGOF for non-migrations equals ***BEGIN PROP XX% END PROP***, and the average of this figure and the CP&M for migrations equals ***BEGIN PROP XX% END PROP***, the CP&M WGOF for migrations must equal ***BEGIN PROP XX% END

PROP***. Therefore, the fact that SBC employed an average does not mean that the *Proposed Order* reached a faulty conclusion in assuming that SBC has applied a CP&M WGOF of ***BEGIN PROP XX% END PROP*** to standalone POTS loop migrations, or that the *Proposed Order* was incorrect in its conclusion that SBC erred by not using the correct CP&M WGOF of 0% in these instances.

SBC's arguments suggest that, rather than incorrectly applying a CP&M WGOF of ***BEGIN PROP XX% END PROP*** to standalone POTS loop migrations, the company instead applied some other figure. That is, implicit in its argument is the assertion that the company averaged two figures to derive its "overall average": (1) an undisclosed value (applicable to the percentage of the time it must dispatch a CP&M technician when provisioning a non-migrated standalone POTS loop) and (2) 0% (applicable to the percentage of the time it must dispatch a CP&M technician to when provisioning a migrated standalone POTS loop). However, this scenario does not fit with the facts. First, the only CP&M WGOF SBC submitted for non-migrated POTS loops was the ***BEGIN PROP X% END PROP*** figure. Any other figure relied on by SBC is not only unsupported, but not identified anywhere in SBC's cost studies, and in any case not a matter of record in this proceeding. Second, SBC expects the Commission to accept that its averaging of non-migrated and migrated standalone POTS loop CP&M WGOFs – utterly coincidentally –yielded <u>precisely the same</u> CP&M WGOF as it derived for non-migrated UNE-P POTS loops. This, needless to say, strains credulity.

As this analysis demonstrates, the *Proposed Order* <u>does not</u> fail to understand the problem with SBC's CP&M WGOF for standalone POTS loops. Rather, the

Proposed Order understands SBC's position all too well, and provides a lucid and accurate description of the problem with SBC's approach.

SBC then refers to new data presented during this proceeding that it asserts "…proves the reasonableness of SBC Illinois' original WGOF proposal, because an even *higher* WGOF would have been fully justified." SBC BOE at 75. SBC expects the Commission to believe that it has found new data, unavailable to it when it developed its cost studies, that confirms that the averaging of non-migrated and migrated standalone POTS loop CP&M WGOFs which coincidentally yielded precisely the same CP&M WGOF as it derived for non-migrated UNE-P POTS loops is correct. Again, needless to say, this assertion strains credulity.

SBC indicates that Staff's proposal to apply the same CP&M WGOF to both standalone and UNE-P POTS provisioning "cannot be correct." SBC BOE at 75. SBC has offered no credible evidence to support this. In fact, when Staff attempted to discern whether SBC might possess evidence in support of its assertion, SBC stipulated to the fact that the witness responsible for addressing this issue was not qualified to address it. Staff IB at 169. Nevertheless, SBC's sole reference in support of its argument is to the testimony of this witness. SBC BOE at 75.

For the reasons above, the Commission should not revise the *Proposed Order* with respect to the issue of the CP&M WGOF for standalone UNE POTS loops.

4. [IV.E.1.] Special Access to UNE Conversions

The *Proposed Order*, based in part on Staff's recommendation, rejects SBC's design and coordination charge. Proposed Order at 210. SBC asserts that "Staff's entire argument was a hollow word-game." SBC BOE at 77. SBC is, again, incorrect.

SBC admits that provisioning of special access to UNE conversions does not involve physical provisioning work. SBC BOE at 78. For this reason, Staff has, in contrast to SBC's assertion, demonstrated that there is no reason why SBC must involve its physical provisioning groups in provisioning of these conversions. That is, Staff very clearly demonstrated the unlikelihood that the activities SBC asserts must be performed by its physical provisioning groups are necessary at all. Staff IB at 180. Staff is not engaged in "word games". If the physical provisioning groups do not do any physical provisioning – as appears to be the case here -- SBC should not be permitted to include costs associated with these groups in its special access to UNE conversion cost estimates.

SBC argues that its physical provisioning groups do indeed perform activities related to the provisioning of special access to UNE conversions and explains that this work includes analyzing two orders to make sure the "information within the system across the two orders is identical." SBC BOE at 78. Staff attempted to determine why a task seemingly related to service orders needs to be performed by SBC's physical provisioning groups. SBC's witness on this matter indicated that in cases where the order was properly entered (which is presumably verified by SBC's service order provisioning groups), this function is unnecessary. *See* Staff IB at 182-183. When Staff attempted to further identify any legitimate purpose for SBC's physical provisioning group activities, SBC's witness was unable to provide further detail. *See* Staff IB at 183.

The charges SBC proposes to access for the activities performed by its provisioning group are not trivial. SBC estimates a cost that in some instances equals ***BEGIN CONF XXXX END CONF***, not considering service order related charges.

Staff IB at 181. This is quite clearly excessive for the order comparison activities SBC has asserted it needs to perform when provisioning a special access to UNE conversion, quite apart from the fact that these activities appear to rarely if ever be necessary.

