

**BEFORE THE
ILLINOIS COMMERCE COMMISSION**

<p>In the Matter of</p> <p>Illinois Commerce Commission on its own Motion</p> <p>v.</p> <p>McLeodUSA Telecommunications Services, Inc. d/b/a PAETEC Business Services</p> <p>Investigation into whether Intrastate Access Charges of McLeodUSA Telecommunications Services, Inc. d/b/a PAETEC Business Services are just and reasonable</p>	<p>Docket No. 09-0315</p>
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DIRECT TESTIMONY OF

DR. KENT A. CURRIE

**ON BEHALF OF
AT&T COMMUNICATIONS OF ILLINOIS, INC.**

PUBLIC VERSION

February 22, 2010

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1 I. INTRODUCTION AND SUMMARY

2 **Q1.** PLEASE STATE YOUR NAME, ADDRESS AND NATURE OF EMPLOYMENT.

3 A1. My name is Kent A. Currie. My business address is 45 Erieview Plaza, Cleveland, Ohio
4 44114. AT&T Services, Inc. employs me as Area Manager – Rates/Tariffs within the
5 Cost Analysis Division. AT&T Services, Inc. is a centralized staff organization for
6 AT&T, Inc. that provides cost analysis and other regulatory support to various AT&T
7 subsidiaries.

8 **Q2.** ON WHOSE BEHALF ARE YOU PRESENTING THIS TESTIMONY?

9 A2. I am testifying on behalf of AT&T Communications of Illinois, Inc. (“AT&TCI”), which
10 is a certificated provider of interexchange service in Illinois and, as such, uses the
11 intrastate switched access services provided by McLeodUSA Telecommunications
12 Services, Inc. d/b/a PAETEC Business Services (“McLeodUSA”) and other local
13 exchange carriers in Illinois.

14 **Q3.** WHAT ARE YOUR JOB RESPONSIBILITIES?

15 A3. My job responsibilities at AT&T are similar to my previous positions at Ameritech and
16 SBC, where I was responsible for developing and maintaining the methodological
17 framework for economic cost studies for telecommunications services. These cost
18 methods are used in many studies, such as Long Run Service Incremental Cost
19 (“LRSIC”) studies, Total Service Long-Run Incremental Cost (“TSLRIC”) studies and
20 Total Element Long-Run Incremental Cost (“TELRIC”) studies. In order to monitor the
21 application of these methods, I direct, supervise, and prepare studies using these methods.
22 In addition, my responsibilities have included the internal and external dissemination of
23 AT&T's policies regarding studies using these methods and related issues. Furthermore,

24 my responsibilities have included the review and evaluation of cost studies performed by
25 companies not affiliated with AT&T.

26 **Q4. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND.**

27 A4. I received a Ph.D. in economics from the University of Iowa in 1973. In addition, I have
28 a Master of Science degree in economics from the University of Iowa, and a Bachelor of
29 Science degree in mathematics from Bradley University. I specialize in microeconomic
30 theory and industrial organization, concentrating in public utility economics. After
31 completing my graduate studies, I held full-time teaching and research appointments at
32 two engineering universities.

33 **Q5. PLEASE BRIEFLY DESCRIBE YOUR TELECOMMUNICATIONS WORK**
34 **EXPERIENCE.**

35 A5. I began my telecommunications career in 1980 at Ohio Bell Telephone Company. I have
36 performed, directed, and supervised many telecommunications cost analyses across the
37 entire range of services offered by AT&T's incumbent local exchange companies.
38 Furthermore, I have developed and monitored cost methods used in such cost studies, and
39 I have reviewed cost studies performed by local exchange carriers not affiliated with
40 AT&T.

41 **Q6. HAVE YOU PREVIOUSLY TESTIFIED BEFORE ANY REGULATORY**
42 **COMMISSIONS?**

43 A6. Yes. I have testified on cost and other economic issues in regulatory proceedings before
44 the Illinois Commerce Commission ("ICC" or "Commission") and many other regulatory
45 commissions. I have attached Schedule KAC-1 to this testimony, which summarizes my
46 testimonies and lists my other pertinent experiences and activities.

47 **Q7. WHAT IS THE PURPOSE OF YOUR DIRECT TESTIMONY**

48 A7. The primary purpose of my testimony is to analyze the cost portions of the direct
49 testimony of Mr. Michael Starkey on behalf of McLeodUSA. Hence, I will provide a
50 critique of McLeodUSA's cost study. In addition, I will make reasonable and necessary
51 corrections to this study that reduce substantially the estimated usage costs for
52 McLeodUSA's switched access services. My testimony, thus, supports and compliments
53 the direct testimony of AT&T witness Dr. Ola A. Oyefusi.

54 **Q8.** YOU MENTIONED EARLIER THAT YOU HAVE EXPERIENCE IN
55 REVIEWING ECONOMIC COST STUDIES. WHAT KIND OF COST STUDY
56 HAS MCLEODUSA EMPLOYED AND ARE YOU FAMILIAR WITH THAT
57 PARTICULAR TYPE?

58 A8. McLeodUSA provided a study using a proprietary model called Network Usage Cost
59 Assessment ("NUCA") developed by QSI Consulting, Inc. ("QSI"), whose President is
60 Mr. Starkey. Mr. Starkey has indicated that this study is designed to follow a TSLRIC
61 methodology.¹ A fundamental characteristic of TSLRIC is to measure forward-looking
62 costs, which are costs a company, such as McLeodUSA, expects to incur efficiently on a
63 going forward basis. I am very familiar with economic cost studies generally and
64 TSLRIC studies specifically.

65 **Q9.** PLEASE SUMMARIZE YOUR DIRECT TESTIMONY.

66 A9. McLeodUSA has claimed that one of the considerations that the Commission could use
67 as a guiding principle in determining whether McLeodUSA's intrastate switched access
68 charges are just and reasonable is to evaluate McLeodUSA's margin, *i.e.*, the difference
69 between rate and cost, for its intrastate switched access service. McLeodUSA identified
70 six usage-sensitive rate elements of its intrastate switched access service that

¹ Starkey Direct Testimony, p. 37.

71 McLeodUSA claims are the specific rates subject to this determination. McLeodUSA
72 averred that rates and costs should be compared on a composite basis for these six usage-
73 rated charges rather than for each individual charge. McLeodUSA has developed a
74 composite rate and cost for wireless originated traffic and another composite rate and cost
75 for all other intrastate switched access traffic. Since very little wireless traffic should be
76 subject to McLeodUSA's intrastate access tariff, as explained further in Dr. Oyefusi's
77 testimony, any comparison of McLeodUSA's switched access rates and costs should
78 focus on the composite rate and cost for other traffic.

79 Dr. Oyefusi explains why McLeodUSA's computation of access cost is irrelevant,
80 because the proper comparison is between McLeodUSA's access *price* and the
81 corresponding price charged by competing incumbent local exchange companies
82 ("ILECs") for the same service. Confidential Schedule KAC-2 shows McLeodUSA's
83 current charges for the six usage-sensitive rate elements identified by McLeodUSA along
84 with composite rates as well as the corresponding prices and composite rates of the three
85 ILEC with whom McLeodUSA competes for retail customers: Illinois Bell Telephone
86 Company ("AT&T Illinois"), Verizon North Inc. and Illinois Consolidate Telephone
87 Company. If McLeodUSA is operating efficiently, it should be able to match the ILECs'
88 price and still recover its costs; if McLeodUSA is operating *inefficiently*, it should not be
89 allowed to extract subsidies from other providers through high access charges.

90 My testimony shows that, even if the Commission were to consider
91 McLeodUSA's access costs, it simply gives the Commission more reason to accept
92 AT&TCI's proposal.

93 McLeodUSA's purported estimate of a composite cost including overhead
94 loadings of **[BEGIN CONFIDENTIAL ***** ** END CONFIDENTIAL]**
95 for the six usage-rated elements and McLeodUSA's purported composite estimate
96 excluding overhead loadings of **[BEGIN CONFIDENTIAL ***** ** END**
97 **CONFIDENTIAL]** per minute are both vastly overstated and are not consistent with the
98 Commission's Cost of Service rules. These costs are found under Column A and B on
99 Confidential Schedule KAC-3. I have identified several major errors in McLeodUSA's
100 cost development. I have made the following adjustments to McLeodUSA's cost
101 calculations to correct for McLeodUSA's quantifiable errors: (1) associating all loop
102 costs with the CCL charge, (2) properly matching minutes and costs, (3) properly
103 categorizing distance-sensitive costs, (4) removing non-traffic sensitive ("NTS") loop
104 costs from CCL costs, (5) removing NTS costs from switching costs, (6) removing
105 common costs, (7) updating McLeodUSA's cost of capital, (8) updating McLeodUSA's
106 economic lives and (9) updating some hardware prices. The results of these quantified
107 corrections are shown under Column C of Confidential Schedule KAC-3. With just these
108 corrections, I have developed an upper bound of **[BEGIN CONFIDENTIAL *****
109 ******* ** END CONFIDENTIAL]** per minute on the "true" LRSIC for
110 McLeodUSA's usage-rated charges of its intrastate switched access service.

111 Based on my upper bound estimate of McLeodUSA's LRSIC, McLeodUSA's
112 current composite rate has a minimum contribution of **[BEGIN CONFIDENTIAL *****
113 ******* ** END CONFIDENTIAL]** per minute, or a
114 minimum markup of **[BEGIN CONFIDENTIAL *** ***** ****
115 ***** END CONFIDENTIAL]**. This markup is higher than each of the margins found in

116 Mr. Starkey's Table 6 with which Mr. Starkey used to make apples-to-oranges
117 comparisons.²

118 AT&TCI's proposed composite rate ceiling for each ILEC in whose territory
119 McLeodUSA competes, thus, passes the LRSIC test, *i.e.*, LRSIC does not exceed rate.
120 Thus, for AT&T Illinois' territory the composite rate cap of [BEGIN CONFIDENTIAL
121 *** ***** END CONFIDENTIAL] per minute from Confidential Schedule
122 KAC-2 exceeds my upper bound composite LRSIC estimate of [BEGIN
123 CONFIDENTIAL ***** END CONFIDENTIAL] per minute, and
124 reflects a maximum markup of [BEGIN CONFIDENTIAL *** ***** END
125 CONFIDENTIAL]. The maximum markup where McLeodUSA competes in Verizon
126 North's territory is [BEGIN CONFIDENTIAL ***** END
127 CONFIDENTIAL], and the maximum markup where McLeodUSA competes in Illinois
128 Consolidated's territory is [BEGIN CONFIDENTIAL *** ***** END
129 CONFIDENTIAL]. Clearly, these markups are [BEGIN CONFIDENTIAL *** *****
130 ***** END CONFIDENTIAL] in Docket
131 Nos. 97-0601/97-0602/97-0516. Thus, Dr. Oyefusi's recommendations yield a range of
132 just and reasonable rates that provide McLeodUSA the ability to cover LRSIC and have a
133 positive contribution for its usage-rated switched access service in each ILEC territory in
134 which it competes. In fact, Dr. Oyefusi's proposed caps give McLeodUSA even more
135 contribution than the Commission has found reasonable for AT&T Illinois' and
136 Verizon's switched access rates.

² Starkey Direct Testimony, p. 58.

137 In addition, I must make clear that the “upper bound” I calculate is still well
138 above McLeodUSA’s actual cost, because I have not attempted to correct *all* of
139 McLeodUSA’s overstatements. Indeed, McLeodUSA has not provided a cost study that
140 develops current forward-looking costs, but something more akin to one developing
141 forward-looking costs in 2005. Some of the inputs used in McLeodUSA’s cost study can
142 be reasonably updated, and I have done so. However, other inputs cannot be reasonably
143 updated by any party in this proceeding other than McLeodUSA.

144 These observations together with more specific criticisms I make regarding
145 McLeodUSA’s common cost development and documentation lead to the conclusion that
146 the Commission should not set McLeodUSA’s rates based on NUCA.

147 **Q10. IS IT YOUR INTENT TO PERFORM A COMPREHENSIVE APPRAISAL AND**
148 **RE-STATEMENT OF MCLEODUSA’S COSTS?**

149 A10. No. My analysis is sufficient to show that the Commission should not rely upon
150 McLeodUSA’s study. It is not my intention nor is it necessary to conduct a
151 comprehensive appraisal and re-statement of McLeodUSA’s costs. I have appraised
152 McLeodUSA’s cost study, and I have found significant deficiencies, which undermine its
153 reliability. In fact, just correcting for major deficiencies lowers McLeodUSA’s cost
154 estimates for intrastate switched access services sufficiently to demonstrate that
155 McLeodUSA’s intrastate switched access services are collectively compensatory using
156 AT&TCI’s recommended rate caps. While a complete overhaul of McLeodUSA’s cost
157 model would show that McLeodUSA’s access costs are lower still, no useful purpose is
158 satisfied by pursuing them further in this proceeding, and I have not done so.

159 **Q11. HAS MCLEODUSA’S “NUCA” MODEL BEEN REVIEWED BY ANY**
160 **COMMISSION IN A CONTESTED PROCEEDING?**

161 A11. Yes. The New Jersey Board of Public Utilities (“NJBPU”) recently issued an order
162 rejecting several switched access cost studies including two studies based on NUCA.³
163 NUCA was provided as cost support for One Communications and PAETEC
164 Communications, Inc. in New Jersey. PAETEC Communications is a sister CLEC of
165 McLeodUSA, *i.e.*, both are owned by PAETEC Holding Corp. Also, Mr. Starkey
166 testified on behalf of several CLECs, including One Communications and PAETEC
167 Communications, in which he sponsored NUCA as the tool for developing costs for
168 intrastate switch access. In rejecting the cost studies presented by ILECs and CLECs in
169 the New Jersey proceeding, the NJBPU said

170 Many of the parties in this proceeding offered into evidence their cost studies to
171 support their positions. The record shows that each and every cost model
172 presented in this proceeding overstates, and in some cases, grossly overstates
173 intrastate switched access costs. The record shows that flaws in the access cost
174 models include, but are not limited to, cost of capital, common overheads and
175 depreciation rates that were inappropriately inflated. Furthermore, loop costs,
176 which should not be included, are in some cases the largest cost elements in the
177 cost model. These costs are inappropriate for inclusion in the access cost models
178 in this proceeding. Moreover, there is evidence that the cost models offered by the
179 parties are not forward looking as required by the Board’s December 2008 Order.
180 Accordingly, the Board HEREBY FINDS that the cost models offered by the
181 parties to this proceeding included inappropriate costs, are flawed and overstate
182 costs for providing intrastate switched access service, such that they do not form a
183 foundation for higher access rates.⁴ (emphasis in original)

184 My testimony here shows that McLeodUSA’s filed cost of capital, common overheads or
185 costs and depreciation rates, using the same NUCA model that was rejected in New
186 Jersey, are similarly inflated. Also, McLeodUSA has inappropriately included loop costs
187 in its calculation of switched access costs. Furthermore, McLeodUSA’s costs are not

³ *In the Matter of the Board’s Investigation and Review of Local Exchange Carrier Intrastate Exchange Rates*, N.J. Board of Public Utility, Docket No. TX08090830, Telecommunications Order (“*NJ Order*”), dated February 1, 2010.

⁴ *Ibid.*, p. 27.

188 forward looking but use out-dated information. Hence, the New Jersey Board's
189 conclusion that NUCA provided no foundation for switched access rates in New Jersey is
190 equally applicable to McLeodUSA's costs presented here.

191 **II. LRSIC METHODOLOGY AS STANDARD FOR SWITCHED**
192 **ACCESS COST STUDIES**

193 **Q12. WHAT COST STANDARD HAS THE COMMISSION USED TO EXAMINE THE**
194 **REASONABLENESS OF SWITCHED ACCESS RATES?**

195 A12. The Commission has determined for three non-rural ILECs –Verizon North Inc. and
196 Verizon South Inc. (collectively, “Verizon”) and AT&T Illinois – that LRSIC studies,
197 *i.e.*, performed in accordance with the rules governing the development of costs set forth
198 in the Commission's “Cost of Service” rule (83 Illinois Administrative Code Part 791),
199 be used for examining the reasonableness of their intrastate switched access rates.⁵
200 Consistent with the treatment of those carriers, if economic costs are to be developed for
201 McLeodUSA's switched access service, then any study developing such costs should also
202 follow the LRSIC methodology as formulated by the Commission's Cost of Service rules

203 **Q13. WHAT IS THE DEFINITION FOR LRSIC FOUND IN THE COMMISSION'S**
204 **COST OF SERVICE RULES?**

205 A13. Section 791.20(a) defines LRSIC as “the forward-looking additional costs incurred by the
206 telecommunications carrier (‘carrier’) to provide the entire output of a service, including
207 additional resources such as labor, plant, and equipment.” This section also notes that
208 LRSIC “excludes any costs, including common costs, that would be incurred if the
209 service is not produced.”

⁵ Order, *Investigation into Non-Cost Based Access Charge Rate Elements in the Intrastate Access Charges of Incumbent Local Exchange Carriers in Illinois; Investigation into Implicit Universal Service Subsidies in Intrastate Access Charges and to Investigate how these Subsidies should be Treated in the Future; Investigation into the Reasonableness of the LS2 Rate of Illinois Bell Telephone Company*, Docket Nos. 97-0601, 97-0602 and 97-0516 (Consolidated), March 29, 2000, (“*ILEC Cost-Based Switched Access Order*”), p. 49.

210 **Q14.** IS THERE A SINGLE OVERRIDING ECONOMIC PRINCIPLE UNDERLYING
211 THE ATTRIBUTION OF COSTS TO A SERVICE?

