

**Rebuttal Testimony of  
J. Thomas O'Brien**

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Q. Please state your name, title and business address.

A. J. Thomas O'Brien, Executive Director-Regulatory Affairs, Ameritech Illinois, 225  
W. Randolph Street, Chicago, Illinois 60606.

Q. Are you the same J. Thomas O'Brien who previously filed testimony in this  
proceeding?

A. Yes, I am.

Q. What is the purpose of your rebuttal testimony?  
A. The purpose of my rebuttal testimony is to address issues that were raised in the May  
11, 2001 direct testimony of several other parties to this proceeding. In particular, I  
will be addressing issues that have been raised relating to proposed criteria for  
determining the need a particular carrier might have for high cost funding. I will also  
address the issue of affordability and how affordable rates might be phased-in over  
time. I will comment on the proposals for assessing fund contributions and how  
contributing carriers would recover these contributions. Finally, I will demonstrate  
how the proposals of the interexchange carriers (IXCs) relative to any true-up of the  
past funding of the DEM Weighting Fund validate my position that any such true-up  
would not be in the best interest of customers and would be bad public policy.

1 Q. Several of the parties have commented in their direct testimony on the use of HAI  
2 model for determining high cost fund needs. What is your position?

3 A. I have not done an assessment of the specifics of the use of the HAI model in this  
4 proceeding, but I am generally familiar with the broad outline of the HAI model.  
5 However, besides Mr. Schoonmaker, several of the parties, including Dr. Beauvais of  
6 Verizon, Mr. Clarke of AT&T, Mr. Sands of MCI WorldCom, and Mr. Koch of Staff,  
7 have presented evidence relative to the HAI model. It is evident from reading this  
8 testimony that there are many varying opinions relative to the design of the model,  
9 the appropriate inputs, appropriateness of use of the model on an exchange or  
10 company specific basis versus on a statewide basis, and, most importantly, the  
11 validity of the results. In fact, Mr. Schoonmaker himself, in his March 23, 2001  
12 direct testimony, pages 19 - 21, points out some inherent deficiencies in the HAI  
13 model.

14  
15 Because of the many problems that appear to be inherent in the HAI model, the  
16 Commission should not use the study results presented by Mr. Schoonmaker to size  
17 the high cost fund. If such high cost funding were based on the HAI model outputs as  
18 proposed by Mr. Schoonmaker's testimony, the size of the fund would be  
19 approximately \$73 million, more than 5 times greater than the combined total of the  
20 current small company high cost fund and the DEM Weighting fund. This result  
21 alone makes it apparent that the HAI model is not a useful predictor of high cost fund  
22 needs. This would suggest that, on average, small companies would need \$525 per  
23 year (almost \$44 per month) per access line (\$60 million in additional funding

1 divided by 116,000 access lines) over and above current revenues in order to stay  
2 viable. This is obviously an unrealistic conclusion and cannot be taken seriously.

3

4 My recommendation, therefore, is that the use of the HAI model should be limited to  
5 a general acknowledgement of the Section 13-301 (d) requirement that allows for the  
6 use of a proxy cost model, rather than a company specific cost model, in order to  
7 demonstrate that, on average for all of the small companies, the forward-looking costs  
8 exceed their current revenues, exclusive of any external funding. However, the  
9 model cannot accurately predict the degree to which such costs exceed revenues, nor  
10 can it be used for any cost/revenue comparisons for any individual company.

11 Therefore, the Commission should afford no weight to the HAI model, whether for a  
12 specific company or in total, when determining the amount of any high cost funding  
13 needs.

14

15 Q. If, as you suggest, the HAI model should not be used to determine any specific  
16 funding needs, how should such a determination be made?

17 A. The Commission determined in its November 21, 2000 Order in this docket that the  
18 small companies must make a showing of financial need as one of the requirements  
19 for qualifying for funding. My understanding is that, in recognition of the limited  
20 time frame for completion of this proceeding, the IITA and Staff developed an agreed  
21 upon "short-form" methodology for the small companies to use to do a rate of return  
22 analysis upon which to establish an individual company's financial need, if any.

1 In general, Ameritech Illinois does not oppose the approach developed by Staff and  
2 the IITA to satisfy this demonstration of financial need. Further, it is more  
3 appropriate for the Staff, not another local exchange carrier such as Ameritech  
4 Illinois, to recommend to the Commission what the proper inputs are, such as cost of  
5 capital, for this analysis.

