BEFORE THE ILLINOIS COMMERCE COMMISSION

Docket No. 08-0569

Surrebuttal Testimony of Timothy Dominak
On Behalf of AT&T Illinois

AT&T Illinois Exhibit 7.1

February 6, 2009

SURREBUTTAL TESTIMONY OF TIMOTHY DOMINAK

ON BEHALF OF AT&T ILLINOIS

Q. Please state your name and business address.

A. Timothy Dominak, 2000 West AT&T Center Drive, Hoffman Estates, Illinois 60192.

Q. Are you the same Timothy Dominak who previously submitted Rebuttal testimony in this case?

A. Yes, I am.

Q. What is the purpose of your Surrebuttal Testimony?

A. The purpose of my testimony is to respond to portions of the Additional Rebuttal Testimony of Attorney General ("AG") witness Dr. Lee Selwyn.

Q. Dr. Selwyn maintains that AT&T Illinois' revised rates of return ("ROR") on intrastate investment and rates of return on common equity ("ROE"), both as originally reported to the Illinois Commerce Commission and as revised in your rebuttal testimony, would be "considerably higher" if AT&T Illinois (i) had not "transferred revenues" to nonregulated affiliates (AG Ex. 3.0, p. 9), (ii) had reported revenues that appropriately tracked all of its costs (*id.*, p. 10), and (iii) had not included costs above-the-line (ATL) when associated revenues had been shifted below-the-line (BTL) (*id.*, p. 13). Are these assertions correct?

A. No. As I will explain in this testimony, Dr. Selwyn completely ignores the regulatory accounting requirements to which AT&T Illinois was subject during the period 2000 through 2007 under the FCC's Uniform System of Accounts (47 C.F.R. Part 32) and Allocation of Costs rule (47 C.F.R. Part 64.901), which were adopted by this Commission in 83 Ill. Admin Code Parts 710 (Uniform System of Accounts) and 711 (Cost Allocations for Large Local Exchange Carriers). AT&T Illinois fully complied with these rules. All of Dr. Selwyn's allegations regarding revenue transfers and suggestions of improper cost accounting are incorrect.

Q. In response to your rebuttal testimony regarding the significant decrease in AT&T Illinois' net operating revenues over the past eight years, Dr. Selwyn argues that you failed to mention that from 2000 through 2007 "there was a significant *transfer of revenues* from what was then SBC Illinois to one or more non-regulated affiliates, offset by a significantly less than proportionate transfer of investment costs and operating expenses." (AG Ex. 3.0, p. 9). Do you have any comments in response to his argument?

A. Yes, there was no such "transfer of revenues" or "disproportionate" "transfer of costs or operating expenses." Since 1988, including the time period in question (2000-2007), all transactions between AT&T Illinois and its non-regulated affiliates were conducted in full compliance with the FCC's "Joint Cost Order," CC Docket No. 86-111, released February 6, 1987 and the identical requirements adopted by this Commission in 83 Ill. Admin. Code Part 711, Cost Allocations for Large Local Exchange Carriers. The Joint Cost Order established two separate but complementary sets of rules: (1) a cost allocation process which separates the costs of regulated and nonregulated activities offered by a carrier (47 C.F.R. Part 64.901), and (2) rules governing transactions for goods and services between a carrier and its nonregulated affiliates (47 C.F.R. Part 32.27). The results of the applications of these rules to AT&T Illinois' operations and its transactions with affiliates are reviewed annually by an independent auditor.[1]

Q. To the extent that AT&T Illinois provides goods and services to its non-regulated affiliates, do those affiliates compensate AT&T Illinois?