SBC asserts that its costs are justified because its witness is not aware of any system available today that would cost-effectively perform these functions automatically, and none of the parties have been able to point to any. SBC BOE at 77. There are two fundamental problems with SBC's argument. First, the fact that its witness is unable to point to a more cost-efficient system is of little consequence, given the fact that SBC's witness expressed unfamiliarity with SBC's existing system. Staff IB at 183. Second, it is of little consequence that no other party has pointed to a more efficient process because SBC has not identified why these tasks are performed. That is, it is not surprising that no party has come forward with a better process for performing ill-defined tasks that appear unnecessary.

For the above reasons, SBC's proposal to reverse the *Proposed Order* finding and to permit its design and coordination charges should be rejected.

H. [VI.] Wholesale Shared Cost Denominator

The *Proposed Order* concluded that the UNE shared and common cost factor should consist of the wholesale shared costs added to the common costs as the numerator over the total direct costs as denominator. The *Proposed Order* explains that: "This formula is contained in the testimony of SBC witness Barch and Staff witness Patrick/Chang and is consistent with Staff's recommendation that the Commission direct SBC to combine shared and common costs, and distribute those costs over a single denominator (Staff Ex. 8.0 at 30)." *Proposed Order* at 257. Staff inadvertently failed to take exception to this conclusion when it filed its BOE. It was only upon reviewing SBC's BOE that Staff realized that it should have taken exception to this language. Staff clarifies its position below.

First, although the *Proposed Order* accurately cites to the direct testimony of Staff witness Dr. Melanie Patrick (as adopted by Ms. Chang) for the proposition of employing a single denominator, Staff's position, as noted by SBC[6], had evolved.[7] Staff regrets any resulting confusion. As Staff explained in its Reply Brief, "if SBCI can prove . . . that there actually are shared wholesale costs (UNE + other wholesale), then it must develop a denominator that includes all UNE direct costs plus all other wholesale direct costs." Staff Reply Brief at 91. If the Commission agrees with the *Proposed Order* that SBC sufficiently demonstrated that there are shared wholesale costs (uncollectibles and wholesale marketing costs) and its treatment of the uncollectibles, Staff recommends that the Commission order SBC to work with Staff to develop a "wholesale shared cost denominator" that includes both UNE costs based on extended TELRICs plus all other wholesale costs. *Id*. Under this scenario, Staff agrees with SBC that wholesale shared costs should not be combined with common costs and then distributed over a single common cost denominator. SBC BOE at 51.[8] Staff, moreover, under this scenario

6 As SBC pointed out in its BOE, "although Staff did initially recommend combining wholesale marketing expense with common costs, Staff later disavowed this approach and recommended use of wholesale direct costs in the denominator." SBC BOE at 53.

7 *See e.g., Proposed Order* at 256 ("Alternatively, Staff recommends that if any of the wholesale marketing costs are to be allocated to UNEs, it is more appropriate to add those to common costs given the lack of evidence of cost causation relationship."), *citing* Staff Ex. 28.0 (Chang), p. 9.

8 Staff, however, expressly disagrees with SBC's characterization of the *Proposed Order's* analysis and conclusion as a "detour into the 'Twilight Zone'". SBC BOE at 50.

supports the SBC proposed replacement language, which would replace the third and fourth full paragraphs on page 257 of the *Proposed Order*. See SBC BOE, App. B, at 25.

However, if the Commission disagrees with the *Proposed Order*, and finds that SBC has not sufficiently demonstrated that the wholesale marketing costs are relevant to the UNE services (and that uncollectibles are tied to revenues), the Staff agrees with the *Proposed Order's* conclusion that the Shared and Common Cost Factor be developed using a ratio of "Shared" and Common Costs divided by Total Direct Costs.

I. [VIII.] Imputation

The Joint CLECs take exception to the Proposed Order's finding that the Commission should rule in a subsequent proceeding on whether SBC's business NAL rates pass imputation. *See, generally,* Joint CLEC BOE at 247 *et seq*. First, the Joint CLECs contend that the Commission's administrative rules, specifically 83 Ill. Admin. Code §792.30(d), require a ruling on imputation within 120 days, unless all parties agree to a waiver of this requirement. Joint CLEC BOE at 250-51. Next, they assert, while conceding that all parties agreed to a waiver of this provision, that the waiver to which the parties in fact agreed was one that required the Commission to rule upon the imputation issue no later than its *Final Order* in this proceeding. Id. at 252-53. This being the case, aver the Joint CLECs, the Proposed Order's recommendation that the Commission defer ruling on the issue constitutes a breach of the Commission's own administrative rule. Id.

The Commission should disregard the Joint CLECs' arguments. The *Proposed Order*, in recommending that the Commission defer ruling on imputation, did so for the most sensible of reasons: that Commission-approved rates that will not be set, and hence cannot be known, until the Commission issues its *Final Order* in this proceeding.[9] Proposed Order at 289. Accordingly, it will – contrary to the CLECs' assertions – be impossible to conduct an imputation test prior to that time. The *Proposed Order* properly recognizes this, and addresses it in a practical manner, and one that places a premium on actual, meaningful implementation of Section 13-505.1.