6

7 Once the Commission has determined the parameters and inputs, each small company  
8 should be required to re-file its financial analysis, if necessary, showing any shortfalls  
9 between its financial needs and current revenues.

10

11 Q. Should these revised analyses then form the basis for the amount of funding each  
12 company should receive from the high cost fund?

13 A. No. As I testified in my direct testimony, and as several others have also stated in  
14 direct testimony, prior to receiving any high cost fund support, a small company  
15 should first be required to raise its rates to an affordable level, or to impute such a rate  
16 in its calculations supporting high cost fund needs. Without such a requirement,  
17 small companies would have no incentive to place any of the burden for recovery of  
18 the higher costs on their own customers. Instead, the additional burden would be  
19 passed on in the form of increased charges to customers of those carriers providing  
20 the high cost funding.

21

22 Q. You discussed potential approaches for determining an affordable rate level in your  
23 direct testimony and indicated you would comment further upon review of the direct

1 testimony of other parties. Do you have a specific proposal relative to the affordable  
2 rate level at this time?

3 A. Yes, I do. There was general agreement among the parties filing direct testimony that  
4 the affordable rate level to be used when determining need for high cost funding  
5 should be in excess of the current rate levels for most of the small companies. While  
6 several potential methods for determining the level for an affordable rate were  
7 discussed, there was also general agreement that there should be a single affordable  
8 rate level to be applied to all small LECs, rather than company specific affordable  
9 rate levels. Among the suggestions for determining the affordable rate levels were  
10 the average rate for Verizon's exchanges, the average rates paid by customers of  
11 Verizon South and McLeod USA, the highest rate currently being charged by any of  
12 the IITA companies, and a rate that would equate to 2.4% of the income for a  
13 household earning at just above the poverty level. These suggestions resulted in  
14 affordable rate levels generally between \$20 and \$30 per month.

15  
16 Based on these analyses and the position I took in my direct testimony that the  
17 affordable rate should be greater than the rates in effect today, I would agree with  
18 Staff witness Staranczak that the affordable rate be \$24 for residence customers and  
19 \$27 per month for business customers. These rates are approximately in the mid-  
20 range of the proposals.

21

22 Q. Do you also agree with Dr. Staranczak's proposal that these affordable rates be  
23 phased in over time?

1 A. Yes, I do. However, I would make one change to the phase-in schedule proposed by  
2 Dr. Staranczak. He suggests that the phase-in be over a 5-year period with each  
3 year's increase being equal to one fifth of the difference between the rate currently in  
4 effect and the \$24 affordable rate level. I would suggest that the phase-in period be  
5 4-years, with the first increase being equal to two-fifths of the difference between the  
6 rate currently in effect and the \$24 affordable rate level, followed by an increase of  
7 one-fifth of the difference in each of the succeeding three years.

8

9 Q. Why do you propose a shorter phase-in period with a larger initial increase?

10 A. To my knowledge, most of these companies have not increased their basic local rates  
11 over the past several years, and, in fact, some of these companies have decreased  
12 rates during this period. During this same period, these companies have been  
13 receiving subsidies through the existing high cost and DEM Weighting funds, as well  
14 as implicit subsidies through access charges, long distance charges, and other  
15 services. Because customers have enjoyed the benefits of these below cost,  
16 subsidized rates without increase over this long period, it does not seem unreasonable  
17 or unduly burdensome on customers to implement a proportionately larger initial  
18 increase and to phase-in the total increase over a shorter period.

19

20 Q. There have been several suggestions relative to what form of funding basis would be  
21 most appropriate. Do you have any comments on these proposals?

22 A. Yes, I do. In my direct testimony I proposed that intrastate retail revenues form the  
23 basis for funding. It appears that most of the other parties, including Mr., Clausen of

1 Staff, Mr. Rearden of Sprint, and Dr. Beauvais of Verizon, agree that, for the type of  
2 fund being considered in this proceeding, use of intrastate retail revenues forms the  
3 most competitively neutral funding basis.

4  
5 However, Ms. Hegstrom of AT&T and Mr. Sands of MCI WorldCom recommend  
6 that the funding basis be total intrastate retail revenues minus intercarrier payments.