A. Yes. During the time period in question, the affiliates were charged for the services and goods in accordance with the pricing hierarchy prescribed by 47 C.F.R. Part 32.27. Under that rule, the following regulatory pricing hierarchy is used to charge affiliates for goods and services: 1) tariffed rates; 2) publicly filed agreements /statements of generally available terms; 3) prevailing price; 4) higher of fair market value/ net book cost (for assets); and 5) higher of fair market value/fully distributed cost (for services). For example, as discussed by Karl Wardin, an advanced data services affiliate of AT&T Illinois purchases transport services used in the provision of DSL services from AT&T Illinois' interstate special access tariff. The charges for those services are governed by the tariff. The revenues from an affiliate's purchases of goods and services from AT&T

[1] In an Order issued on April 24, 2008, the FCC granted AT&T forbearance from these sections, and, therefore, those sections do not apply to AT&T Illinois on a going forward basis. FCC Memorandum Opinion and Order, WC Docket No. 07-21, WC Docket No. 05-342, Adopted & Released April 24, 2008, *In the Matter of Petition of AT&T Inc. For Forbearance Under 47 U.S.C. §160 From Enforcement of Certain of the Commission's Cost Assignment Rules AND Petition of BellSouth Telecommunications, Inc. For Forbearance Under 47 U.S.C. § 160 From Enforcement of Certain of the Commission's Cost Assignment Rules (FCC 08-120);* FCC Public Notice DA 08-2827, Release Date: December 31, 2008, *Wireline Competition Bureau Approves Compliance Plans RE: WC Docket Nos. 07-21, 07-204, 07-273.*

Illinois are recorded as normal operating revenues. Thus, such revenues are included in the Total Operating Revenue data in Table 1 of my Rebuttal Testimony.

Q. Did the ROR on regulated intrastate investment figures presented in your Rebuttal Testimony reflect an allocation of costs between regulated and not-regulated activities.

A. Yes. In accordance with 47 C.F.R. Part 64.901, the data I presented for 2000 through 2007 reflected an assignment and allocation of costs and expenses between regulated and non-regulated activities, including services provided to non-regulated activities. The non-regulated costs and expenses were also removed from total company data prior to the calculation of jurisdictional separations. The annual results of this process for 2000 through 2007 are publicly posted on the FCC ARMIS web site along with an audit opinion for each year from an independent public accountant.

Q. Dr. Selwyn asserts that the 10% decrease in operating expenses experienced by AT&T Illinois during the period of 2000 to 2007 (reflected on Table 1 of your Rebuttal Testimony) relative to the 28% decrease in operating revenue during the same period was the result of "use of creative accounting." (AG Ex. 3.0, p. 10). Is this claim accurate?

A. No. As previously stated, the operating revenues and expense data included in Table 1 reflect AT&T Illinois' compliance with the accounting rules and regulations of the FCC and ICC. Dr. Selwyn has presented no evidence to the contrary. There are several fundamental reasons why the operating expenses during this period decreased at a much slower rate than the associated operating revenues. First, the decrease in operating revenues over the past several years is primarily the result of lost customers and access lines and reduced usage due to competition. Because of the high fixed cost nature of its operations, the expenses associated with operating and maintaining its network could not be reduced in the same proportion as the decreases in access lines and revenues.

Second, the widely publicized skyrocketing increases in health care costs, including post retirement benefits, have caused these expenses to outpace most other costs during this period.

Third, depreciation expense continues to increase as the company continues to reinvest in the telephone plant of AT&T Illinois. A review of the ARMIS 43-02 shows that, for the period of 2000 through 2007, Telephone Plant in Service increased by $2.7 billion and the corresponding depreciation expense increased by $206 million. The expense increases in these two operational areas offset many other expense decreases.

Accordingly, there is no basis for Dr. Selwyn's assertion that some type of misclassification of costs or "creative cost accounting" is the cause of the percentage decrease in operating expense being lower than the percentage decrease in operating expenses during this period.

Q. Dr. Selwyn alleges that reported returns are "likely understated" due to "revenue shifts" below-the-line and the company's ability to "divert revenues away from its

regulatory books while carrying the costs on its regulatory books." Is this assertion correct? (AG Ex. 3.0, p. 13).