212 A14. Yes. Section 791.30 enunciates the Cost Causation Principle as the primary determining
213 factor of whether or not a cost is attributable to or caused by a service.

214 **Q15.** WHAT IS THE COST CAUSATION PRINCIPLE?

215 A15. The Cost Causation Principle is that “[c]ost are recognized as being caused by a service
216 or group of services if:

217 a) The costs are brought into existence as a direct result of providing the service or
218 group of services; or

219 b) The costs are avoided if the service or group of services is not provided.

220 **Q16.** WHAT COST METHODOLOGY DID MCLEODUSA STATE WAS THE BASIS
221 FOR ITS SWITCHED ACCESS SERVICES COST DEVELOPMENT?

222 A16. Mr. Starkey said that NUCA is based on the TSLRIC approach.⁶ However, he destroyed
223 his own claim when he stated that “TSLRIC and TELRIC are methodologically identical,
224 with the only difference being that TELRIC focuses on developing costs for discrete
225 piece-parts of the network (*i.e.*, elements) while TSLRIC focuses on costs relevant to
226 providing a finished service.”⁷ This claimed equivalence of being “methodologically
227 identical” is not correct. NUCA inappropriately reflects TELRIC methods when and
228 where LRSIC methods should have been used, and there are instances in NUCA that
229 would more resemble a TELRIC cost study and not the stated, but potentially
230 appropriate, “TSLRIC” approach.

231 **Q17.** CAN YOU CONTRAST THE UNDERLYING METHODOLOGICAL PURPOSES
232 AND ORIGINS OF LRSIC AND TELRIC?

⁶ Starkey Direct Testimony, p. 37.

⁷ *Ibid.*, p. 38.

233 A17. Yes. TELRIC is the direct offspring of the FCC's implementation of rules on the Federal
234 Telecommunications Act of 1996, and is formulaically designed along with shared and
235 common costs to produce an actual price for charging interconnecting carriers using
236 unbundled network elements ("UNEs"). As a foundation for price, it is, effectively, a
237 *ceiling* on what can be charged. On the other hand, LRSIC, which has a longer history in
238 Illinois, is an economic measure of cost. It measures direct costs, or the costs that would
239 be avoided were a carrier to cease to offer a given service. It provides a standard for
240 identifying below-cost rates. For example, if the price of a service were to descend
241 below its LRSIC, the service would necessarily be receiving a subsidy. However, while
242 LRSIC is normally used to determine a price floor rather than a price for competitive
243 services, the Commission has used LRSIC along with a reasonable allocation of common
244 costs to set switched access rates for several non-rural ILECs.⁸

245 **Q18.** SINCE THE TELRIC METHODOLOGY WAS DEVELOPED TO PRODUCE A
246 PRICE CEILING FOR UNES, ARE CERTAIN COSTS INCLUDED WHEN
247 FOLLOWING THE TELRIC METHODOLOGY THAT WOULD OTHERWISE
248 BE EXCLUDED WHEN FOLLOWING THE LRSIC METHODOLOGY?

249 A18. Yes. The FCC has distinguished TELRIC from TSLRIC and other methodologies, by
250 emphasizing some of the unique characteristics of TELRIC. For example, the FCC has
251 noted that "certain shared costs that have conventionally been treated as common costs
252 (or overheads)" for TSLRIC and LRSIC, but under TELRIC "shall be attributed directly
253 to the individual [unbundled network] elements to the greatest extent possible."⁹ The
254 FCC thus acknowledges that there are other inherent methodological differences such as

⁸ *ILEC Cost-Based Switched Access Order*, p. 47.

⁹ First Report and Order, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98, and *Interconnection between Local Exchange Carriers and Commercial Mobile Radio Service Providers*, CC Docket No. 95-185, 11 FCC Rcd 15499, ¶ 672 (1996) ("*Local Competition Order*").

255 the following: "...the amount of joint and common costs that must be allocated among
256 separate offerings is likely to be much smaller using a TELRIC methodology rather than
257 a TSLRIC approach that measures the costs of conventional services."¹⁰

258 **Q19.** CAN YOU SUMMARIZE THIS DISTINCTION THAT CERTAIN
259 CONVENTIONAL SHARED COSTS WITHIN TSLRIC NOW ARE TO BE
260 TREATED AS DIRECT WITHIN TELRIC?

261 A19. Yes. What the FCC found was that not all costs that would be shared costs when
262 determining service costs are shared and common for deriving UNE prices. The *First*
263 *Report and Order* specifically required that costs be assigned directly to UNEs to the
264 greatest extent possible. What this means is that costs of standby capacity are generally
265 considered a shared cost to a group of retail or non-UNE services rather than a direct cost
266 to services, and are recovered by contribution in non-UNE pricing. Consequently, when
267 the cost object becomes a UNE, its standby capacity often becomes a direct cost in a
268 TELRIC study rather than in a LRSIC study

269 **Q20.** HAS THE COMMISSION RECOGNIZED THAT THERE ARE FUNDAMENTAL
270 METHODOLOGICAL DIFFERENCES BETWEEN LRSIC AND TELRIC?

271 A20. Yes. For example, the treatment of fill factors and related capacity treatments are
272 different between LRSIC and TELRIC methodologies. I will discuss McLeodUSA's fill
273 factors in more detail below. For now, the point to keep in mind is that Mr. Starkey's
274 view that LRSIC and TELRIC are interchangeable reflects a deficiency in his whole
275 approach to cost, which is another reason why McLeodUSA's cost study is unreliable and
276 virtually designed to overstate cost.

¹⁰ *Ibid.* at ¶ 678.

277 III. SWITCHED ACCESS RATES AND COSTS

278 A. MCLEODUSA’S SWITCHED ACCESS RATES AND PROPOSED COSTS

279 **Q21.** WHAT ARE THE SWITCHED ACCESS MINUTE-RATED ELEMENTS THAT
 280 MCLEODUSA VIEWS ARE THE SUBJECT OF THIS INVESTIGATION?

281 A21. Mr. Starkey at page 4 and 5 of his direct testimony identified six rate elements as the
 282 switched access minute-rated elements that in McLeodUSA’s view are the subject of this
 283 investigation. Table 1 shows McLeodUSA’s current intrastate rates for these rate
 284 elements. These rates are also found on Confidential Schedule KAC-2.

Rate Element	Rate
1. CCL Charge	\$0.0113 per minute
2. Switching, Origination or Termination	\$0.02193 per minute
3. Tandem Functionality	\$0.01204 per minute
4. Tandem Transport, Tandem Switched Termination	\$0.00236 per minute
5. Tandem Transport, Tandem Switched Facility	\$0.00213 per minute-mile
6. Interconnection Charge	\$0.013443 per minute

285 **Table 1**

286 Now, Dr. Oyefusi in his direct testimony indicates that this proceeding should not be
 287 limited to these rate elements. Nevertheless, my analysis will be primarily focused only
 288 on these six rate elements, since these are the only rate elements that Mr. Starkey
 289 attempted explicitly to cost out.

290 **Q22.** WHAT DOES MCLEODUSA CLAIM IS THE COST OF PROVIDING
 291 INTRASTATE SWITCHED ACCESS SERVICE ASSOCIATED WITH USAGE
 292 CHARGES TO IXCS SUCH AS AT&TCI?

293 A22. McLeodUSA claims that its weighted average or composite cost of providing intrastate
 294 switched access to IXCs such at AT&TCI is **[BEGIN CONFIDENTIAL *** *******
 295 ***** END CONFIDENTIAL]** per MOU. Mr. Starkey displayed this cost as the
 296 Composite–Other Traffic cost based on an older model forecast in Table 4 at page 53 of

297 his Direct Testimony.¹¹ This composite cost consists of three components of intrastate
298 switched access service—Local Switching, Tandem Transport / Switched Termination
299 and Tandem Transport / Switched Facility—and an allocation of loop costs. This cost
300 also includes an allocation of common overhead costs. These costs are almost
301 exclusively based on information that is at least four years old.

302 **Q23.** DOES MCLEODUSA PROVIDE ANY OTHER ESTIMATES OF THE COST OF
303 PROVIDING INTRASTATE SWITCHED ACCESS SERVICE?

304 A23. Yes. First, Mr. Starkey’s Table 4 also showed McLeodUSA’s estimated cost for Tandem
305 Functionality. The Tandem Functionality Charge or Tandem Switching charge applies
306 when McLeodUSA is an “intermediate carrier.”¹² While McLeodUSA’s tariff does not
307 define “intermediate carrier,” it appears to convey the ordinary meaning that an
308 intermediate carrier transits traffic between two other carrier’s networks. McLeodUSA is
309 not an intermediate carrier when providing switched access service to IXCs such as
310 AT&TCI. On the other hand, Tandem Functionality Charge applies for wireless
311 originated traffic pursuant to McLeodUSA’s access tariff.¹³ Thus, Mr. Starkey’s Table 4
312 also showed the composite cost of providing intrastate switched access for wireless
313 originated traffic. In addition, Mr. Starkey developed a blended composite cost
314 combining wireless originated traffic with all other traffic. My Confidential Schedule
315 KAC-2 replicates these calculations.

316 Second, because of the age of the information used in these cost estimates, Mr. Starkey
317 provided in his Table 4 a second set of cost estimates, which he calculated using recent

¹¹ Mr. Starkey chose to round this cost to four places, while I have rounded it to six places.

¹² See McLeod’s Illinois Tariff No. 5 (“Intrastate Access Services Tariff”), Original Sheet No. 60, effective April 4, 2006.

¹³ See McLeod’s Intrastate Access Services Tariff, Original Sheet No. 62, effective April 4, 2006.

318 traffic volumes. Mr. Starkey claimed that the passage of time made this second set to
319 have higher costs than the costs that come out of NUCA.

320 **Q24.** IS MR. STARKEY’S CLAIM AT PAGE 51 OF HIS DIRECT TESTIMONY THAT
321 “THE PASSAGE OF TIME HAS ONLY MADE NUCA’S RESULTS MORE
322 CONSERVATIVE” A REASONABLE ONE?

323 A24. No. Mr. Starkey has noted that McLeodUSA’s traffic volumes have decreased
324 significantly since 2005, which is the basic timeframe for information used by NUCA.
325 Then, he has claimed that total cost “would likely not change significantly due to inertia
326 inherent in operating telecommunication network.”¹⁴ Based on these assumptions, he
327 concluded that cost per MOU must increase, since the numerator in his view did not
328 change and the denominator decreased significantly. However, his argument is
329 implausible, for if it were true, then none of McLeodUSA’s switched access costs would
330 be usage sensitive and cost-based rates following McLeodUSA’s recommended approach
331 should thereby be effectively zero. In other words, if the “total cost” for McLeodUSA’s
332 switched access service does not change with a significant change in minutes, then usage
333 is not a cost driver at all. However, neither I nor, I suspect, Mr. Starkey or McLeodUSA
334 believe in such an extreme position.

335 **Q25.** WHY NOT?

336 A25. The basic problem with Mr. Starkey’s argument is his sleight of hand. He has completely
337 failed to consider any changes in cost, claiming that cost should be the same as it was
338 years ago due simply to “inertia.” “Inertia” is not part of the LRSIC or TSLRIC
339 methodologies, *i.e.*, cost when calculated following the LRSIC or TSLRIC methodology
340 is calibrated to total demand and not to some previous calculation. Likewise, LRSIC and

¹⁴ Starkey Direct Testimony, p. 52.

341 TSLRIC methodologies include no sunk costs. Therefore, Mr. Starkey’s attempt to
342 “update” his cost calculations by using recent traffic volumes without any updated cost
343 information is completely untenable and unusable – an attempt to mix apples and
344 oranges. As a result, I will focus my remaining testimony on analyzing the results that
345 flow from the NUCA study. At least the original study purports to develop costs with
346 matching demand levels.

347 **Q26.** MR. STARKEY SHOWED ONLY ONE RATE ELEMENT FOR CCL AS
348 DISPLAYED IN TABLE 1. DOES MCLEODUSA’S INTRASTATE ACCESS
349 TARIFF HAVE ONLY ONE RATE ELEMENT FOR CCL?

350 A26. No. McLeodUSA’s intrastate access tariff reports two charges for CCL –CCLC
351 Origination and CCLC Termination. However, only one of these charges can apply for
352 any access minute, since an access minute either originates from a McLeodUSA end-user
353 customer or terminates to the customer. For switched access the other end of the call is
354 on another carrier’s network. Furthermore, these two charges are the same. By
355 collapsing these two rate elements into one, as Mr. Starkey has done, he is presuming that
356 charges for these two rate elements should always be the same. I view this assumption as
357 reasonable in the context of the historical treatment of CCL for non-rural ILECs by this
358 Commission, which I will discuss later in my testimony.

359 **Q27.** HAS MR. STARKEY PROVIDED AN EXPLANATION OF ANY OF THESE
360 RATE ELEMENTS?

361 A27. Mr. Starkey did not provide a comprehensive explanation. He primarily relied on the
362 description of these rate elements as found in his Attachment MS-2, which contains
363 excerpts from McLeodUSA’s current intrastate access tariff. These excerpts also provide
364 the source for the prices shown in my Table 1. However, neither Mr. Starkey’s testimony

365 nor McLeodUSA's intrastate access tariff include diagrams displaying standard
366 configurations available for provisioning its switched access services.

367 **Q28. WHY IS IT IMPORTANT THAT AN EXPLANATION BE PROVIDED FOR**
368 **THESE SIX RATE ELEMENTS?**

369 A28. It is important that an explanation be provided for the six rate elements for several
370 reasons. First, each rate element needs to be adequately understood so that it is charged
371 where appropriate. Second, this understanding can also help in making valid
372 comparisons of McLeodUSA's switched access rates with ILEC switched access rates
373 such as those of AT&T Illinois. Third, and most important for purposes of my testimony,
374 this understanding is needed to be able to identify properly what costs go with what rate
375 element, *i.e.*, understanding the functionalities being purchased with each rate element is
376 necessary to properly identify its costs.

377 **Q29. WHAT FUNCTIONALITIES DOES A CARRIER PURCHASE WHEN PAYING**
378 **THE CCL CHARGE?**

379 A29. McLeodUSA's Illinois Access Tariff says that the CCL charge pays for the CCL Access
380 Service, which permits the use of McLeodUSA's common lines by another carrier for
381 access to McLeodUSA's end-user customers to furnish intrastate communications
382 service.¹⁵ If McLeodUSA were an ILEC, a common line would be an end-users
383 customer's local loop. A local loop is a communications path from the ILEC's
384 demarcation point at the end-user customer's premises to the main distribution frame
385 ("MDF") at the central office ordinarily serving the end-user customer's premises. In
386 other words, the local loop goes from the end user customer's premises to the edge of the
387 ILEC's network that connects to the first switch of the public switched network.

¹⁵ McLeodUSA's Illinois Intrastate Access Tariff, Original Sheet No. 55.

388 However, as Mr. Starkey's testimony repeatedly made clear, McLeodUSA's network is
389 not the same as an ILEC's network. A comparison of the rate elements used by
390 McLeodUSA to provide switched access service and the most closely related ones by an
391 ILEC such as AT&T Illinois may provide some important insights. Hence, I will
392 compare McLeodUSA's switched access services to AT&T Illinois' Direct Transport and
393 Tandem-Switched Services configuration for offering its intrastate switched access
394 services.

395 **B. RELEVANT SWITCHED ACCESS NETWORK CONFIGURATIONS**

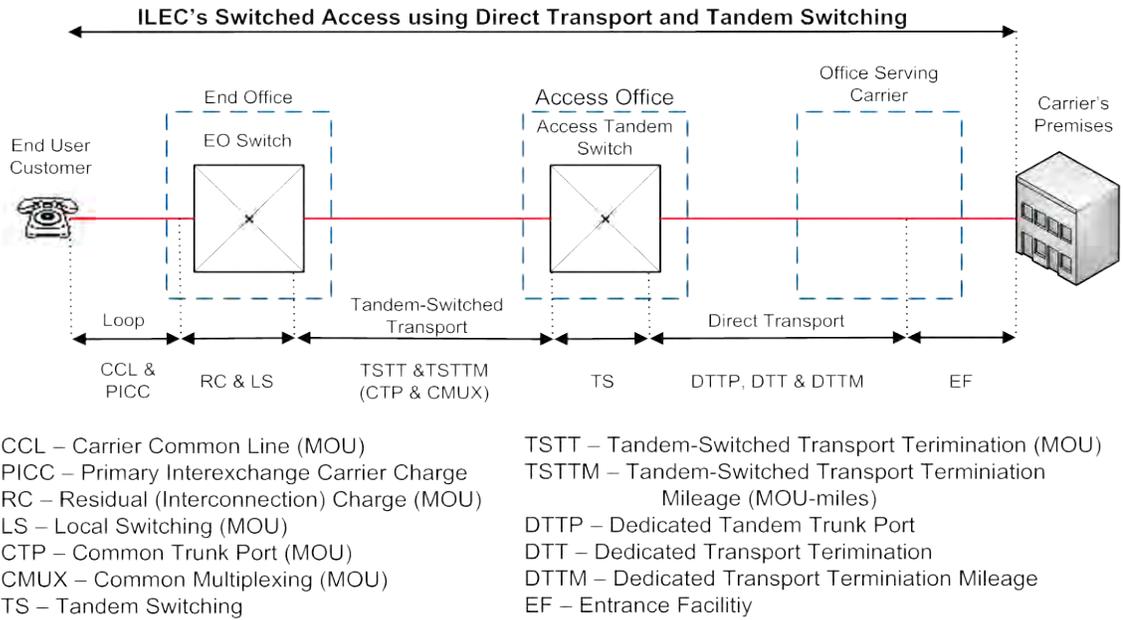
396 **Q30. WHY IS AT&T ILLINOIS' DIRECT TRANSPORT AND TANDEM-SWITCHED**
397 **SERVICES CONFIGURATION FOR PROVIDING ITS INTRASTATE**
398 **SWITCHED ACCESS SERVICES THE MOST CLOSELY RELATED AT&T**
399 **ILLINOIS CONFIGURATION TO MCLEODUSA'S CONFIGURATION?**

400 A30. As discussed in greater detail below, McLeodUSA's offering of switched access services
401 as depicted in NUCA ordinarily has an end-office switch and a tandem switch in the call
402 path. This understanding is also confirmed by McLeodUSA response to Staff Data
403 Request JZ 1.62, which is attached as Confidential Schedule KAC-4. This is exactly the
404 switch components in AT&T Illinois' Direct Transport and Tandem-Switched Services
405 configuration for offering its intrastate switched access services.