An administrative agency is not a slave to its rules. Cartwright v. Ill. Civil Service Comm'n., 80 Ill. App. 3d 787, 791 (1st Dist. 1980). *Ad hoc* changes to rules are permissible in proper cases, especially where the rule in question is procedural, and the agency's intended change or modification will not cause substantial prejudice. Id.

Here, there is no question that the requirement that the Commission rule within 120 days is procedural, and the failure to adhere to the rule will not cause substantial prejudice to anyone. Moreover, the *Proposed Order*, by requiring SBC to make, within 30 days of entry of the *Final Order*, an imputation compliance filing, has assured that Section 13-505.1 will be implemented and obeyed – based upon final rates. Accordingly, the *Proposed Order's* recommendation is sensible and lawful, and should be adopted.

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9 The Staff notes that the Joint CLECs have, in the past, complained that the Commission's various Orders regarding TELRIC rates have not been self-executing, and have not resulted in actual rates until SBC makes one or more compliance filings, which are often themselves contested. The *Proposed Order* addresses this concern by directing Staff and SBC to develop rates consistent with its findings, so that known, effective rates would result immediately from the Commission Order in this proceeding.

III. CALCULATION OF RATES RECOMMENDED BY THE PROPOSED ORDER

A. UNE Loop Recurring Cost Studies

1. TELRIC rates

The two major differences between Staff's and SBC's proposed recurring loop rates before loading for shared and Common factors occur with respect to DS1 loops and DS3 loops.

a) DS1 Rates

The difference between Staff's and SBC's proposed UNE rate is largely explained by how each party treated cell AE77 in the Yearly_Input tab of LoopCAT. According to the Proposed Order (p. 106), 21.6 units of common investment should be assigned to a DS-1 loop rather than 24. The 21.6 reflects the fact that UDLC is used in 88% of the remote terminals and IDLC is used in 12% of the remote terminals. Accordingly, Staff changed cell AE77 in the Yearly_Input Tab from 24 to 21.6. SBC on the other hand, continued to assign 24 units of investment in DSX1 Channel Units to DS1. If a value of 24 is assigned to cell AE77 then Staff's calculated DS1 rates move to within 5 cents of SBCI's proposed DS1 rates. The remaining nickel difference in rates is likely due to the fact that Staff truncated input values to 4 decimal places while SBC did not.

b) DS3 Rates

Staff's DS3 rates are approximately 10 cents lower than SBCI's. This is largely due to a couple of errors made in the fourth decimal place on two inputs. In addition, Staff's input values were rounded off to four decimal places. Once these errors were corrected and input values were extended to five from four decimal places Staff's calculated DS3 rates are within 2 cents of SBCI 's.

c) Labor rates

Staff's other expense loading for labor rates is 0.45% vs 0.3% for SBC. As a result, Staff's labor rates are a cent or two higher than SBCI's. Since labor rates are inputted in all the recurring loop models this difference in labor rates could impact all loop rates by a fraction of a cent.

d) Removal of collocation investment and expenses from land and building ACF's

The Proposed Order adopted the methodology put forth by CLEC witnesses Starkey/Fischer to remove collocation investment and expenses from the land and building ACF's. Proposed Order at 264. The CLECs, Staff, and SBC agree that the appropriate amount of investment and expenses to remove is ***BEGIN CONF XXX% END CONF***. However, in review of the ACF model provided by SBC in support of the rates developed in its BOE, it appears that there is a disparity between the parties as to how to implement this reduction. The CLECs proposed, in the direct testimony of Starkey/Fischer, to make the adjustment via a reduction in the beginning and ending land and building investment in the Inputs worksheet of the ACF model. Joint CLEC Exhibit 1.P at 133. As the Proposed Order indicated that it is accepting the Starkey/Fischer methodology, Staff applied its reductions accordingly. SBC, on the other hand, made its adjustments via adjustments in the Land Factor and Building Factor worksheets within the ACF model. The difference between the two methodologies is small, but does partially explain the discrepancy between rates provided by parties in their respective BOEs.

B. Non-Recurring Cost Studies

Staff noted some errors and omissions in the rate calculations submitted with its Brief on Exceptions: Those errors and omissions were with respect to the following rates:

Electronic-Non Channelized DS1 EEL-Establish Service Ordering Charge

(Connection+Disconnection)	$16.10
Connection	$10.13
Disconnection	$7.85

Manual-Non Channelized DS1 EEL-Establish Service Ordering Charge

Connection+Disconnection	$92.83
Connection	$63.40
Disconnection	$38.61

Electronic –2 wire Digital Loop EEL-Service Ordering Charge

Connection+Disconnection	$15.50
Connection	$9.53

IV. CONCLUSION

WHEREFORE, the Staff of the Illinois Commerce Commission respectfully requests that its recommendations be adopted in this proceeding and that the Proposed Order be modified as set forth in this Reply Brief on Exceptions and Staff's Brief on Exceptions.

Respectfully submitted,

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