A. No. As I have previously discussed, AT&T Illinois was required to follow, and has followed, the accounting classification requirements of the FCC and ICC. There are no such accounting provisions that would allow AT&T Illinois to shift revenues or costs in the manner Dr. Selwyn alleges.

Q. Dr. Selwyn asserts that AT&T Illinois is recording "above-the-line" costs associated with the use of plant and company resources used to generate revenues recorded either "below-the-line" or on the books of a non-regulated affiliate, thereby "effectively conceal[ing] benefits from a direct examination of reported *regulatory* rates of return." (AG Ex. 3.0, p. 13). Is Dr. Selwyn's analysis correct?

A. No. Dr. Selwyn fails to differentiate between (i) revenues and costs associated with services provided by AT&T Illinois to non-affiliated (e.g., retail and/ or wholesale) customers and recorded on AT&T Illinois' books of account; (ii) services AT&T Illinois provides to nonregulated affiliates, the revenues and costs for which are recorded on AT&T Illinois' books of account; and (iii) services the nonregulated affiliate provides to its own customers, the revenues and costs for which are recorded on the nonregulated affiliate's books of account. As previously discussed, the FCC's and ICC's Uniform System of Accounts and Cost Allocation rules, in effect since 1988, do not permit the recording of costs "above-the-line" if those costs are used to generate revenues recorded "below-the-line" or revenue earned by a nonregulated affiliate and recorded on the nonregulated affiliate's books of account. AT&T Illinois classifies and accounts for its revenues and expenses as either regulated or nonregulated. When AT&T Illinois provides affiliated services, the services and associated expenses to provide these services are also classified as regulated or nonregulated. That is, regardless of whether the service AT&T Illinois provides is to a non-affiliated customer or an affiliate, the revenues and costs associated with that service are treated consistently on AT&T Illinois' books of account as regulated or nonregulated. Nonregulated AT&T Illinois affiliates account for their product revenues and associated expenses (which could include expenses paid to AT&T Illinois for such services as access and building rent) on their own, separate legal entity books of account.

Q. Dr. Selwyn continues in his assertion (pg. 9) that "as customers shifted from dial-up to DSL and, more recently to AT&T's *U-verse* for their Internet access" that revenues were "diverted away from AT&T Illinois." Please comment on this assertion.

A. This is another example of Dr. Selwyn's failure to differentiate the proper accounting treatment for services provided by AT&T Illinois and services provided by nonregulated affiliates and the respective required accounting treatment. In addition, U-verse℠ is a nonregulated product provided by AT&T Illinois (not an affiliate) and, therefore, U-verse℠ revenues are recorded in Account 5280, Nonregulated Operating Revenue, on AT&T Illinois' books of account.

Q. Dr. Selwyn continues to criticize your data presented in Table 1 and 2 of your Rebuttal Testimony, concluding that "they actually confirm a persistent level of

excessive earnings on the part of AT&T Illinois." Do you have any further comments regarding Dr. Selwyn's conclusions?

A. Yes. Dr. Selwyn is wrong for all the reasons discussed in my Rebuttal Testimony and in the Rebuttal and Surrebuttal Testimony of AT&T Illinois witnesses Dr. William Taylor and Karl Wardin. On Table 1 of my Rebuttal Testimony, I presented the fundamental operating data of the Company that would be required to generate any meaningful changes to returns – operating revenues and expenses. In this regard, further discussions as to regulatory accounting returns as compared to an external GAAP return become pointless since ultimately "cash is cash" and there is no distinction between regulatory "cash" from externally reported "cash." Earnings cannot be generated from vapor. The primary drivers of any earnings must come from the Company's revenue increases or expense decreases which, in turn, would generate cash. The data I have presented in this regard show that net operating revenues (the difference between operating revenues and operating expenses) decreased by 57% from 2000 through 2007, refuting any claim of "excessive earnings."

Q. Does this conclude your Surrebuttal Testimony?

A. Yes.