406 **Q31. WHAT IS AT&T ILLINOIS' DIRECT TRANSPORT AND TANDEM-**
407 **SWITCHED SERVICES CONFIGURATION FOR OFFERING INTRASTATE**
408 **SWITCHED ACCESS SERVICES?**

409 A31. Figure 1 displays AT&T Illinois' Direct Transport and Tandem-Switched Services
410 configuration.¹⁶

¹⁶ This figure relies on the "Direct Transport to Tandem Services" diagram found in Illinois Bell Telephone Company ICC Tariff No. 21, Section 6 (Switched Access Service), 1st revised page 120.2.



411
 412

Figure 1

413 Starting from the right side of this figure and going to the left, an entrance facility
 414 provides a permanent connection from the carrier's premises to the ILEC's central office
 415 that ordinarily serves the location of the carrier's premises. This carrier could be an IXC,
 416 a CMRS carrier or even another CLEC. Many large carriers such as AT&TCI have its
 417 premises in the same wire center as an AT&T Illinois' tandem switch—often AT&TCI's
 418 premises is next door to an AT&T Illinois' access tandem central office. If the office
 419 serving the carrier and the access tandem office are not the same central office, then
 420 direct transport is used to get the carrier's circuit from the office serving the carrier to the
 421 tandem office. Next, the circuit is terminated on a dedicated trunk port that is part of the
 422 tandem switch. Up to this point, the applicable rates are charged on a monthly basis and
 423 have no usage component, because the equipment and facilities that support the circuit
 424 are dedicated to the carrier and are not usage sensitive from the point of view of the
 425 ILEC.

426 Next, the circuit is switched on the access tandem switch to be directed across
427 common transport facilities to the end-office switch that serves the end-user customer.
428 Here, a circuit exists only for the duration of a call. Common multiplexing may be used
429 by the ILEC so that the common transport between the access tandem switch and the end-
430 office switch can be sized and used efficiently. The common transport services
431 ultimately terminate on a common trunk port that is part of the end-office switch. Then,
432 the circuit is switched on the end-office switch to connect to the end user's loop. At this
433 end, the connection again uses dedicated facilities.

434 **Q32.** WHAT ARE THE RATE ELEMENTS THAT ARE CHARGED ON A MINUTE
435 BASIS FOR THE SWITCHED ACCESS SHOWN IN FIGURE 1?

436 A32. Underneath the network diagram shown in Figure 1 is a list of the rate elements that may
437 be charged for switched access services using the depicted configuration. Those
438 elements that have MOU as part of its description are charged on an access minute basis,
439 while the other elements are charged on a monthly basis.

440 **Q33.** WHAT IS A COMPARABLE NETWORK DIAGRAM FOR MCLEODUSA'S
441 SWITCHED ACCESS SERVICES?

442 A33. Figure 2 displays a network diagram for McLeodUSA's switched access services that is
443 comparable to AT&T Illinois' Direct Transport and Tandem-Switched Services
444 configuration.

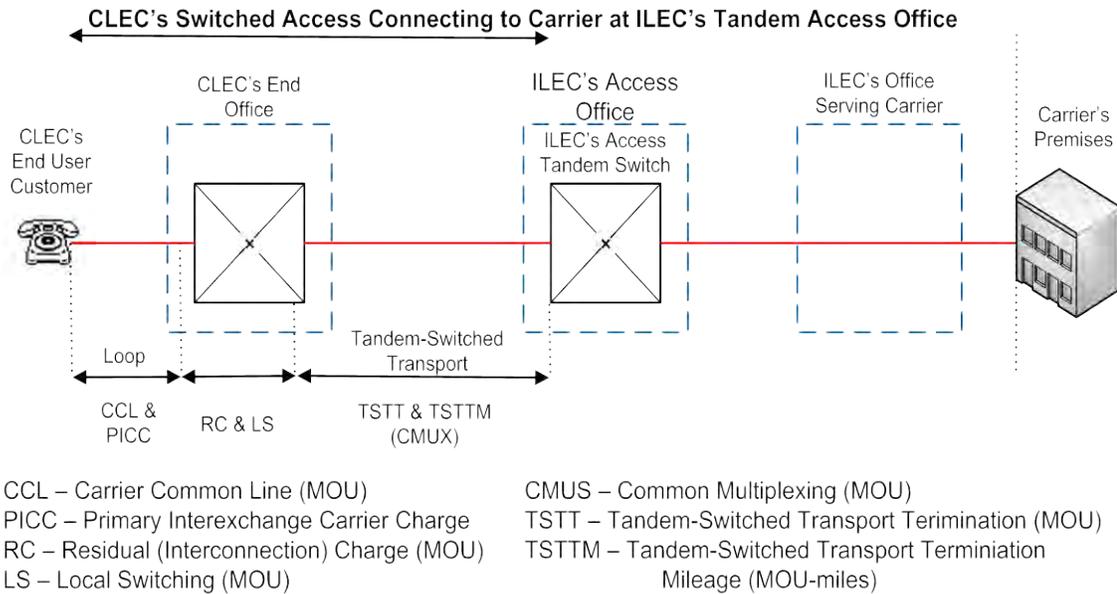


Figure 2

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447 **Q34.** IS THIS NETWORK DIAGRAM FOR MCLEODUSA CONSISTENT WITH THE
 448 NETWORK ARCHITECTURE THAT IS DISPLAYED IN DIAGRAM 2 OF MR.
 449 STARKEY'S TESTIMONY?

450 A34. Yes. The key in comparing my Figure 2 to Mr. Starkey's Diagram 2 is to recognize that
 451 there is only *one* McLeodUSA switch. While McLeodUSA's switches may be capable of
 452 performing tandem switching functions, tandem-switching functions involve dynamically
 453 connecting circuits from one switch to another. A tandem switch sits in between two
 454 other switches. With only one switch in Mr. Starkey's diagram no tandem functionality
 455 can occur. More importantly, what should be obvious in examining Mr. Starkey's
 456 Diagram 2 is that it depicts in general McLeodUSA's network architecture for loops, *i.e.*,
 457 the connections from end users to their serving end-office switch.

458 **Q35.** HOW IS IT THAT MR. STARKEY'S DIAGRAM 2 DEPICTS MCLEODUSA'S
 459 NETWORK ARCHITECTURE FOR LOOPS?

460 A35. A loop for a POTS end-user customer is the connection from the customer's premises to
 461 the central office containing the Class 5 switch that provides dial-tone and switching

462 functions for the customer. Even to connect two McLeodUSA customers as depicted in
463 Diagram 2, each customer's loop must connect to the single McLeodUSA's switch,
464 which then can provide a connection linking the loops. Now, McLeodUSA's loop can be
465 broken into two parts. First, the local loop is the connection from the customer's
466 premises to McLeodUSA's serving Access Node. Generally, McLeodUSA leases the
467 local loops from the ILEC in whose service territory the end-user customer's premises is
468 located. Second, the extended loop is the connection continuing the local loop from
469 McLeodUSA's serving Access Node to the cross-connect equipment at the McLeodUSA
470 Service Node central office. In a UNE context, a McLeodUSA's loop is similar to an
471 Enhanced Extended Loop ("EEL") offered by AT&T Illinois.¹⁷

472 In addition, while it may appear in Diagram 2 that there is a direct connection between
473 end-user customers without needing to go through McLeodUSA's switch, that is an
474 artifact of the extended loop being carried on a SONET ring, which NUCA models as one
475 of the designs for extended loops. Of course, Mr. Starkey does not claim that the SONET
476 rings are the only means of providing these extended loops. In fact, Mr. Starkey shows in
477 his Diagram 3 some Access Nodes having extended loops using a ring (the four CLEC
478 collocations in the upper half of the diagram) and some that do not use a ring (each of the
479 two CLEC collocations in the lower half). Generally speaking, SONET rings used for
480 extended loops are treated as self-provisioned in NUCA, while leased facilities are used
481 in NUCA for other extended loops.

¹⁷ An Enhanced Extended Loop ("EEL") is a combination of UNEs consisting of Unbundled Loops and Unbundled Dedicated Transport, combined using the appropriate Cross-Connects, and where needed, multiplexing.

482 **Q36.** BUT, IS DIAGRAM 5 FOUND IN MR. STARKEY'S TESTIMONY NOT A
483 BETTER REPRESENTATION OF THE NETWORK COMPONENTS USED TO
484 PROVIDE MCLEODUSA'S SWITCHED ACCESS SERVICES?

485 A36. Yes. But, this is because Diagram 5 also depicts network components used to
486 interconnect with carriers for handling calls that use McLeodUSA's switched access
487 services. In addition, my depiction in Figure 2 also reflects this aspect of McLeodUSA's
488 network, although at a more conceptual level. The difference is that I am emphasizing
489 here the relationship between functions and rate elements associated with switched access
490 services. Mr. Starkey's discussion at pages 46-48 of his testimony emphasized the
491 functions of the network elements in McLeodUSA's switching and transport network
492 design.

493 **Q37.** COULD YOU PROVIDE A DIAGRAM FOR MCLEODUSA'S SWITCHED
494 ACCESS SERVICE SHOWING THE VARIOUS "COST" ELEMENTS FOUND
495 IN NUCA?

496 A37. Yes. Figure 3 below shows McLeodUSA's network architecture for handling intrastate
497 switched access calls as modeled in NUCA, which corresponds with the more generic
498 diagram shown in Figure 2.

NUCA's Network Design Used for Handling McLeodUSA's Intrastate Switched Access Calls

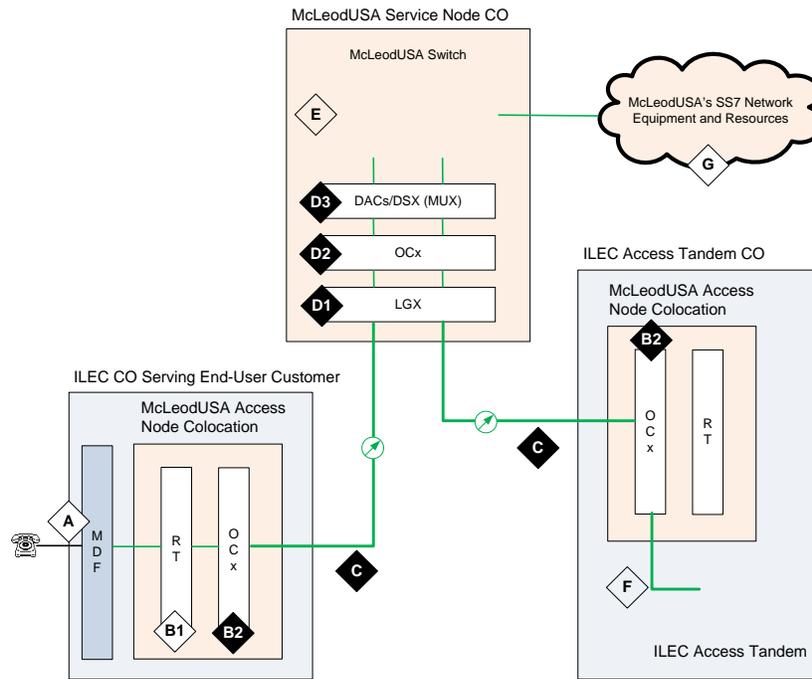


Figure 3

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Now, NUCA categorizes investments and costs for this network design into ten baskets identified in Figure 3 by an alphabetic symbol surrounded by a diamond. To help explain the investments, costs and minutes associated with each basket, I will describe the baskets in the order the assets in the basket are used to handle an intrastate toll call originated by a McLeodUSA's end-user customer that has presubscribed with a carrier other than McLeodUSA such as AT&TCI. This ordering follows Mr. Starkey's description of this originating toll call found on Confidential Schedule KAC-4. After setting up the call using McLeodUSA's SS7 resources, the originating call follows a path starting from the end-user customer's premises and goes through equipment and facilities associated with A, B1, B2, C, D1, D2, D3, E, D3, D2, D3, C, B2 and F and finally terminating on an AT&T Illinois Access Tandem, which AT&TCI uses to interconnect with McLeodUSA. Since Mr. Starkey generally describes at pages 46-48 the equipment

513 and facilities associated with each basket, I will only provide a synopsis of important
514 characteristics of each basket in what follows.

515 A – Basket A contains the costs and MOUs associated with the local loop. NUCA
516 does not develop these costs. Instead, McLeodUSA performed a separate cost
517 study that presumes all local loops are leased from other carriers.

518 B1 – Basket B1 contains the costs and MOUs associated with the Access Node
519 aggregation equipment, which is viewed as digital loop carrier equipment.

520 B2 – Basket B2 contains the costs and MOUs associated with SONET Transport
521 Equipment, which is used twice in the illustrative call path at different locations –
522 first in the ILEC central office that ordinarily would serve McLeodUSA’s end-
523 user customer’s premises and second in the ILEC central office containing the
524 ILEC's access tandem utilized by the served carrier, here AT&TCI.

525 C – Basket C contains the costs and MOUs associated with the SONET transport
526 facilities from ILEC central offices containing Access Node equipment to
527 McLeodUSA’s Service Node central office that is the hub for the Access Node
528 offices. When fiber rings are modeled by NUCA for these facilities, they are
529 presumed to be owned by McLeodUSA for modeling purposes. When fiber rings
530 or not modeled, the facilities are presumed to be leased from third parties such as
531 AT&T Illinois. Again, for the illustrative call path there are two occurrences in
532 which SONET transport facilities or use – first for the facilities connecting the
533 ILEC central office that ordinarily would serve McLeodUSA’s user-customer's
534 premises to McLeodUSA’s Service Node central office and second from

535 McLeodUSA's Service Node central office to the ILEC central office containing
536 the ILEC's access tandem utilized by the served carrier.

537 D1 – Basket D1 contains the costs and MOUs associated with fiber termination
538 equipment. This equipment is used twice for the illustrated call.

539 D2 - Basket D2 contains the costs and MOUs associated with SONET transport
540 equipment. This equipment is used twice for the illustrated call.

541 D3 - Basket D3 contains the costs and MOUs associated with digital cross-connect
542 equipment. This equipment is used twice for the illustrated call.

543 E - Basket E contains the costs and MOUs associated with McLeodUSA's switch that
544 serves both end-user customer and the served carrier. The switch connects the
545 originating traffic from the end-user customer to the served carrier.

546 F - Basket F contains the costs and MOUs associated with any additional equipment
547 and facilities for McLeodUSA to interconnect with the served carrier. NUCA
548 assumes that there is no such additional equipment and facilities.

549 G - Basket G contains the costs and MOUs associated with SS7 equipment and
550 facilities owned or leased by McLeodUSA to handle call-set and other signaling
551 functions.

552 IV. COSTS AND MOU MAPPING PROBLEMS

553 **Q38.** HOW SHOULD THE COSTS FOR THE TEN COST BASKETS ABOVE BE
554 MAPPED INTO MCLEODUSA'S SWITCHED ACCESS RATE ELEMENTS?

555 A38. The costs for each basket can be assigned to a switched access rate element based on a
556 basic understanding of the Baskets and the capabilities being purchased with each rate
557 element. Theoretically, this could be accomplished by utilizing the information found in

558 Figure 2. It is also important to ensure such assignments are consistent with
 559 McLeodUSA’s description of these rate elements in its intrastate access tariff.

560 **Q39.** HOW DID NUCA MAP THE COSTS FOR EACH BASKET INTO THE
 561 SWITCHED ACCESS RATE ELEMENTS SHOWN ON CONFIDENTIAL
 562 SCHEDULE KAC-2?

563 A39. Table 2 shows how NUCA mapped costs in each basket into each rate element.

564 **NUCA’s Cost-to-Rate Mapping**

	A	B1	B2	C	D1	D2	D3	E	F	G
1. CARRIER COMMON LINE										
2. INTERCONNECTION CHARGE										
3. LOCAL SWITCHING		1	1	1	1	1	1	1		1
4. TANDEM FUNCTIONALITY CHARGE			1	1	1	1	1	1		1
5. TANDEM TRANSPORT / TANDEM SWITCHED TERMINATION			1		1	1	1		1	
6. TANDEM SWITCHED FACILITY				1						

565 **Table 2**

566 For example, this table shows that NUCA mapped the average cost per MOU for Baskets
 567 B1, B2, C, D1, D2, D3, E and G into Local Switching. Also, NUCA mapped no costs
 568 into the CCL Charge or the Interconnection Charge. However, costs per MOU for Basket
 569 A was developed outside of NUCA, and those costs were assigned to the CCL Charge.