7 As I discussed in my testimony in Phase 1 of this proceeding last year, such an  
8 approach would not be competitively neutral and would discourage carriers from  
9 investing in their own facilities. This approach would not be competitively neutral  
10 because carriers who served end users partially or entirely through resale or use of an  
11 incumbent LEC's unbundled network elements (UNEs) would have the costs that they  
12 pay to another carrier for the resale or UNEs deducted from the total revenues upon  
13 which the assessments are made. On the other hand, a facilities-based carrier would  
14 not be allowed to deduct the cost of these identical facilities it actually uses to provide  
15 the same services to its own end user customers from its assessment. This unequal  
16 treatment would favor the carrier using wholesale inputs in providing its end user  
17 services and thus would give such a carrier a competitive advantage over a purely  
18 facilities-based ILEC or CLEC. It would also put an unequal burden on end users.  
19 That means the end user of a CLEC using UNEs or resale would pay less towards the  
20 fund than the end user of a facilities-based CLEC. The intent should be that all  
21 customers of all companies share the same high cost funding burden.

22

1 I would also concur with Mr. Clausen (Staff Ex. 4.0, pg. 7) that the “net revenue”  
2 approach to funding proposed by MCI and AT&T would be administratively  
3 burdensome and would likely cause disagreements relative to what qualifies as  
4 “deductible” inputs, thus driving up administrative costs, with no benefit to the  
5 process.

6

7 Q. Should any carriers be excluded from a funding requirement?

8 A. No carrier should be explicitly excluded. Dr. Beauvais proposes that all LECs,  
9 including those who are potentially fund recipients, be subject to fund assessments. I  
10 would agree.

11

12 I would also reiterate my statement in my direct testimony that it should be  
13 considered whether wireless carriers will be included in the intrastate high cost  
14 funding requirements. The FCC has recognized that all carriers, including wireless,  
15 should be subject to funding the interstate high cost fund. As stated by Mr. Rearden  
16 (Sprint Ex. 1.0 pg. 4), “By requiring all local and interexchange telecommunications  
17 carriers to subsidize universal service, the Illinois universal service fund is equal and  
18 nondiscriminatory.” However, to exclude wireless service would fail to recognize  
19 that wireless is a substitute for landline service for a sizable and growing number of  
20 subscribers.

21

1 Q. You stated in your direct testimony that companies should recover their funding  
2 obligations directly from end users. Would you please comment further on this  
3 proposal?

4 A. Yes, I will. As I stated in my direct testimony, in order for there to be competitive  
5 neutrality relative to high cost fund assessments, all carriers must be treated equally  
6 relative to the manner in which they are allowed to recover these assessments. To  
7 give one carrier or class of carriers options relative to recovery that are not available  
8 to all carriers would not meet the requirement of competitive neutrality. I further  
9 stated that allowing all companies to recover their funding requirements through a  
10 separate line item surcharge on the bill, explicitly identifying the purpose for the  
11 surcharge, would meet the competitively neutral standard.

12  
13 I believe that there is general agreement among all of the parties submitting testimony  
14 that an explicit end user surcharge is the most appropriate method for fund recovery.  
15 Some parties preferred a flat rate charge to all customers, others proposed a flat  
16 percentage surcharge, and others said the choice should be left to the carrier. Mr.  
17 Rearden of Sprint (Sprint Ex. 1.0, pg. 6) recommends that the surcharge should be a  
18 percentage of the retail carrier's total bill (intrastate revenues) and that all  
19 telecommunications carriers would assess the same percentage surcharge. Mr.  
20 Clausen makes a similar proposal in his testimony (Staff Ex. 4.0, pg. 9). I would  
21 concur that this is the most competitively neutral funding method. Furthermore, once  
22 the fund administrator calculated the percentage surcharge, all carriers would apply  
23 this same surcharge and simply remit the amount collected via this surcharge to the

1 fund administrator. This would eliminate the need to calculate each carrier's  
2 assessment separately and leaving it then to the carrier to determine how to spread its  
3 assessment among its own customers. Furthermore, this would preclude  
4 gamesmanship by carriers who might pass on disproportionate amounts of fund  
5 recovery to certain portions of their customer base and a lesser portion to the more  
6 competitive base of customers, for example, large businesses, thus trying to gain a  
7 competitive pricing advantage.

8

9 Q. Several of the other parties continue to advocate the DEM Weighting Fund true up.  
10 Would you respond to these proposals?