570 **Q40.** IS NUCA’S MAPPING OF COSTS TO RATES REASONABLE?

571 A40. No, because, in part, it is inconsistent with generic mapping shown in Figure 2. More
 572 importantly, NUCA’s mapping is not fully consistent with McLeodUSA’s intrastate
 573 access tariff.

574 **A. MODIFICATIONS BASED ON MCLEODUSA’S TARIFF**

575 **Q41.** HOW IS NUCA’S MAPPING INCONSISTENT WITH MCLEODUSA’S
 576 INTRASTATE ACCESS TARIFF?

577 A41. First, the Local Switching rate element, called Switching - Origination or Termination in
578 McLeodUSA intrastate access tariff, “provides for the use of McLeodUSA’s Switching
579 equipment for purposes of originating or terminating calls, the terminations for the end
580 user common lines terminating in the McLeodUSA Switch, and the termination of a call
581 at a Company Intercept operator or recording.”¹⁸ Clearly, the Local Switching rate
582 element only pays for switching functions. In NUCA as displayed in Figure 3, only
583 McLeodUSA’s switch and SS7 equipment and facilities provide such functions.
584 Consequently, only costs per minute associated with Baskets E and G should be mapped
585 to the Local Switching rate element. The costs per minute from Baskets B1, B2, C, D1,
586 D2, and D3 that NUCA assigned to the Local Switching rate element should be assigned
587 to the CCL rate element, which is related to use of McLeodUSA’s common lines or
588 loops.

589 Second, the Tandem Switching rate element, called the Tandem Functionality charge
590 only applies when a McLeodUSA is an “intermediate” carrier or when an 800 call
591 originates on a CMRS network. Since NUCA does not model any switch as reflecting a
592 situation in which McLeodUSA acts like an intermediate carrier in addition to providing
593 end-office switching, the mapping of costs to rates for Tandem Switching should be the
594 same as the Local Switching mapping. That means that based on the network design
595 found in NUCA, local switching and tandem switching using McLeodUSA’s switching
596 never occurs for an originating access call from a McLeodUSA end-user customer and
597 never occurs for a terminating access call to a McLeodUSA end-user customer.

598 Furthermore, as discussed by Mr. Starkey at page 35 of his testimony, only tandem

¹⁸ McLeodUSA’s Intrastate Access Services Tariff, Original Sheet No. 60.

599 switching functionality applies to CMRS originated access traffic. Also, cost mappings
 600 that are no longer appropriate for Tandem Switching should moved the same way as
 601 occurs for Local Switching.

602 **Q42.** WITH THESE CHANGES WHAT ARE THE COST-TO-RATE MAPPINGS FOR
 603 NUCA?

604 A42. The new cost-to-rate mapping for NUCA is shown in Table 3.

605 **NUCA’s Cost-to-Rate Mapping with Tariff Adjustments**

	A	B1	B2	C	D1	D2	D3	E	F	G
1. CARRIER COMMON LINE		1	1	1	1	1	1			
2. INTERCONNECTION CHARGE										
3. LOCAL SWITCHING								1		1
4. TANDEM FUNCTIONALITY CHARGE								1		1
5. TANDEM TRANSPORT / TANDEM SWITCHED TERMINATION			1		1	1	1		1	
6. TANDEM SWITCHED FACILITY				1						

606 **Table 3**

607 **Q43.** WHAT IS THE IMPACT OF THESE CHANGES ON THE COSTS PER MOU ON
 608 THESE SIX RATE ELEMENTS?

609 A43. Confidential Schedule KAC-5 shows the impact of each major modification I recommend
 610 in this testimony. Column A shows the costs per access minute for the six rate elements
 611 as well as the composite and blended per-minute costs as reported by Mr. Starkey. As I
 612 have stated previously, the relevant composite for analyzing costs is the “Composite—
 613 Other Traffic” row. Column B shows the impact of correcting Mr. Starkey’s costs-to-
 614 rates mapping to be consistent with McLeodUSA’s intrastate access tariff. This
 615 correction does not change the composite or blended per-minute costs, but does move
 616 costs per MOU into the CCL rate and out of local and tandem switching. Hence, this
 617 change results in a composite cost of **[BEGIN CONFIDENTIAL *******
 618 **END CONFIDENTIAL]**. The percentage change of making this correction, which is

619 shown lower under Column B, is **[BEGIN CONFIDENTIAL ***** END**
620 **CONFIDENTIAL]**, because this change just rearranges costs for IXC traffic, but moves
621 costs out of rate elements associated with wireless originated traffic. The remaining
622 columns in this schedule I will discuss as I provide the rationale for further needed
623 changes in McLeodUSA's cost calculations.

624 **B. MODIFICATIONS DUE TO MISMATCHED MINUTES**

625 **Q44. ARE THERE ANY OTHER PROBLEMS WITH MCLEODUSA'S COSTS-TO-**
626 **RATES MAPPING?**

627 A44. Yes. The minutes that McLeodUSA has used in calculating the costs per MOU for many
628 baskets are severely understated. Specifically, the minutes used in calculating the costs
629 per minute for Baskets B2, C, D1, D2 and D3 are half what they should be. As a result,
630 the costs per minute calculated for these baskets are severely overstated.

631 **Q45. HOW ARE THE MINUTES USED IN CALCULATING THESE COSTS PER**
632 **MINUTE HALF WHAT THEY SHOULD BE?**

633 A45. Consider the intrastate toll call that I discussed above. For each calling minute the call
634 goes over some equipment and facilities associated with Baskets B2, C, D1, D2 and D3
635 twice. First, MOUs are associated with these baskets for the traffic moving from the end-
636 user customer's premises to McLeodUSA's switch. Second, additional MOUs are
637 associated with these baskets for continuing to move the traffic from McLeodUSA's
638 switch to the interconnection point with the IXC. However, NUCA does not develop
639 separate costs for the "going to" traffic and the "coming from" traffic for each of these
640 baskets. Instead, NUCA includes that combined traffic costs in each basket. Since
641 NUCA combines the traffic costs, the minutes for the traffic must also be combined,
642 which NUCA did not do. Either the traffic costs must be split or the minutes aggregated

643 for each these five baskets. To keep things simple I propose to change the weights in
 644 Table 3 to have the effect of using half the total cost per minute for each of these baskets
 645 as the “going to” traffic and “coming from” traffic costs per minute.

646 There are other problems with the MOUs that NUCA used to develop its costs per
 647 minute. For example, the MOUs used to calculate the cost per MOU for Basket B1
 648 appear to have removed certain minutes twice, which causes these minutes to be vastly
 649 understated in developing NUCA’s cost per MOU for this basket. Given my subsequent
 650 recommendation to eliminate any charge for loops, which includes all of the costs
 651 contained in Basket B1 and my intent to show only the minimum necessary adjustments
 652 to McLeodUSA’s cost analysis, I will not go into the problem further at this time.

653 **Q46.** WHAT DO THESE CHANGES DO TO THE WEIGHTS SHOWN IN TABLE 3?

654 A46. Table 4 shows the results of these recommended changes to the weights shown in Table
 655 3.

656 **NUCA’s Cost-to-Rate Mapping with Tariff and MOU Adjustments**

	A	B1	B2	C	D1	D2	D3	E	F	G
1. CARRIER COMMON LINE		1	0.5	0.5	0.5	0.5	0.5			
2. INTERCONNECTION CHARGE										
3. LOCAL SWITCHING								1		1
4. TANDEM FUNCTIONALITY CHARGE								1		1
5. TANDEM TRANSPORT / TANDEM SWITCHED TERMINATION			0.5		0.5	0.5	0.5		1	
6. TANDEM SWITCHED FACILITY				0.5						

657 **Table 4**

658 **Q47.** WHAT IS THE IMPACT OF THESE CHANGES ON THE COSTS PER MOU ON
 659 THESE SIX RATE ELEMENTS?

660 A47. Column C of Confidential Schedule KAC-5 shows the impact of this adjustment.

661 Comparing Column C to Column B indicates that costs go down for all costs that were
 662 positive in Column B. The resulting composite cost is **[BEGIN CONFIDENTIAL *****

663 ***** **END CONFIDENTIAL**]. The percentage change of making this
664 correction to Column B is a decrease of [**BEGIN CONFIDENTIAL *** *******
665 **END CONFIDENTIAL**].

666 C. MODIFICATIONS DUE TO MISMATCHED MILEAGE COSTS

667 **Q48.** ARE THERE ANY OTHER PROBLEMS WITH MCLEODUSA'S MAPPING OF
668 COSTS PER MINUTE TO THESE SIX RATE ELEMENTS?

669 A48. Yes, there is one additional problem regarding the mapping for Basket C.

670 **Q49.** WHAT IS THE ADDITIONAL PROBLEM REGARDING THE MAPPING FOR
671 BASKET C?

672 A49. It is reasonable to assume that the costs for the "going to" traffic and "coming from"
673 traffic for Baskets D1, D2 and D3 are the same using my modified weights, because the
674 "going to" traffic and "coming from" traffic for each basket is using exactly the same
675 equipment. In addition, given the way NUCA has modeled the costs for Basket B2 using
676 my modified weights, it seems reasonable to treat the average cost per minute for this
677 basket to be the same for "going to" and "coming from" traffic. However, the costs in
678 Basket C are distance sensitive, which are likely to be significantly different between
679 "going to" and "coming from" traffic. Furthermore, the Tandem Switched Transport
680 Facility is charge on a minute-mile, but NUCA made no attempt to develop a cost on this
681 basis.

682 **Q50.** HAVE YOU PERFORMED ANY ANALYSIS THAT DEMONSTRATES THE
683 AVERAGE TRANSPORT MILEAGE IS DIFFERENT BETWEEN THE "GOING
684 TO" TRAFFIC VERSUS THE "COMING FROM" TRAFFIC?

685 A50. Yes. I developed the air mileage associated with switched DS0-equivalent circuits
686 appearing at McLeodUSA's Access Node locations from those locations to the
687 appropriate serving McLeodUSA switch as reported in NUCA. Also, I developed the air

688 mileage between McLeod's switching location and the location of the ILEC tandem
689 switch that was nearest to McLeod's switch. I calculated these mileages based on the
690 method and sources referred to by McLeodUSA's Intrastate Access Tariff.¹⁹ Because
691 McLeodUSA's Illinois switches included in NUCA are located very close to a central
692 office containing an AT&T Illinois' Access Tandem, the transport mileage for traffic
693 from McLeodUSA's switch location to the location of the relevant AT&T Illinois'
694 Access Tandem is always one mile. Thereby, I was able to estimate total switched DS0-
695 equivalent circuit mileage for Access Node locations without an ILEC tandem switch and
696 for Access Node locations with an ILEC tandem switch.

697 **Q51. WHAT DID YOU CONCLUDE FROM THIS ANALYSIS?**

698 A51. I concluded that approximately [**BEGIN CONFIDENTIAL ***** *** END**
699 **CONFIDENTIAL**] of the total switched DS0-equivalent circuit mileage is attributable to
700 the fiber facilities used in providing McLeodUSA's extended loops and only [**BEGIN**
701 **CONFIDENTIAL ***** *** END CONFIDENTIAL**] is attributable to the fiber
702 facilities used to transport traffic from McLeodUSA's switch to an interconnecting
703 carrier such as AT&TCI. Consequently, I recommend that Table 4 be modified to reflect
704 a more reasonable cost apportionment for the mileage-driven cost assignments so as to be
705 consistent with the Cost Causation Principle. Table 5 shows the results of modifying
706 Table 4.

¹⁹ See McLeodUSA's Intrastate Access Tariff, Original Sheet Nos. 42 and 43, effective April 4, 2006.

707 **NUCA’s Cost-to-Rate Mapping with Tariff, MOUs and Mileage Adjustments**

708 **[BEGIN CONFIDENTIAL *****

		A	B1	B2	C	D1	D2	D3	E	F	G
1.	CARRIER COMMON LINE										
2.	INTERCONNECTION CHARGE										
3.	LOCAL SWITCHING										
4.	TANDEM FUNCTIONALITY CHARGE										
5.	TANDEM TRANSPORT / TANDEM SWITCHED TERMINATION										
6.	TANDEM SWITCHED FACILITY										

709 ***** END CONFIDENTIAL]**

710 **Table 5**

711 **Q52.** WHAT IS THE IMPACT OF CORRECTLY MAPPING MILEAGE DRIVEN
 712 COSTS ON THE COSTS PER MOU ON THESE SIX RATE ELEMENTS?

713 A52. Column D of Confidential Schedule KAC-5 shows the impact of correctly mapping
 714 mileage driven costs. Comparing Column D to Column C indicates that composite costs
 715 do not go down for IXC traffic, because this adjustment just moves costs between CCL
 716 and tandem switched facility charges. Thus, the resulting composite cost is still **[BEGIN**
 717 **CONFIDENTIAL ***** *** END CONFIDENTIAL]**.

718 **V. COSTS THAT DO NOT BELONG IN LRSIC STUDY OF USAGE-**
 719 **SENSITIVE PORTION OF SWITCHED ACCESS SERVICES**

720 **Q53.** BEYOND THE MAPPING PROBLEMS DISCUSSED ABOVE, IS THE COST
 721 ANALYSIS USED TO DEVELOP MR. STARKEY’S ESTIMATE FOR THE
 722 COMPOSITE COST OF SWITCHED ACCESS SERVICE VALID?

723 A53. No. This analysis has numerous additional problems. Significantly, Mr. Starkey’s
 724 calculation of McLeodUSA’s switched access costs as shown in his Table 4 includes
 725 items that are not costs of switched access functionality at all, but rather are subsidy
 726 elements that McLeodUSA wishes to continue to charge carriers; in particular it includes
 727 recovery of “loop costs.” In other words, these are the very subsidy elements that access
 728 reform is intended to ultimately eliminate from carrier switched access fees. It is

729 tautological that if one includes as a “cost” the subsidies that are embedded in the current
730 rate structure, then one’s rate will continue to include those subsidy amounts in order to
731 cover that “cost.” Such an “analysis” nevertheless provides the Commission no
732 information regarding whether McLeodUSA’s intrastate rates for switched access service
733 cover McLeodUSA’s economic costs of providing that service.

734 A. LOCAL LOOP COSTS SHOULD NOT BE INCLUDED

735 **Q54. WHAT “LOOP COSTS” ARE INCLUDED IN MR. STARKEY’S CALCULATION**
736 **FOR THE COMPOSITE COST OF SWITCHED ACCESS SERVICE?**

737 A54. The “loop costs” included in Mr. Starkey’s calculation for the composite cost of switched
738 access service include costs for local loops, which are developed outside of NUCA, and
739 costs for extended loops, which are calculated within NUCA.

740 **Q55. WHY IS IT INCORRECT TO INCLUDE LOCAL LOOP COSTS IN A**
741 **CALCULATION OF DIRECT COSTS FOR USAGE-RATED SWITCHED**
742 **ACCESS SERVICES?**

743 A55. The reason is simple — local loop costs are not direct costs of usage-rated switched
744 access services, and they are not caused by IXC’s use of McLeodUSA’s network. Hence,
745 it is incorrect to include such costs in a calculation of direct costs for these services.

746 Local loop costs are also not shared costs for the family of all usage services, of which
747 switched access service is a part. In fact, most local loop costs are direct costs of basic
748 exchange service. In addition, as develop by Mr. Starkey, local loops are leased from
749 other carriers. None of the payments made by McLeod for these local loops are incurred
750 on a usage basis, but are incurred on a fixed monthly basis.

751 Local loop costs are recurring costs. Local loop costs almost never vary
752 according to how the customer uses the loop, *i.e.*, the costs are ordinarily the same

753 regardless of whether the customer makes only local calls, only long distance calls, or no
754 calls at all. Costs that do not vary with usage are often called NTS costs. Thus, once a
755 LEC incurs the loop cost to establish local service, there is no further cost to use that loop
756 for *other* services. The cost of a local loop cannot be avoided by not making toll calls,
757 nor is it increased by making numerous toll calls; the cost of a loop can only be avoided
758 by *not* ordering local service. Thus, based on elementary, sound and well-accepted cost
759 causation principles, the local loop cost is attributable exclusively to local service. Local
760 exchange service costs are *not* a cost of providing switched access.

761 **Q56. HAS THE COMMISSION PREVIOUSLY DETERMINED THE**
762 **INAPPROPRIATENESS OF RECOVERING LOOP COSTS THROUGH**
763 **SWITCHED ACCESS SERVICE RATES?**

764 A56. Yes. The Commission stated in 1998:

765 One of the long-standing goals of this Commission has been to promote
766 movement toward a pricing methodology for telecommunications services under
767 which the rates charged for services reflect the way in which the costs to provide
768 those services are incurred. To that end, we have made substantial efforts over the
769 last decade to prohibit the recovery of nontraffic sensitive costs through traffic
770 sensitive intrastate access charges. By eliminating the recovery of NTS costs from
771 usage sensitive rates, we have been able to curtail the subsidization of non-traffic
772 sensitive costs associated with the carrier common line, or CCL, with revenues
773 from usage sensitive access charges. This is in accordance with a concept that has
774 been approved in numerous prior Commission orders: the party who causes the
775 costs to be incurred should pay those costs.²⁰

776 More recently, the Commission has recapitulated its orders from the 1980s that began the
777 phase out of the intrastate traffic-sensitive CCL charges and recovering these NTS costs

²⁰ Order, *Investigation into Non-Cost Based Access Charge Rate Elements in the Intrastate Access Charges of Incumbent Local Exchange Carriers in Illinois; Investigation into Implicit Universal Service Subsidies in Intrastate Access Charges and to Investigate how these Subsidies should be Treated in the Future; Investigation into the Reasonableness of the LS2 Rate of Illinois Bell Telephone Company*, Docket Nos. 97-0601, 97-0602 and 97-0516 (Consolidated), December 16, 1998 (“*LS2 Switched Access Order*”), pp. 34-35.

778 from end users and not from interexchange carriers via access charges.²¹ Also, because of
779 regulatory serendipity, the Primary Interexchange Carrier Charge (“PICC”) had evolved
780 to recover some NTS loop costs. The PICC is a monthly charge to interexchange
781 carriers. The Commission’s *ILEC Cost-Based Switched Access Order* eliminates the
782 intrastate PICC.²² Thus, the Commission directed AT&T Illinois and Verizon to cease
783 including charges for local loop costs in their intrastate switched access services.

784 **Q57. WHAT LOCAL LOOP COSTS HAS MR. STARKEY INCLUDED IN**
785 **COMPOSITE COST OF SWITCHED ACCESS FOR IXCS?**

786 A57. The local loop cost included in Mr. Starkey’s composite cost of switched access for IXCs
787 is **[BEGIN CONFIDENTIAL *** ***** END CONFIDENTIAL]** per
788 minute. This cost was developed outside of NUCA in apparent clear recognition that
789 local loop costs are not usage sensitive.

790 **Q58. ARE THERE ANY OTHER PROBLEMS WITH MCLEODUSA’S COST**
791 **ESTIMATE FOR LOCAL LOOPS?**

792 A58. Yes. It has several significant problems including the apparent inclusion of an estimate
793 of nonrecurring costs and the lack of recognizing that McLeodUSA’s end-user customers
794 pay recurring rates to use the local loop. However, because of the purpose of my
795 testimony and my conclusion that such costs are not part of the LRSIC for switched
796 access service at all, I will not attempt to quantify these other significant concerns at this
797 time.

²¹ See Order, *Investigation into Non-Cost Based Access Charge Rate Elements in the Intrastate Access Charges of Incumbent Local Exchange Carriers in Illinois; Investigation into Implicit Universal Service Subsidies in Intrastate Access Charges and to Investigate how these Subsidies should be Treated in the Future; Investigation into the Reasonableness of the LS2 Rate of Illinois Bell Telephone Company*, Docket Nos. 97-0601, 97-0602 and 97-0516 (Consolidated), March 29, 2000, (“*ILEC Cost-Based Switched Access Order*”), pp. 5-6; also see, *LS2 Switched Access Order*, pp. 35-36.

²² *ILEC Cost-Based Switched Access Order*, p. 47.

798 **Q59.** WHAT IS THE IMPACT OF REMOVING LOCAL LOOP COSTS ON THE
799 COSTS PER MOU ON THESE SIX RATE ELEMENTS?

800 A59. Column E of Confidential Schedule KAC-5 shows the result of removing the NTS costs
801 associated with local loops. Comparing Column E to Column D indicates that composite
802 costs go down for IXC traffic because of the removal of costs from CCL. Thus, the
803 resulting composite cost is **[BEGIN CONFIDENTIAL *** ***** END**
804 **CONFIDENTIAL]**, which reflects a percentage decrease of **[BEGIN**
805 **CONFIDENTIAL *** ***** END CONFIDENTIAL]** over Column D.

806 B. EXTENDED LOOP COSTS SHOULD NOT BE INCLUDED

807 **Q60.** HAS MR. STARKEY INCLUDED ANY OTHER LOOP COSTS IN HIS
808 ANALYSIS?

809 A60. Yes. NUCA includes the costs for extended loops in NUCA, which are all or part of the
810 costs found in Baskets B1, B2, C, D1, D2 and D3. I have modified the portion allocated
811 to the CCL rate element based on the cost-to-rate weightings that I discussed in the
812 previous section of my testimony. Mr. Starkey allocates these costs, as modified herein,
813 to a usage-based rate element, because Mr. Starkey asserts that NUCA contains only
814 traffic-sensitive costs.²³ Mr. Starkey described investments as not being “traffic
815 sensitive” to mean that such investments “do not vary whether traffic volumes are large
816 or small.”²⁴ Mr. Starkey further clarified his use of the terms “traffic sensitive” in
817 McLeodUSA’s Response to Staff Data Request JZ 1.61, attached as Confidential
818 Schedule KAC-6, and in McLeodUSA’s Response to Verizon Data Request 1-11,
819 attached as Schedule KAC-7.

²³ See Starkey Direct Testimony, p. 37.

²⁴ See Starkey Direct Testimony, p. 49.

820 **Q61.** HAS MCLEODUSA PERFORMED ANY QUANTIFIABLE ANALYSIS THAT
821 SUPPORTS THE CLAIM THAT EXTENDED LOOP COSTS ARE MINUTE
822 DRIVEN RATHER THAN ACCESS LINE DRIVEN?

823 A61. No. The responses found in Schedules KAC-6 and KAC-7 indicate that the claim that
824 extended loop costs are minute driven, i.e., vary with minutes were based on Mr.
825 Starkey's experience in the telecommunications industry and undocumented detailed
826 discussions with McLeodUSA's network engineers.

827 **Q62.** HAVE YOU PERFORMED ANY ANALYSIS TO TEST THE VERACITY OF
828 THIS CLAIM?

829 A62. Yes, I have.

830 **Q63.** WHAT DID YOU DO?

831 A63. NUCA developed its estimates of the direct cost for various baskets using several
832 modules that feed into NUCA's Model Results module. One of these modules is the
833 Access Node Module, which developed the direct costs for Basket B1, Access Node
834 Aggregation Facilities. The direct costs developed by NUCA for this basket is **[BEGIN**
835 **CONFIDENTIAL ***** *** END CONFIDENTIAL]** per month in Illinois,
836 which is easily the largest cost assigned to any other basket in NUCA for Illinois. Mr.
837 Starkey stated at page 49 of his testimony that NUCA removed investments that were not
838 "traffic sensitive," i.e., NUCA removed NTS investments.²⁵ In addition, McLeodUSA
839 has used the Access Node Module to illustrate that NUCA has taken steps to remove
840 NTS investments and, thereby, to include only traffic-sensitive costs.²⁶ Consequently,
841 examining the usage sensitivity of costs in this basket may provide a meaningful
842 assessment of the general claim that NUCA's results only include usage-sensitive costs.

²⁵ Also, see McLeodUSA's data request response attached as Schedule KAC-8.

²⁶ See McLeodUSA's responses attached as Schedule KAC-9.

843 Now, NUCA's Access Node Module developed monthly costs for the access node
844 aggregation equipment for **[BEGIN CONFIDENTIAL ***** END**
845 **CONFIDENTIAL]** access node locations—**[BEGIN CONFIDENTIAL *******
846 **END CONFIDENTIAL]** of these locations are located in Illinois. The Access Node
847 Module also contained the number of DS0 circuits, lines or local loops connected to a
848 McLeodUSA switch. Using this information, I performed a linear regression to ascertain
849 whether local loop counts might be related to access node aggregation costs. The results
850 of that regression are shown at page 1 on Confidential Schedule KAC-10, showing that
851 local loop counts are correlated with access node aggregation costs. This is not
852 surprising, since the number of DS0 connections on the AnyMedia[®] Access Systems is a
853 factor in sizing this equipment. Clearly, this regression implies that it is unreasonable to
854 assume that only usage causes the costs associated with access node aggregation
855 equipment, as NUCA has assumed.

856 Unfortunately, NUCA does not have usage data available at this level of
857 granularity so as to able to see if usage also matters. But, NUCA does have usage data
858 when access nodes are aggregated by their associated service nodes. In these
859 circumstances, there are **[BEGIN CONFIDENTIAL ***** END**
860 **CONFIDENTIAL]** service nodes modeled in NUCA—**[BEGIN CONFIDENTIAL**
861 ******* END CONFIDENTIAL]** of these nodes are located in Illinois. I performed
862 the simple regression again on this more aggregated data, and once again local loops, as
863 expected, matter statistically. The results for this second regression are shown at page 2
864 on Confidential Schedule KAC-10. Next, I performed three similar statistical tests asking
865 whether adding minutes to the analysis makes a significant contribution to explaining the

866 variation in costs. The statistics for testing this hypothesis along with basic supporting
867 material are shown at page 3 on Confidential Schedule KAC-10. Contrary to Mr.
868 Starkey's claim that all NTS costs have been removed, the hypothesis that NUCA's
869 access node aggregation costs are all NTS costs cannot be statistically rejected, which
870 means that assuming that usage does not matter is more reasonable than Mr. Starkey's
871 claim that NUCA's results contain only traffic-sensitive costs, because either non-traffic.
872 Obviously, NUCA itself contradicts this central usage-centric claim regarding NUCA's
873 costs.

874 **Q64. WHAT SIGNIFICANCE DOES THIS ANALYSIS HAVE ON ESTIMATING**
875 **MCLEODUSA'S COSTS FOR ITS SWITCHED ACCESS SERVICE?**

876 A64. McLeodUSA has the burden of supporting fundamental assumptions of its cost model.
877 The assumption that NUCA's results only include usage-driven costs is one such
878 assumption. As is clear from McLeodUSA's data request response shown in Schedules
879 KAC-6 and KAC-7, McLeodUSA has performed no quantitative analysis or
880 documentation supporting this claim. The analysis that I have performed above
881 regarding the costs modeled by NUCA for Access Node Aggregation Facilities refutes
882 McLeodUSA's claim and shows that costs for Access Node Aggregation Facilities are
883 more reasonably described as driven only by local loop counts. Consequently, all costs
884 for Access Node Aggregation Facilities are not caused by usage, and these costs should
885 be removed from LRSIC calculations of usage-based rate elements.

886 **Q65. HAVE YOU DONE A SIMILAR ANALYSIS FOR OTHER COSTS ASSOCIATED**
887 **WITH MCLEODUSA'S EXTENDED LOOPS?**

888 A65. No. McLeodUSA controls its facilities and its accounting records, and it has the burden
889 of supporting its own cost model. AT&TCI does not have the burden of disproving each
890 and every one of McLeodUSA's assumptions.

891 **Q66. WHAT IS THE IMPACT OF REMOVING EXTENDED LOOP COSTS ON THE**
892 **COSTS PER MOU ON THESE SIX RATE ELEMENTS?**

893 A66. Column F of Confidential Schedule KAC-5 shows the consequences of removing
894 extended loop costs. Comparing Column F to Column E indicates that composite costs
895 go down for IXC traffic because of the removal of costs from CCL. Thus, the resulting
896 composite cost is [**BEGIN CONFIDENTIAL ***** END**
897 **CONFIDENTIAL**], which reflects a percentage decrease of [**BEGIN**
898 **CONFIDENTIAL ***** END CONFIDENTIAL**] over Column E.

899 C. MOST SWITCHING COSTS SHOULD NOT BE INCLUDED

900 **Q67. HAS MCLEODUSA PERFORMED ANY QUANTIFIABLE ANALYSIS THAT**
901 **SUPPORTS THE CLAIM THAT ALL SWITCHING COSTS ARE MINUTE**
902 **DRIVEN RATHER THAN ACCESS LINE DRIVEN?**

903 A67. No. McLeodUSA has performed no quantifiable analysis supporting the claim that all of
904 the costs that it categorizes as "switching" costs are minute driven rather than access line
905 or loop driven, as again shown in McLeodUSA's data request responses found in
906 Schedules KAC-6 and KAC-7. Nevertheless, McLeodUSA presumes that NUCA's
907 results only include usage-sensitive costs associated with all switching equipment, which
908 are associated with Baskets E and G.

909 **Q68. WHAT ARE EXAMPLES OF SWITCHING EQUIPMENT COSTS IN NUCA**
910 **THAT ARE VOLUME INSENSITIVE, BUT MCLEODUSA ASSUMES ARE**
911 **USAGE SENSITIVE?**

912 A68. An example of switching equipment costs in NUCA that are volume insensitive is the
913 material price for [BEGIN CONFIDENTIAL *****
914 ***** *** END CONFIDENTIAL] per switch, which clearly does not
915 depend on any volumes, but merely the number of switches.

916 **Q69.** WHEN MCLEOD BUYS SWITCHING EQUIPMENT, DOES MCLEODUSA PAY
917 ANY SWITCH VENDOR INCLUDED IN NUCA ON A PER-MINUTE BASIS?

918 A69. Based on my review of supporting documentation regarding prices for switching
919 equipment included in NUCA, I saw no price that changed by minutes or was priced on a
920 per-minute basis. In this sense, McLeodUSA does not incur material expenditures for
921 switching equipment on a usage basis. This type of information has been sufficient for
922 the Commission to exclude any switching costs as usage sensitive in AT&T Illinois'
923 original TELRIC proceeding.²⁷

924 **Q70.** ARE YOU RECOMMENDING THAT ALL SWITCHING BE DEEMED USAGE
925 INSENSITIVE?

926 A70. No. In spite of what the Commission determined in this old TELRIC proceeding, I do
927 not contest that a part of the switching costs modeled by NUCA may be usage sensitive.
928 However, the evidence does not support McLeodUSA's claim that switching costs are
929 entirely usage sensitive.

930 **Q71.** HAVE YOU PERFORMED ANY ANALYSIS TO DETERMINE THE VOLUME
931 DRIVERS FOR THE SWITCHING COSTS FOUND IN NUCA?

932 A71. Yes. I performed a regression analysis for end-office switching costs (Basket E) that was
933 similar to the analysis I performed for Access Node Aggregation costs. This analysis

²⁷ See *Investigation into forward looking cost studies and rates of Ameritech Illinois for interconnection, network elements, transport and termination of traffic and Proposed rates, terms and conditions for unbundled network elements*, Docket Nos. 96-0486/96-0569 (consolidated), Second Interim Order, February 17, 1998 at p. 59.

934 supports the conclusion that **[BEGIN CONFIDENTIAL ***** END**
935 **CONFIDENTIAL]**or nearly half of switching costs is access line or port driven in
936 Illinois, where access lines are measured by McLeodUSA’s loops that connect to
937 McLeodUSA’s switches. In contrast to my analysis of Access Node Aggregation costs,
938 **[BEGIN CONFIDENTIAL ***** END CONFIDENTIAL]** or about one-third
939 of switching costs is MOU driven in Illinois with the remaining **[BEGIN**
940 **CONFIDENTIAL ***** END CONFIDENTIAL]** being volume insensitive.
941 Thus, the non-traffic sensitive (“NTS”) portion is **[BEGIN CONFIDENTIAL *** ****
942 ******* ** END CONFIDENTIAL]**. Confidential Schedule KAC-11 shows the
943 calculations supporting the identification of the NTS portion of McLeodUSA’ switching
944 costs in Illinois as well as the regression analysis that is the basis for this identification.
945 Once again, NUCA itself contradicts the claim that its results have excluded NTS costs.

946 **Q72. WHAT IS YOUR RECOMMENDATION REGARDING THE USE OF THIS**
947 **ANALYSIS IN MCLEODUSA’S COST STUDY?**

948 A72. I recommend that the NTS portion of Basket E be removed from the cost development of
949 minute-rated switching rate elements. Thus, only **[BEGIN CONFIDENTIAL *******
950 ***** END CONFIDENTIAL]** of total switching costs should be used to develop
951 switching costs for switched access service, because this is the maximum portion of
952 switching costs that can be attributable to usage services using McLeodUSA’s switches
953 following the Cost Causation Principle and using the information found in NUCA. I
954 propose that it be implemented by modifying Table 5 to match Table 6.

955 **NUCA’s Cost-to-Rate Mapping with Tariff, MOUs, Mileage and Switching Adjustments**
956 **[BEGIN CONFIDENTIAL *****

		A	B1	B2	C	D1	D2	D3	E	F	G
1.	CARRIER COMMON LINE										
2.	INTERCONNECTION CHARGE										
3.	LOCAL SWITCHING										
4.	TANDEM FUNCTIONALITY CHARGE										
5.	TANDEM TRANSPORT / TANDEM SWITCHED TERMINATION										
6.	TANDEM SWITCHED FACILITY										

957 *** END CONFIDENTIAL]

958 **Table 6**

959 **Q73.** WHAT IS THE IMPACT OF REMOVING NTS SWITCHING COSTS ON THE
 960 COSTS PER MOU ON THESE SIX RATE ELEMENTS?

961 A73. Column G of Confidential Schedule KAC-5 shows the consequences of removing
 962 extended loop costs. Comparing Column G to Column F indicates that composite costs
 963 go down for IXC traffic because of the removal of costs from the two switching rate
 964 elements. Thus, the resulting composite cost is [BEGIN CONFIDENTIAL ***
 965 ***** END CONFIDENTIAL], which reflects a percentage decrease of
 966 [BEGIN CONFIDENTIAL ***** END CONFIDENTIAL] over Column F.

967 D. COMMON COSTS SHOULD NOT BE INCLUDED IN A LRSIC STUDY

968 **Q74.** ARE COMMON COSTS PART OF THE LRSIC OF ANY SERVICE UNDER THE
 969 COMMISSION’S COST OF SERVICE RULES?

970 A74. No. Clearly, Section 791.20(a) says LRSIC “excludes any costs, including common
 971 costs, that would be incurred if the service is not produced.” Therefore, common costs
 972 are not part of LRSIC.

973 **Q75.** WHAT IS THE IMPACT OF REMOVING COMMON COSTS ON THE COSTS
 974 PER MOU ON THESE SIX RATE ELEMENTS?