11 A. Yes, I will. I believe that the testimony provided by other parties advocating true-ups  
12 further validates the position I took in my direct testimony that it would not be in the  
13 interest of Illinois customers, if there were to be true-ups relating to the funding of the  
14 existing DEM Weighting proposal. The parties that advocate true-ups are the IXC's,  
15 which are seeking such true-ups for the sole financial benefit of their own companies,  
16 at the expense of all local service customers in the state. This is evidenced by the  
17 fact that not one of the parties advocating true-ups have offered to refund any true-ups  
18 they would receive to their end user toll customers, who have already provided 100%  
19 of the DEM Weighting funding that has been assessed to the carriers. Sprint's  
20 witness, Mr. Rearden, in fact, makes very clear that there is no intention of sharing  
21 any DEM Weighting true-up payment with customers. He says on page 13 of his  
22 testimony that "ISCECA should begin flowing credits to carriers..." (emphasis  
23 added).

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In addition, the carriers continue to allege that they have somehow been harmed by the past funding methodology. Mr. Rearden alleges that the credits should go to carriers that “overpaid into the DEM Weighting funds.” (Sprint Ex. 1.0, pg. 13) MCI WorldCom's witness, Mr. Sands, states on page 17 of his direct testimony that the Commission should direct carriers who have overpaid to receive refunds from carriers who have underpaid (again indicating payments are to the carrier, not the toll customers who have already paid the funding). No carrier has overpaid or underpaid into the DEM Weighting fund. The basis for the assessments is access minutes of use and the carriers (LECs and IXC's alike) have collected 100% the payments to date into the fund from their end users as part of the toll rates. Furthermore, the DEM Weighting fund was simply a substitute for the previous implicit subsidy contained in access charges, and when the DEM Weighting fund was established, access charges were reduced by the same amount. All carriers remained revenue neutral as a result of the shift of the subsidy flow from access charges to the DEM Weighting fund.

AT&T's witness, Ms. Hegstrom, indicates that the DEM Weighting fund was not competitively neutral because carriers who provide little or no toll service are not assessed. However, these carriers did not previously pay access charges, nor did they receive the financial benefit of the access charge reductions that accompanied the implementation of the DEM Weighting Fund.

1 Finally, the carriers are recommending that local service customers should now be  
2 assessed for the DEM Weighting Fund retroactively. Mr. Sands states on page 17 of  
3 his direct testimony that the Commission should now find that the payments  
4 previously made into those funds should have been based on regulated end user  
5 revenues. In other words, Mr. Sands would have the Commission say to local service  
6 customers, in effect, “We didn’t tell you this over 3 years ago, but we decided now  
7 that you should have been paying into the DEM Weighting Fund, so now we’re going  
8 to back bill you for those three and a half years.” Also, under the carriers' scenario,  
9 the Commission would not also add to this statement that if you used toll you will get  
10 a refund of what you paid, because the IXCs' plan, apparently, is to keep that money,  
11 not pass it along to their customers.

12  
13 The Commission should find that no true-up is necessary and it is not in the public  
14 interest to order a true-up. The Commission found in its November 21, 2000 order  
15 that the DEM Weighting Fund was an access charge replacement fund and only the  
16 carriers who benefited from access charge reductions (LECs and IXCs) paid into the  
17 DEM Weighting Fund. All carriers have been kept whole throughout the process. It  
18 is not good policy to retroactively subject customers to funding requirements they  
19 were unaware of until now. Finally, there will be no benefit to the toll users who  
20 have paid into the fund previously because no refunds are being offered by the IXCs.

21  
22 Q. Are there any funding recovery issues that you see on a going forward basis?

1 A. Yes, similar to the DEM Weighting proposals of the IXCs, there is also a potential of  
2 double recovery of going forward high cost fund assessments. It has been  
3 acknowledged that the current DEM Weighting and HCF assessments are being  
4 recovered through toll charges. Under the proposals of all of the parties, assessments  
5 for the new High Cost Fund will be based on retail revenues and will be collected as a  
6 separate charge to customers. Because the current funds are being replaced by the  
7 new fund, there will be no more funding assessments that will need to be recovered  
8 through toll charges—all of the assessments of the new fund will be recovered  
9 directly from the separate line item on each customers bill. Therefore, if carriers do  
10 not lower their toll charges by the amount they are currently being assessed for the  
11 existing DEM Weighting Fund and HCF, they will not have removed the current  
12 subsidy from their toll rates, but will be keeping the money rather than passing it  
13 along to the funds. Thus, users of toll would, in effect, be billed twice for high cost  
14 subsidies, yet the toll carriers would simply keep the portion included in the toll  
15 charges and pass along to the HCF only the amount legitimately being collected  
16 through the surcharge.

17

18 Q. Does this conclude your rebuttal testimony?

19 A. Yes, it does.