975 A75. Column H of Confidential Schedule KAC-5 shows the consequences of removing
 976 common costs. Comparing Column H to Column G indicates that composite costs go

977 down for IXC traffic because of the removal of common costs. The resulting composite
978 cost is [BEGIN CONFIDENTIAL ***** END CONFIDENTIAL], which
979 reflects a percentage decrease of [BEGIN CONFIDENTIAL ***** END
980 CONFIDENTIAL] over Column G.

981 **Q76. ARE THERE ANY ADDITIONAL PROBLEMS WITH MCLEODUSA’S**
982 **COMMON COSTS?**

983 A76. Yes, there are several other fundamental problems. First, McLeodUSA’s cost study is
984 not sufficiently reliable to set any rates today if for no other reason that it reflects a
985 forward-looking cost perspective from about 2005 rather than 2010. As I show below,
986 this creates obvious overstatements in several “common cost” categories. Second,
987 because the inclusion of common costs is improper to include as part of LRSIC, I have
988 not attempted a comprehensive analysis. Thus, additional adjustments would be needed
989 to calculate reasonable cost-based rates. Finally, McLeodUSA’s cost study applies a
990 common cost factor of [BEGIN CONFIDENTIAL ***** *** END
991 CONFIDENTIAL], which is higher than the capped factor the Commission approved in
992 Docket Nos. 97-0601/97-0602/97-0516 – namely, 28.86%.²⁸

993 **Q77. WHERE IN NUCA IS MCLEODUSA’S PROPOSED COMMON COST FACTOR**
994 **DEVELOPED?**

995 A77. McLeodUSA’s proposed common cost factor is developed in the Factor Module of
996 NUCA. The final calculations are found on the “Common Cost Factor” tab in this
997 module.

998 **Q78. WHAT IS THE VINTAGE OF THE DATA USED IN DEVELOPING**
999 **MCLEODUSA’S COMMON COST FACTOR?**

²⁸ See *ILEC Cost-Based Switched Access Order*, p. 51.

1000 A78. The development of McLeodUSA's common cost factor started with from
1001 McLeodUSA's 2003 and 2004 financial records. A large portion of the [BEGIN
1002 CONFIDENTIAL ***** END CONFIDENTIAL] in common costs
1003 identified by NUCA are likely significantly overstated. For example, many operating
1004 expenses included in these common costs declined between 2003 and 2004. While
1005 NUCA captured part of this decline by averaging 2003 and 2004 data, NUCA ignored the
1006 fact that more recent data would likely show continued decreases. At a minimum,
1007 PAETEC's acquisition of McLeodUSA would likely have reduced common costs as a
1008 percentage of direct costs.

1009 1. OVERSTATED SOFTWARE COSTS

1010 **Q79.** COULD YOU PROVIDE SOME EXAMPLES OF THE OVERSTATED
1011 COMMON COSTS DEVELOPED IN NUCA?

1012 A79. Yes. The largest component of NUCA's common costs was [BEGIN CONFIDENTIAL
1013 ***** END CONFIDENTIAL] in expenses for intangible assets before
1014 removing retail costs and [BEGIN CONFIDENTIAL ***** END
1015 CONFIDENTIAL] after removing retail costs associated with computer software.
1016 McLeodUSA's average investment over 2003 and 2004 in software was [BEGIN
1017 CONFIDENTIAL ***** END CONFIDENTIAL]. McLeodUSA's
1018 continuing property records of capitalized software as of November 25, 2009 show a
1019 significant decrease in these intangible software assets to [BEGIN CONFIDENTIAL
1020 ***** END CONFIDENTIAL], which is nearly an [BEGIN

1021 **CONFIDENTIAL ***** END CONFIDENTIAL]** decline.²⁹ In other words, by
1022 November 25, 2009 PAETEC, which wholly owns McLeodUSA, had intangible software
1023 assets on its McLeodUSA books in an amount that is only **[BEGIN CONFIDENTIAL**
1024 ******* END CONFIDENTIAL]** of what is included in McLeodUSA's analysis
1025 relying on 2003 and 2004 data. This is one indication that the common cost development
1026 in NUCA does not reflect efficiently incurred common costs today.

1027 2. OVERSTATED LAND AND BUILDING COSTS

1028 **Q80. DO YOU HAVE ANOTHER EXAMPLE OF OVERSTATED COMMON COSTS?**

1029 A80. Yes. A less significant, but nevertheless indicative, overstatement in NUCA is its lack of
1030 handling of known and knowable changes in land and building costs. McLeodUSA has
1031 sold off significant assets and operations since the time NUCA was initially developed.
1032 One very large sale involved McLeodUSA's main headquarters building and its
1033 associated land in October of 2005. Yet, the costs for the land and building for this
1034 nonexistent asset set are still used in the common factor cost development. All such
1035 inclusions of non-forward-looking costs are inconsistent with the Commission's Cost of
1036 Service rules.

1037 3. UNSUPPORTED AVOIDED COST FACTOR

1038 **Q81. ARE THERE ANY OTHER SIGNIFICANT PROBLEMS IN NUCA'S**
1039 **DEVELOPMENT OF A COMMON COST FACTOR?**

1040 A81. Yes. In order to remove common costs that would be avoided if retail services were not
1041 offered by McLeodUSA, NUCA relied on an avoided cost factor that apparently cam
1042 from a Texas UNE proceeding. McLeodUSA admits in NUCA that McLeodUSA has not

²⁹ These confidential continuing property records are attached to McLeodUSA's response to AT&TCI's Data Request 1-39. McLeodUSA's public response is provided as Schedule KAC-12.

1043 performed an avoided cost study for retail services. In addition, even if one were to
1044 accept the Texas factor at face value, NUCA does not use the Texas value correctly –
1045 essentially failing to attribute any [BEGIN CONFIDENTIAL *****
1046 *****
1047 ***** END CONFIDENTIAL] to retail functions. Based on
1048 PAETEC’s third quarter 2009 10Q, it appears that “carrier services revenue” constitutes
1049 only about 17% of PAETEC’s revenues and as such, one might suggest that about 80% of
1050 McLeodUSA’s support asset costs could be considered avoidable.

1051 4. ADDITIONAL PROBLEMS CAUSED BY MCLEODUSA USING 2003 AND 2004 FINANCIAL
1052 DATA

1053 **Q82.** MANY OF THE PROBLEMS YOU HAVE IDENTIFIED WITH NUCA’S
1054 COMMON COST FACTOR DEVELOPMENT HAVE CENTERED ON THE USE
1055 OF OLD FINANCIAL DATA. CAN NUCA’S COMMON COST FACTOR
1056 DEVELOPMENT BE REASONABLY RESOLVED USING THE 2003 AND 2004
1057 DATA?

1058 A82. No. The reliance on 2003 and 2004 financial data in NUCA’s development of its
1059 common costs factor is too fundamental and pervasive a problem. McLeodUSA as part
1060 of PAETEC appears to be a much more efficiently run company than the 2003-2004
1061 company that McLeodUSA used to develop NUCA’s common cost factor.
1062 Consequently, the Commission should just say no to any common cost factor based on
1063 the old company.

1064 VI. DEFICIENCIES IN NUCA FOR COSTS THAT BELONG IN LRSIC
1065 STUDY

1066 **Q83.** HAVE YOU IDENTIFIED DEFICIENCIES IN THE COST DEVELOPMENT
1067 FOUND IN NUCA FOR COSTS THAT DO BELONG IN A LRSIC STUDY OF
1068 MCLEODUSA’S INTRASTATE SWITCHED ACCESS SERVICE?

1069 A83. Yes. Because of the limited nature of my analysis, I have focused on the three
1070 components in cost studies that are generally the most important—namely, cost of
1071 capital, economic lives and fill factors.

1072 A. OVERSTATED COST OF CAPITAL

1073 **Q84.** PLEASE DEFINE THE COST OF CAPITAL FOR A COMPANY SUCH AS
1074 MCLEODUSA.

1075 A84. The overall or weighted average cost of capital (“WACC”) for McLeodUSA is the sum
1076 of the component costs of the capital structure – debt and equity – after each is weighted
1077 by its proportion to the total financial capital.

1078 **Q85.** WHAT DOES THE COMMISSION’S COST OF SERVICE RULES SAY ABOUT
1079 COST OF CAPITAL?

1080 A85. The pertinent portion of the Commission’s Cost of Service rules appears in Part
1081 791.80(b)(1) regarding the cost of capital to be used in a LRSIC study:

1082 The cost of capital associated with an investment shall be the weighted average of
1083 the carrier's costs of debt and equity applied to the net investment. The
1084 development of this component shall be based upon the current amount and
1085 weighted cost of debt. Carriers shall use the cost of equity approved by the
1086 Commission in the carrier's latest proceeding in which cost of money was
1087 litigated. (For purposes of a cost study submitted in a rate proceeding in which the
1088 telecommunications carrier is presenting evidence on its cost of capital, the
1089 telecommunications carrier may, as an alternative, base the return components
1090 upon the costs submitted in the proceeding, subject to the final Commission
1091 action on such issue.)

1092 **Q86.** WHAT IS THE COST OF CAPITAL MR. STARKEY USED IN MCLEODUSA’S
1093 COST STUDY?

1094 A86. **[BEGIN CONFIDENTIAL ***** END CONFIDENTIAL]**, which is found
1095 at page 54 of Mr. Starkey’s Attachment MS-4 and is labeled “Cost of Capital (Before Tax
1096 Return).” The following table displays the cost of equity, the cost of debt and the

1097 debt/equity ratios used to develop McLeodUSA's WACC, which are also found at page
 1098 54 of Mr. Starkey's Attachment MS-4.

1099 McLeodUSA's Proposed Weighted Average Cost of Capital

1100 [BEGIN CONFIDENTIAL ***

	Cost A	Weight B	Weighted Cost C=AxB
Debt			
Equity			
WACC			

1101 *** END CONFIDENTIAL]

1102 **Q87.** ARE THE COST OF EQUITY, COST OF DEBT AND DEBT-EQUITY RATIO
 1103 USED BY MR. STARKEY REASONABLE TO DEVELOP LRSICS FOR
 1104 SWITCHED ACCESS SERVICES?

1105 A87. No. The analysis supporting Mr. Starkey's inputs for developing McLeodUSA's WACC
 1106 are based on 2006 data, as indicated by McLeodUSA's responses to Staff Data Request
 1107 JZ 1.44(A-D) attached as part of Confidential Schedule KAC-13.³⁰ As a result, it does
 1108 not reflect McLeodUSA's acquisition by PAETEC that closed in February 2008. Simply
 1109 put, this information is not current for developing a reasonable WACC for McLeodUSA
 1110 today and does not comply with the Commission's Cost of Service rules that require
 1111 carriers to use their current cost and ratio of debt and their recently approved cost of
 1112 equity, if available.

1113 By basically updating McLeodUSA's calculation for more current figures, as I describe
 1114 in more detail below, I calculate a cost of capital of 10.63 %.

³⁰ Also, see the file "CONFIDENTIAL – CAPM.xls" attached to McLeodUSA's response to Verizon's Data Request 1-3.

1115

Recommended Weighted Average Cost of Capital

	Cost A	Weight B	Weighted Cost C=AxB
Debt	8.36%	61.5%	5.14%
Equity	14.25%	38.5%	5.49%
WACC			10.63%

1116

1117

These estimates are not surprising, given that McLeodUSA is now **[BEGIN**

1118

CONFIDENTIAL * *******

1119

******* *** END CONFIDENTIAL]**. In fact, as shown in

1120

Schedule KAC-14, McLeodUSA has admitted that using information subsequent to its

1121

acquisition by PAETEC would likely lead to a lower WACC.

1122

1. COST OF EQUITY DEVELOPMENT

1123

Q88. WHAT IS YOUR ESTIMATE FOR THE COST OF EQUITY FOR

1124

MCLEODUSA?

1125

A88. My estimate of the cost of equity for McLeodUSA to be used in a LRSIC study of its

1126

switched access services is 14.25%, which is significantly less than McLeodUSA's

1127

claimed cost of equity of **[BEGIN CONFIDENTIAL ***** END**

1128

CONFIDENTIAL]. Both estimates are based on a standard "risk premium" model,

1129

which takes the rate of return for risk-free assets (Treasury bonds) and then calculates the

1130

premium that investors would require for the risk associated with a more volatile

1131

investment in a company like McLeodUSA. The principal causes of the difference are (i)

1132

my estimate is based on a more current and representative sample of analogous

1133

telecommunications companies, (ii) I used more current data for calculating the risk

1134

premium, and (iii) I calculated a "size premium" based on McLeodUSA's current size

1135

following the acquisition by PAETEC.

1136

Q89. WHAT FIRMS DID MCLEODUSA USE IN ITS SAMPLE?

1137 A89. McLeodUSA's sample included [BEGIN CONFIDENTIAL *** *****
1138 *****
1139 *****
1140 ***** *** END CONFIDENTIAL]

1141 Q90. DID YOU USE THE SAME FIRMS?

1142 A90. No. My sample includes the following CLECs: Cbeyond, Inc., Level 3
1143 Communications, RCN Corp., SureWest Communications, tw telecom inc. and Vonage
1144 Holdings Corporation.

1145 Q91. WHY DID YOU NOT USE MCLEODUSA'S SAMPLE?

1146 A91. My focus was on competitive carriers with local exchange operations that are currently
1147 publicly traded and also included in the universe of companies followed by the Value
1148 Line investment survey and Yahoo Finance. When looking at the set of firms used in
1149 McLeodUSA's earlier analysis, three have been taken private directly or by acquisition
1150 by other private firms [BEGIN CONFIDENTIAL *** *****
1151 *****
1152 ***** *** END CONFIDENTIAL],
1153 two others have been acquired by publicly traded firms [BEGIN CONFIDENTIAL ***
1154 *****
1155 ***** END CONFIDENTIAL], and one is only trading
1156 over-the-counter on Pink Sheets at this time [BEGIN CONFIDENTIAL *****
1157 ***** *** END CONFIDENTIAL].³¹ Of the remaining firms in McLeodUSA's

³¹ The SEC website at <http://www.sec.gov/answers/pink.htm> provides as description of Pink Sheets including the following quote:

1158 sample both are included in my sample [BEGIN CONFIDENTIAL *** *****
1159 ***** END CONFIDENTIAL].

1160 **Q92.** HOW DID YOU ESTIMATE THE RISK-FREE RATE OF RETURN?

1161 A92. I used the average yield on twenty-year U.S. Treasury bonds from November 2, 2009
1162 through January 29, 2010 of 4.38%. These yields ranged from 4.07% per year on
1163 November 27th and November 28th to 4.64% on January 11th.

1164 **Q93.** WHAT EQUITY RISK PREMIUM DID YOU RELY ON AND WHY?

1165 A93. I relied on the Ibbotson supply-side market equity risk premium of 5.2% through
1166 December 31, 2009 as published by Morningstar, one of the most widely used purveyors
1167 of such information. I selected the supply-side version over the historical measure of
1168 6.7% because the supply-side version of the equity risk premium reflects the most current
1169 forward-looking view of the expected equity risk premium

1170 **Q94.** HOW DID YOU ESTIMATE THE BETA USED IN YOUR CAPM ANALYSIS?

1171 A94. I started by finding Yahoo's Beta for each firm in my sample of comparable firms.
1172 Yahoo's Beta values are derived using the movement of the stock's price each month
1173 relative to the movement of the S&P500 over a period of three years. The observed
1174 market beta for each company is reflective of its respective capital structure (debt and

"Pink OTC Markets, formerly known as Pink Sheets, operates Pink Quote, an electronic quotation system that displays quotes from broker dealers for many over-the-counter (OTC) securities. "Market makers" and other brokers who buy and sell OTC securities, can use the Pink Quote to publish their bid and ask quotation prices. The name "Pink Sheets" comes from the color of paper they were historically printed on. They are published electronically today by Pink OTC Markets Inc., a privately owned company. Pink OTC Markets Inc. is not registered with the SEC in any way and it is not the Financial Industry Regulatory Authority (FINRA) Broker-Dealer. Pink OTC Markets Inc. does not require companies whose securities are quoted upon its systems to meet any listing requirements. With the exception of a few foreign issuers, the companies quoted in Pink Quote tend to be closely held, extremely small and/or thinly traded. Most do not meet the minimum listing requirements for trading on a national securities exchange, such as the New York Stock Exchange or the Nasdaq Stock Market. Many of these companies do not file periodic reports or audited financial statements with the SEC, making it very difficult for investors to find reliable, unbiased information about those companies. For all of these reasons, companies quoted in Pink Quote can be among the most risky investments."

1175 equity mix) and in order to develop the appropriate Beta applicable to McLeodUSA
1176 (PAETEC) I had to determine the Beta value for the firm by removing the effects of
1177 leverage for each company. My next step was to average the unlevered Beta of the
1178 comparator firms and then develop a Beta reflective of McLeodUSA's/PAETEC's
1179 current market-weighted debt and equity structure. This "re-levering" produced an
1180 unadjusted Beta for McLeodUSA/PAETEC. The final step was to adjust this result to
1181 account for the expected long-term reversion to the market mean Beta value of 1.00. The
1182 result was an adjusted McLeodUSA/PAETEC-specific Beta of 1.42.

1183 **Q95.** WHAT DID MCLEODUSA USE TO ESTIMATE ITS RECOMMENDED BETA?

1184 A95. McLeodUSA used adjusted Betas from Bloomberg.

1185 **Q96.** WHY DID YOU USE YAHOO'S BETAS RATHER THAN BLOOMBERG'S
1186 BETAS?

1187 A96. Bloomberg Betas are produced on a proprietary basis, and both the Value Line and the
1188 Yahoo measures are publicly reported and readily available.

1189 **Q97.** PLEASE DISCUSS THE "SIZE PREMIUM" INCLUDED IN THE RISK
1190 PREMIUM MODELS.

1191 A97. The use of a size premium reflects historic data that smaller firms with lower equity
1192 capitalization have tended to produce higher long-run returns on equity. I could have
1193 excluded a size premium altogether and reduced McLeodUSA's cost of capital further; its
1194 use is sometimes controversial because of claims that small-cap returns are biased
1195 upward because of survivorship or because of the inclusion of previously successful but
1196 now-troubled firms in the mix. At a minimum, though, it is improper for McLeodUSA to
1197 calculate a "size premium" based on its smaller size *before* its acquisition by PAETEC.

1198 Simply put, McLeodUSA is not that small today. I have included a size premium based
1199 on McLeodUSA's present size.

1200 **Q98.** HOW DID YOU ESTIMATE THE SIZE PREMIUM FOR MCLEODUSA?

1201 A98. I selected the size premium based on PAETEC's average market-value equity
1202 capitalization over a recent three-month period and utilized the most recent data from
1203 Ibbotson. I utilized a three-month average because of the volatility in PAETEC's market
1204 price in recent months. Based on current market conditions, the appropriate size
1205 premium value is 2.49%. This compares to the size premium of [BEGIN
1206 **CONFIDENTIAL ***** *** END CONFIDENTIAL**] used by McLeodUSA.

1207 **Q99.** WHAT IS INCORRECT WITH MCLEODUSA'S DEVELOPMENT OF ITS
1208 ESTIMATE FOR A SIZE PREMIUM?

1209 A99. The basic problem with McLeodUSA's size premium is that it is outdated; it is based on
1210 the much smaller size of McLeodUSA before the PAETEC acquisition. Consequently,
1211 the size premium used by McLeodUSA is not a reasonable estimate today.

1212 **Q100.** HAVING MADE ESTIMATES OF ALL OF THE PARAMETERS NEEDED TO
1213 CALCULATE MCLEODUSA'S/PAETEC'S COST OF EQUITY, WHAT IS THE
1214 FINAL CALCULATION MADE TO YIELD 14.25% ?

1215 A100. Using the CAPM formula discussed above and the my recommended values for the
1216 parameters yields a cost of equity of 14.25% as a result of the following calculation:

1217
$$14.25\% = 4.38\% + 1.42 \times 5.0\% + 2.49\%.$$

1218 2. COST OF DEBT DEVELOPMENT

1219 **Q101.** WHAT SUPPORT HAS MCLEODUSA PROVIDED REGARDING ITS
1220 ESTIMATE OF THE COST OF DEBT?

1221 A101. The only narrative support provided by McLeodUSA for its estimated cost of debt is its
1222 response to Staff Data Request JZ 1.44(A), which is part of my Confidential Schedule

1223 KAC-13.³² McLeodUSA's estimated cost of debt relied on debt from 2006 rather than
1224 current debt. Consequently, McLeodUSA's development of its cost of debt does not
1225 comply with the Commission's Cost of Service rules, which require a carrier to use its
1226 current cost of debt.

1227 **Q102. WHAT IS YOUR ESTIMATE FOR THE CURRENT COST OF DEBT FOR**
1228 **MCLEODUSA?**

1229 A102. My analysis estimates the current cost of debt for McLeodUSA to be used in a LRSIC
1230 study of its switched access services is 8.36%.

1231 **Q103. HOW DID YOU DEVELOP YOUR ESTIMATE?**

1232 A103. McLeodUSA currently hold no debt directly. Rather all debt is held by PAETEC.³³
1233 Therefore, I began by examining PAETEC's September 30, 2009 Form 10-Q. PAETEC
1234 reported at page 9 the market value of \$268.2 million for its senior credit facilities,
1235 \$272.3 million for its 9.5% Senior Notes due 2015 and \$348.3 million for its 8 7/8%
1236 Senior Secured Notes due 2017. In addition, PAETEC reported at page 7 an unamortized
1237 discount on its senior credit facilities of \$1.594 million, an unamortized discount on its 8
1238 7/8% Senior Secured Notes due 2017 of \$11.701 million and capital lease obligations and
1239 other debt of \$10.814 million. Based on this information, the best estimate of PAETEC's
1240 current market value of total debt is \$886.319 million. Next, PAETEC reported at page
1241 2 for the first nine months of 2009 as \$54.300 million and \$19.776 million in the third
1242 quarter of 2009. Since the third quarter debt expense was larger than the average
1243 quarterly debt expense for the first three quarters of 2009, I used the third quarter debt

³² This narrative also referred to McLeodUSA's Form S-1 publicly filed with the Securities and Exchange Commission ("SEC") on March 22, 2007, which was provided in response to Verizon's Data Request 1-3.

³³ See McLeodUSA's response to Staff Data Requests JZ 1.44(E), which is part of Confidential Schedule KAC-13.

1244 expense as the estimate for the fourth quarter yielding an annualized debt expense of
1245 \$74.076 million. Finally, I calculated McLeodUSA's current cost of debt as 8.36% =
1246 \$74.076 million / \$886.319 million.

1247 3. DEVELOPMENT OF FORWARD-LOOKING DEBT AND EQUITY MIX

1248 **Q104. WHAT SUPPORT HAS MCLEODUSA PROVIDED REGARDING ITS**
1249 **ESTIMATE OF THE FORWARD-LOOKING DEBT AND EQUITY MIX FOR**
1250 **MCLEODUSA?**

1251 A104. The only narrative support provided by McLeodUSA for its estimated of the forward-
1252 looking debt and equity mix are its responses to Staff Data Request JZ 1.44(C and D),
1253 which are part of Confidential Schedule KAC-13.³⁴ McLeodUSA's estimated mix of
1254 debt and equity relied on 2006 data. Furthermore, McLeodUSA depressed its debt figure
1255 by subtracting Unrestricted Cash and Cash Equivalents from its total debt in its
1256 calculations. Consequently, McLeodUSA's development of its cost of debt does not
1257 comply with the Commission's Cost of Service rules.

1258 **Q105. WHAT IS YOUR ESTIMATE OF THE FORWARD-LOOKING DEBT AND**
1259 **EQUITY MIX FOR MCLEODUSA FOR USE IN A LRSIC STUDY OF**
1260 **MCLEODUSA'S SWITCHED ACCESS SERVICES?**

1261 A105. My analysis estimates the forward-looking share of debt as 61.5% and the forward-
1262 looking share of equity as 38.5%

1263 **Q106. HOW DID YOU DEVELOP THIS DEBT-EQUITY MIX?**

1264 A106. Having developed above an estimate of the current market value for McLeodUSA's total
1265 debt, the next step is to develop the market capitalization of PAETEC's shares. I
1266 obtained from Yahoo Finance the closing share prices for PAETEC over the three-month

³⁴ This narrative also referred to McLeodUSA's Form S-1 publicly filed with the Securities and Exchange Commission ("SEC") on March 22, 2007, which was provided in response to Verizon's Data Request 1-3.

1267 period from November 5, 2009 through February 4, 2010. The average closing share
1268 price over this period was \$3.81 per share. PAETEC reported on its title page of its 2009
1269 third-quarter 10Q report that it had 145,642,230 common stock shares outstanding on
1270 November 2, 2009. Thus, my estimate of market value of PAETEC's equity is
1271 \$555,170,284 (= 145,642,230 shares x \$3.81 per share). Thus, the debt share is 61.5% =
1272 \$886,319,000 / (\$886,319,000 + \$555,170,284) and the equity share is 38.5% = 1 -
1273 61.5%.

1274 **Q107. WHAT IS THE IMPACT OF UPDATING MCLEODUSA'S WACC ON THE**
1275 **COSTS PER MOU ON THESE SIX RATE ELEMENTS?**

1276 A107. Column I of Confidential Schedule KAC-5 shows the consequences of updating
1277 McLeodUSA's WACC. Comparing Column I to Column H indicates that composite
1278 costs go down for IXC traffic because of this update. The resulting composite cost is
1279 **[BEGIN CONFIDENTIAL *** ***** END CONFIDENTIAL]**, which
1280 reflects a percentage decrease of **[BEGIN CONFIDENTIAL *** ***** END**
1281 **CONFIDENTIAL]** over Column H.

1282 **B. UNDERSTATED ECONOMIC LIVES**

1283 **Q108. WHAT ARE ECONOMIC LIVES AND WHY ARE THEY IMPORTANT TO**
1284 **THIS CASE?**

1285 A108. Companies invest in long-lived assets that provide the capability to provide services over
1286 many years. The economic life of an asset is the time from placing the asset in service
1287 until it is economical to retire it. Typically, the yearly loss in value for an asset, *i.e.*, its
1288 depreciation expense, can reasonably be measured by dividing the acquisition cost of an

1289 asset by its economic life.³⁵ Consequently, economic lives are important inputs to
1290 develop depreciation expenses associated with McLeodUSA providing switched access
1291 services. If economic lives are understated, the acquisition cost is spread over fewer
1292 years and depreciation expense is overstated.

1293 **Q109. WHAT DOES THE COMMISSION'S COST OF SERVICE RULES SAY ABOUT**
1294 **THE LIVES TO USE TO COMPUTE DEPRECIATION EXPENSES FOR LRSIC**
1295 **STUDIES?**

1296 A109. The pertinent portion of the Commission's Cost of Service rules appears in Part
1297 791.80(a)(1) regarding the lives to be used in a LRSIC study:

1298 Depreciation shall represent the periodic recognition of investment cost as
1299 dictated by accounting rules (83 Ill. Adm. Code 710). Depreciation costs for a
1300 service shall be computed based upon the projected life of plant at age zero
1301 underlying the depreciation rates most recently approved by the Commission.

1302 **Q110. WHAT ECONOMIC LIVES HAS MCLEODUSA USED IN QSI'S NUCA?**

1303 A110. McLeodUSA has stated that McLeodUSA's financial reporting lives that existed prior to
1304 its acquisition by PAETEC are used as the economic lives in NUCA. These lives are
1305 shown under column (a) in Confidential Schedule KAC-15.

1306 **Q111. ARE MCLEODUSA'S FINANCIAL ASSET LIVES THAT EXISTED BEFORE**
1307 **ITS ACQUISITION BY PAETEC REASONABLE TO USE IN A LRSIC STUDY**
1308 **OF MCLEODUSA'S SWITCHED ACCESS SERVICES?**

1309 A111. No. As shown in Confidential Schedule KAC-16, McLeodUSA admits that NUCA does
1310 not use McLeodUSA's current financial reporting lives. I show these current financial
1311 lives under Column (b) in Confidential Schedule KAC-15. Given that McLeodUSA
1312 appears to argue that its financial lives are reasonable estimates for economic lives, it is
1313 incomprehensible that Mr. Starkey did not use this easily available information. To

³⁵ For ease of exposition, I have refrained from complicating this analysis with additional details such as cost of removal, salvage value and mass asset accounting.

1314 update McLeodUSA's cost study would only require changing ten values in NUCA's
1315 Factors Module.

1316 **Q112. WOULD THIS CHANGE ALONE GENERATE REASONABLE ECONOMIC**
1317 **LIVES FOR USE IN A LRSIC STUDY?**

1318 A112. No, but for the limited purpose of my testimony it is sufficient to show that AT&TCI's
1319 proposed rate caps are more than compensatory. While McLeodUSA's current financial
1320 lives might be reasonable to use in McLeodUSA's cost study, Mr. Starkey has provided
1321 no explanation or justification why McLeodUSA's current financial lives are reasonable.
1322 I am particularly concerned because Mr. Starkey has argued elsewhere that financial lives
1323 are not reasonable estimates of economic lives. So if anything, my willingness to use
1324 financial lives benefits McLeodUSA.

1325 **Q113. WHAT HAS MR. STARKEY SAID ELSEWHERE REGARDING THE USE OF**
1326 **FINANCIAL LIVES AS ESTIMATES OF ECONOMIC LIVES?**

1327 A113. In AT&T Illinois' last UNE case, Docket No. 02-0864, Mr. Starkey recommended that
1328 AT&T Illinois use "the depreciation lives and future net salvage values recommended by
1329 Mr. Majoros."³⁶ Mr. Majoros concluded, "the depreciation parameters currently
1330 prescribed by the FCC for SBC Illinois should be used in determining the prices are
1331 unbundled network elements."³⁷ The lives recommended by Mr. Majoros are shown
1332 under Column (c) in Confidential Schedule KAC-15.

1333 **Q114. WHAT ECONOMIC LIVES DID THE COMMISSION APPROVE IN THE UNE**
1334 **CASE?**

³⁶ Starkey UNE Direct Testimony, p. 104.

³⁷ Direct Testimony of Michael J. Majoros, Jr., *Illinois Bell Telephone Filing to increase Unbundled Loop and Nonrecurring Rates (Tariffs filed December 24, 2002*, Docket No. 02-0864, filed May 6, 2003, p. 6. Mr. Majoros' recommended lives are found on his confidential Attachment MJM-4 under Column b.

1335 A114. The Commission approved the use of AT&T Illinois' financial reporting lives as
1336 reasonable estimates of economic lives.³⁸ These Commission-approved lines are shown
1337 under Column (e) in Confidential Schedule KAC-15.

1338 **Q115.** HAS MR. STARKEY SUBSEQUENTLY CRITICIZED THE ECONOMIC LIVES
1339 APPROVED BY THE COMMISSION IN DOCKET NO. 02-0864?

1340 A115. Yes. In a payphone proceeding in 2006, Mr. Starkey objected to the Commission using
1341 AT&T Illinois' financial reporting lives as its economic lives.³⁹ In addition, Mr. Starkey
1342 has recommended the use of FCC-prescribed lives in three other AT&T Midwest states.⁴⁰
1343 In each of these states Mr. Starkey referred to Mr. Majoros recommendations.⁴¹

1344 **Q116.** WHAT ECONOMIC LIVES DO YOU RECOMMEND BE USED IN
1345 MCLEODUSA'S LRSIC STUDY?

1346 A116. For the limited purpose here, I used the economic lives shown under Column (f) in
1347 Confidential Schedule KAC-15: PAETEC's current financial lives. However, apparently
1348 PAETEC has many financial lives for capitalized leasehold improvements based on the
1349 varying terms across contracts, which cause a minor inconvenience, since NUCA needs a
1350 single life for each asset. In addition, PAETEC does not appear to have a financial
1351 reporting life for radio system equipment. To resolve both problems, I used
1352 McLeodUSA's original proposed lives for these assets – not because they are right, but to
1353 be conservative (in other words to favor McLeodUSA).

³⁸ *SBC Illinois UNE Order*, p. 77.

³⁹ Direct Testimony of Michael Starkey, *Illinois Bell Telephone Company Compliance with Requirements of 13.505.1 of the Public Utilities Act (Payphone Rates)*, Docket No. 05-0575, dated November 2, 2006, pp. 25-26.

⁴⁰ See Rebuttal Testimony of Michael Starkey and Warren Fischer, Public Service Commission of Wisconsin, Docket 6720-TI-187 at p. 151; Initial Testimony of Michael Starkey and Warren Fischer, Michigan Public Service Commission, Case No. U-13531 at p. 117; and Response Testimony of Michael Starkey and Warren Fischer, Indiana Utilities Regulatory Commission, Cause No. 42393 at p. 114.

⁴¹ See, for example, Initial Testimony of Michael J. Majoros, Jr., Michigan Public Service Commission, Case No. U-13531 at p. 4; and Response Testimony of Michael J. Majoros, Jr., Indiana Utilities Regulatory Commission, Cause No. 42393 at 4.

1354 **Q117. WHAT IS THE IMPACT OF UPDATING MCLEODUSA'S ECONOMIC LIVES**
1355 **ON THE COSTS PER MOU ON THESE SIX RATE ELEMENTS?**

1356 A117. Column J of Confidential Schedule KAC-5 shows the consequences of updating
1357 McLeodUSA's economic lives. Comparing Column J to Column I indicates that
1358 composite costs go down for IXC traffic because of this update. The resulting composite
1359 cost is [BEGIN CONFIDENTIAL ***** END CONFIDENTIAL], which
1360 reflects a percentage decrease of [BEGIN CONFIDENTIAL *** ***** END
1361 CONFIDENTIAL] over Column H.

1362 C. INAPPROPRIATE FILL FACTORS

1363 **Q118. HAS MCLEODUSA USED USABLE CAPACITY FILL FACTORS IN**
1364 **DEVELOPING COSTS IN NUCA?**

1365 A118. No. In reviewing NUCA it quickly became clear that no cost was explicitly developed
1366 using any fill factor. Nevertheless, it is apparent that the amount of spare capacity
1367 included in NUCA are often much larger than the standby capacity required for
1368 maintenance, testing, or administrative purposes. For example, NUCA's development of
1369 access node aggregation costs appears to have spare capacity far beyond what is
1370 appropriate for a LRSIC study. This spare capacity is found in the Access Node module.

1371 **Q119. WHAT IS THE PURPOSE OF NUCA'S ACCESS NODE MODULE?**

1372 A119. This module contains the inputs and calculations pertaining to McLeodUSA's
1373 collocation, *i.e.*, CLEC equipment arrangements within ILEC central offices for the
1374 purpose of interconnection and/or access to UNEs.

1375 **Q120. HOW DOES THE ACCESS NODE MODULE CALCULATE THESE COSTS FOR**
1376 **ILLINOIS?**

1377 A120. NUCA modeled two switches supporting [**BEGIN CONFIDENTIAL ***** END**
1378 **CONFIDENTIAL**] collocation sites with ILEC central offices in Illinois. For each of
1379 these collocation sites, the *number* of AnyMedia[®] Access Systems shelves with
1380 accompanying equipment is the primary investment driver in this module. The
1381 determination of the number of shelves at a site is a function of *usable* DS0 quantities at
1382 that site, since a single AnyMedia[®] Access Systems shelf is limited to [**BEGIN**
1383 **CONFIDENTIAL ***** ** END CONFIDENTIAL**] lines, where DS0 is the
1384 standard speed for digitizing one voice conversation. In addition to shelf and shelf-
1385 equipment material investment, capitalized labor, *i.e.*, installed vendor and McLeodUSA
1386 labor, is added to the material investment via the application of a factor produced in
1387 NUCA's Service Node Transport module. Once Sales Tax is applied, the Annual Charge
1388 Factor converts the investment to an annual cost, which is then divided by 12 to arrive at
1389 a monthly cost. This cost is added to a monthly average of "Collocation Expenses,"
1390 producing the total monthly aggregation cost at a site.

1391 **Q121. IS THE ACCESS NODE AGGREGATION COST SIGNIFICANT?**

1392 A121. Yes. The Access Node module's aggregation costs go into Basket B1. These costs are
1393 [**BEGIN CONFIDENTIAL *** *******
1394 *******.****END CONFIDENTIAL**] I explained earlier in my testimony why none of
1395 these costs are caused by usage and none of them belong in developing usage costs of
1396 switched access services.

1397 **Q122. EVEN IF AGGREGATION COSTS WERE, HYPOTHETICALLY,**
1398 **CONSIDERED APPROPRIATE, WHY ARE YOU CONCERNED ABOUT THE**
1399 **LACK OF DOING PROPER CAPACITY COSTING IN DEVELOPING SUCH**
1400 **COSTS?**

1401 A122. My concern about the lack of doing proper capacity cost in this module is that it is
1402 inconsistent with the Commission’s Cost of Service rules and is likely to overstate
1403 significant volume-sensitive forward-looking costs.

1404 **Q123. WHAT IS THE PROBLEM WITH THE IMPLICIT FILLS ASSOCIATED WITH**
1405 **ANYMEDIA® SHELVES?**

1406 A123. This is a twofold problem. First, McLeodUSA modeled something more akin to a
1407 TELRIC fill, which is typically designed to be much lower than a LRSIC fill, because
1408 spare capacity associated with LRSIC fills only provides support for spare capacity
1409 required for maintenance, testing or administrative purpose. Second, even within the
1410 realm of TELRIC fills, the amount of utilization inherent in the module is generally low
1411 and for many locations, extremely low, as shown in Confidential Schedule KAC-17. The
1412 lower the fill, the higher the cost. So, McLeodUSA’s investment for AnyMedia® Access
1413 System equipment is inappropriately too high.

1414 **Q124. HOW DID YOU DERIVE THE FILL FACTORS FOR THE ACCESS NODE**
1415 **AGGREGATING EQUIPMENT?**

1416 A124. It is a relatively straightforward calculation. I took the amount of “Used” DS0s for each
1417 access node in Illinois and divided it by the “Usable” DS0s or physical capacity for the
1418 same access node. This data is located on columns G and H, under the “IDLC Capacity”
1419 set of columns within the “Per Node Investment” worksheet within the Access Node
1420 module. For example, at McLeodUSA’s collocation site in [BEGIN CONFIDENTIAL
1421 *** ***** ** END
1422 CONFIDENTIAL] NUCA has [BEGIN CONFIDENTIAL ***** ** END
1423 CONFIDENTIAL] “Used” DS0s and [BEGIN CONFIDENTIAL *** ***** ** END
1424 CONFIDENTIAL] “Usable” DS0s, which yields a fill factor of [BEGIN

1425 **CONFIDENTIAL ***** END CONFIDENTIAL].** It is evident
1426 that the vast majority of the line capacity of AnyMedia[®] shelves are unused and are far
1427 beyond the spare capacity required for maintenance, testing or administrative purposes.

1428 **Q125. WHAT WOULD NEED TO BE DONE TO EMPLOY CAPACITY COSTING TO**
1429 **DEVELOP COSTS CONSISTENT WITH THE COMMISSION'S COST OF**
1430 **SERVICE RULES?**

1431 A125. The most direct approach, which follows the guidance contained in the Commission's
1432 Cost of Service rules, would be to develop the investment per usable DS0 appearance on
1433 an AnyMedia[®] shelf. Thus, the first step would be to develop an investment per DS0
1434 based on the physical capacity of a shelf. Next, the investment per usable DS0 is
1435 calculated by dividing the previous among by the appropriate LRSIC fill factor. This fill
1436 factor should be relatively close to one and is unlikely to be less than 80% for digital
1437 circuit equipment based on my experience.

1438 **Q126. HAVE YOU ESTIMATED THE IMPACT OF THIS CORRECTION?**

1439 A126. No, because I previously demonstrated that these Access Node aggregation costs are not
1440 caused by traffic and should not be included in McLeodUSA's access costs at all,
1441 regardless of the fill factor. I make this point simply to illustrate the conceptual
1442 overstatements in McLeodUSA's study that make it unreliable.

1443 **D. OUT-OF-DATE HARDWARE PRICES**

1444 **Q127. MR. STARKEY AT PAGES 40 TO 42 OF HIS DIRECT TESTIMONY ARGUES**
1445 **THAT NUCA DEVELOPS FORWARD-LOOKING COSTS, IN PART, BECAUSE**
1446 **IT USES CURRENT PRICES FOR NEW EQUIPMENT INSTEAD OF**
1447 **EMBEDDED COSTS. DOES THIS MAKE NUCA'S COSTS FORWARD**
1448 **LOOKING?**

1449 A127. No. NUCA generally uses prices that were current in 2005 when NUCA was originally
1450 created. In particular, Mr. Starkey provides a hypothetical regarding 1999 and "current"

1451 prices for AnyMedia[®] equipment. Yet the name of the file containing the actual prices
1452 for AnyMedia[®] equipment, “CONFIDENTIAL - AnyMedia Pricing 08-25-05.xls” and
1453 the last date the file was saved indicate 2005 prices and not 2010 prices. Switching
1454 equipment and fiber cable prices also appear to be from 2005.

1455 **Q128. WHAT DO YOU RECOMMEND BE DONE ABOUT THESE OUT-OF-DATE**
1456 **HARDWARE PRICES?**

1457 A128. My experience is that switching and circuit equipment prices have generally been going
1458 down for many years and declining at times by more than 20% per year.⁴² In general,
1459 there is no reason to expect this to change. On the other hand, I have no concrete
1460 experience as to the general industry trend regarding fiber cable prices. Lacking current
1461 market prices, I recommend that costs associated with Baskets B2, D1, D2, D3, E and G
1462 that are primarily based on the material prices of switching and circuit equipment be
1463 decreased by at least 10% other than leased expenses to other carriers. I have made no
1464 recommended change to Basket B2, because I have previously shown that all of the costs
1465 in this basket are driven entirely by lines and, therefore, do not belong in a LRSIC study
1466 of switched access services. However, some of the costs in Baskets B2, D1, D2 and D3
1467 and a large part of Basket E should remain as a part of switched access so that my
1468 adjustment, in part, is aimed at them.

1469 **Q129. WHAT LEASED EXPENSES ARE FOUND IN NUCA?**

1470 A129. The only place in NUCA that developed leased expenses is found in the Service Node
1471 Transport module. An examination of these expenses indicates that for all practical
1472 purposes McLeodUSA is leasing circuits only from AT&T Illinois. In addition, while

⁴² See David M. Byrne and Carol A. Corrado, “Prices for Communications Equipment: Updating and Revisiting the Record,” Federal Reserve Board, September 10, 2007.

1473 some circuits are apparently special access circuits, most circuits are purchased as UNEs.
1474 McLeodUSA's lease payments do not directly change with changes in hardware prices.
1475 Thus, it is not reasonable to adjust these expenses as part of updating the effect of lower
1476 material prices for switching and circuit equipment.

1477 **Q130. WHAT IS THE IMPACT OF UPDATING MCLEODUSA'S HARDWARE**
1478 **PRICES ON THE COSTS PER MOU ON THESE SIX RATE ELEMENTS?**

1479 A130. Column K of Confidential Schedule KAC-5 shows the consequences of updating
1480 McLeodUSA's hardware prices. Comparing Column K to Column J indicates that
1481 composite costs go down for IXC traffic because of this update. The resulting composite
1482 cost is [**BEGIN CONFIDENTIAL ***** END CONFIDENTIAL**], which
1483 reflects a percentage decrease of [**BEGIN CONFIDENTIAL ***** END**
1484 **CONFIDENTIAL**] over Column H.

1485 **E. PROBLEMS WITH DEVELOPMENT OF OPERATING EXPENSE FACTORS**

1486 **Q131. HOW DOES MCLEODUSA CALCULATE ITS OPERATING EXPENSE**
1487 **FACTORS?**

1488 A131. An examination of NUCA indicates that an operating expense factor for a plant specific
1489 asset category such as digital electronic switching equipment is the ratio of maintenance
1490 expenses for the plant specific asset category plus an assignment of maintenance
1491 expenses for plant non-specific assets that are directly attributable to the plant specific
1492 asset to the book value of the plant specific asset. NUCA makes these calculations in the
1493 Factors Module.

1494 **Q132. WHAT OPERATING EXPENSE FACTORS ARE FOUND IN NUCA?**

1495 A132. The operating expense factors are calculated in the "Operating Expense Factors" tab of
1496 NUCA and includes factors for the following categories:

- 1497 • Account 2212 (Digital Electronic Switching),
- 1498 • Account 2231 (Radio Systems),
- 1499 • Account 2232 (Circuit Equipment),
- 1500 • Account 2311 (Station Apparatus),
- 1501 • Account 2362 (Other Terminal Equipment),
- 1502 • Account 2422 (Aerial Cable), and
- 1503 • Account 2422 (Underground Cable).

1504 My understanding of NUCA is that only operating expense factors for Digital Electronic
1505 Switching, Circuit Equipment, Aerial Cable and Underground Cable were actually used
1506 in calculating NUCA's cost results for switched access services.

1507 **Q133. WHAT ARE THE PROBLEMS WITH MCLEODUSA'S DEVELOPMENT OF**
1508 **OPERATING EXPENSE FACTORS?**

1509 A133. The basic problem with McLeodUSA's operating expense factor development is the
1510 reliance on historical costs without adequate adjustments that would yield forward-
1511 looking costs. I have three specific concerns. First, NUCA used old financial data rather
1512 than current information. Second, it appears that NUCA did not remove all nonrecurring
1513 expenses in developing its operating expense factors. Third, NUCA has not made any
1514 adjustment to the book investment, which has the outcome that the resulting factor does
1515 not generate forward-looking costs.

1516 1. INAPPROPRIATE RELIANCE ON OLD FINANCIAL DATA

1517 **Q134. WHAT IS YOUR CONCERN ABOUT THE AGE OF THE INCOME**
1518 **STATEMENT DATA USED TO DEVELOP MCLEODUSA'S OPERATING**
1519 **EXPENSE FACTORS?**

1520 A134. Both the numerator and the denominator in NUCA used to calculate operating expense
1521 factors are based on averaging financial data from 2003 and 2004. Consequently, this
1522 data is more than five years old and cannot be interpreted as current. Furthermore, this
1523 financial data is sandwiched between McLeodUSA's 2002 bankruptcy and
1524 McLeodUSA's 2005 bankruptcy. From 2002 onward, McLeodUSA has undergone

1525 substantial changes. It discontinued or sold numerous operations, restated the value of its
1526 assets, and radically reduced its workforce by 47% from the end of 2003 to the end of
1527 2005. McLeodUSA’s post-bankruptcy streamlining continued as evidenced by its
1528 December 2006 sale of cable TV operations in its home town of Cedar Rapids, Iowa.⁴³
1529 More recently, McLeodUSA’s acquisition by PAETEC Holding Corp. was completed on
1530 February 8, 2008. McLeodUSA’s use of operating expense factors based on 2003 and
1531 2004 data is another reason why its “cost study” is unsupported and unreliable.

1532 **Q135. DOES THE AVERAGING OF 2003 AND 2004 FINANCIAL DATA AS FOUND IN**
1533 **NUCA REMEDY YOUR CONCERNS ABOUT USING OUT-OF-DATE**
1534 **FINANCIAL DATA?**

1535 A135. No. Under normal circumstances averaging two or three years of operating expenses is
1536 unnecessary. Yet, if there are periodic and systematic changes in operating expenses
1537 across time, averaging operating expenses over several periods might reasonably
1538 normalize operating expenses. However, if systemic changes have subsequently occurred
1539 since 2004, then averaging 2003 and 2004 financial data does not account for systemic
1540 changes occurring after 2004. As discussed above, systemic changes have occurred for
1541 McLeodUSA since 2004—namely, its 2005 bankruptcy proceeding and its acquisition by
1542 PAETEC at the beginning of 2008. Consequently, the averaging approach pursued by
1543 NUCA does not remedy the problem of using such old financial data.

1544 **Q136. HAVE YOU ESTIMATED THE IMPACT OF USING MORE CURRENT**
1545 **FINANCIAL DATA TO DEVELOP MCLEODUSA’S OPERATING EXPENSE**
1546 **FACTORS?**

⁴³ [BEGIN CONFIDENTIAL *** *****

END CONFIDENTIAL]

1547 A136. No. My understanding is that McLeodUSA does not keep its financial records following
1548 the FCC's Part 32 rules. In addition, I understand that McLeodUSA is not required to
1549 keep its financial records following these rules. Nonetheless, the plant specific operating
1550 expense factors developed in NUCA are based on accounts following Part 32 rules.
1551 Hence, NUCA undertook numerous and complex assignments to map McLeodUSA's
1552 accounts into Part 32 accounts.

1553 2. INADEQUATE DOCUMENTING THE REMOVAL OF NONRECURRING EXPENSES

1554 **Q137. SHOULD NONRECURRING EXPENSES BE INCLUDED IN THE FORWARD-**
1555 **LOOKING OPERATING EXPENSE FACTORS USED FOR DEVELOPING**
1556 **USAGE COSTS?**

1557 A137. No. Nonrecurring expenses are expenses incurred in the process of satisfying customer-
1558 specific requests for installation, removal or changes in service. Including nonrecurring
1559 expenses as part of recurring maintenance factor development would be a mismatch
1560 between recurring and nonrecurring costs. This would be a violation of the Cost
1561 Causation Principle. This potential double counting of costs, however, is easily remedied
1562 by explicitly documenting the removal of nonrecurring costs.

1563 **Q138. HAS MCLEODUSA REMOVED ALL NONRECURRING COSTS IN**
1564 **DEVELOPING ITS OPERATING EXPENSE FACTORS?**

1565 A138. Unfortunately, I do not know, because NUCA has not adequately documented any
1566 adjustment of operating expenses to remove nonrecurring expense. This is another
1567 instance in which McLeodUSA has not adequately supported its cost claims.

1568 3. MISMATCH IN NUMERATOR AND DENOMINATOR

1569 **Q139. WHAT IS YOUR CONCERN ABOUT THE MISMATCH IN COMPARING**
1570 **BOOKED EXPENSES TO BOOKED PLANT IN DEVELOPING PLANT-**
1571 **RELATED MAINTENANCE FACTORS?**

1572 A139. This concern regarding the mismatch in comparing booked expenses to booked plant in
1573 developing plant-related maintenance factors is more potentially more severe than my
1574 concern with double counting nonrecurring costs. Without adjusting booked costs for
1575 plant in service to reflect current reproduction costs, most plant maintenance factors are
1576 likely to be substantially misstated. The most common way to adjust booked values so
1577 that maintenance costs are more reasonably calculated is to use current cost to booked
1578 cost ratios (“CC/BC”). While McLeodUSA may not have any plant on its books that are
1579 twenty or thirty years old, merely saying the McLeodUSA’s plant is relatively new can
1580 be irrelevant when equipment or facilities prices have changed dramatically over a short
1581 period of time.

1582 **Q140. DO YOU RECOMMEND ANY CHANGES IN REGARDING THIS MISMATCH**
1583 **PROBLEM?**

1584 A140. Given that I do not have adequate information to propose a reasonable remedy, I make no
1585 recommendation to correct this mismatch. However, if McLeodUSA introduces any cost
1586 study in the future to this Commission that relies on a study based on the detail found in
1587 NUCA regarding the development of operating expense factors, McLeodUSA should
1588 show adequate steps are made in a new cost study that reasonably eliminates this
1589 mismatch.

1590 VII. CONCLUSION

1591 **Q141. WHAT IS THE IMPACT OF ALL YOUR QUANTIFIABLE CHANGES ON THE**
1592 **COSTS PER MOU ON THESE SIX RATE ELEMENTS?**

1593 A141. Column L of Confidential Schedule KAC-5 shows the consequences of my quantifiable
1594 recommendations. The resulting composite cost is [**BEGIN CONFIDENTIAL *****
1595 ******* END CONFIDENTIAL**], which reflects a percentage decrease of

1596 **[BEGIN CONFIDENTIAL ***** END CONFIDENTIAL]** over the costs
1597 filed by McLeodUSA. This cost is well below the composite rate caps proposed by
1598 AT&TCI here. Also, this cost shows a conservative estimate of the markup associated
1599 with McLeodUSA's current usage-rated switched access services is **[BEGIN**
1600 **CONFIDENTIAL ***** END**
1601 **CONFIDENTIAL]**.

1602 **Q142. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?**

1603 A142. Yes, it does.