TESTIMONY OF CHARLOTTE F. TERKEURST

ON BEHALF OF CITIZENS UTILITY BOARD

AND THE ATTORNEY GENERAL OF THE STATE OF ILLINOIS

ON BEHALF OF THE PEOPLE OF THE STATE OF ILLINOIS

BEFORE THE ILLINOIS COMMERCE COMMISSION

ICC Docket No. 01-0128

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I. Introduction and Summary

Q. PLEASE STATE YOUR NAME, POSITION, AND BUSINESS ADDRESS.

A. My name is Charlotte F. TerKeurst. I am a Senior Vice President of Competitive Strategies Group, Ltd. (CSG). My business address is 70 East Lake Street, 7th Floor, Chicago, Illinois 60601.

Q. PLEASE SUMMARIZE YOUR QUALIFICATIONS AND EDUCATIONAL BACKGROUND.

A. I joined CSG in August 1997. I consult primarily on telecommunications issues related to pricing, service quality, alternative regulation, competitive entry, numbering, and universal service.

Prior to joining CSG, I was employed by the Illinois Commerce Commission (Commission) as Manager of the Telecommunications Division and earlier as Director of the Telecommunications Program in the Office of Policy and Planning. In addition to managing technical staff, I was the lead staff witness in several proceedings, including the proceeding that established alternative regulation for Ameritech Illinois and the Commission's first investigation into Ameritech Illinois' compliance with Section 271(c) of the Telecommunications Act of 1996 (the 1996 Act). After passage of the 1996 Act, I spent significant time working with Federal Communications Commission (FCC) and National Association of Regulatory Utility Commissioners representatives on federal and State efforts to implement the new requirements.

I was Manager of the Telecommunications Department at the Missouri Public Service Commission in 1991-1993. That Department addressed most aspects of telecommunications regulation in Missouri, including tariff filings, rate design, depreciation, and quality of service oversight.

From 1980 until 1991, I was employed by the California Public Utilities Commission, where I held several positions on the technical energy staff, as an advisor to a Commissioner, and as an administrative law judge. As an advisor, I dealt with both energy and telecommunications issues, including state implementation of AT&T's divestiture. As an administrative law judge, I handled telecommunications matters, including cases addressing alternative regulation and intraLATA competition for Pacific Bell Telephone Company and GTE California, and regulatory flexibility for AT&T. For five semesters, I taught a graduate course entitled "Legal and Regulatory Aspects of Telecommunications" at Golden Gate University.

I have filed testimony or appeared before commissions in the states of California, Colorado, Illinois, Indiana, Kentucky, Missouri, Ohio, Puerto Rico, Rhode Island, and Texas. I hold a Bachelor of Science degree in mathematics from the University of Mississippi and a Master of Science degree in electrical engineering from the University of Illinois at Champaign-Urbana. I have also taken engineering and economics courses at the Los Angeles and Berkeley campuses of the University of California. A detailed description of my qualifications and experience is attached to my testimony as Attachment 1.

Q. ON WHOSE BEHALF ARE YOU TESTIFYING IN THIS PROCEEDING?

A. I am presenting testimony on behalf of the Citizens Utility Board and the Attorney General of the State of Illinois on behalf of the People of the State of Illinois (CUB/AG).

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I was asked to address how merger-related costs and savings should be assessed for purposes of meeting the sharing requirements established in the Commission's orders approving the Ameritech/SBC merger,[1] and also to evaluate the Barrington-Wellesley Group, Inc. (BWG) audit from that perspective. I discuss the standards and policies that should be used for determining merger-related costs and savings and assess whether certain types of costs and savings identified by BWG meet those standards and policies. CUB/AG witness Charles R. Stroub addresses accounting procedures and standards that should be used in tracking merger-related costs and savings, and evaluates whether SBC/Ameritech and the BWG audit have complied with those accounting procedures and standards.

Q. PLEASE SUMMARIZE YOUR TESTIMONY AND RECOMMENDATIONS IN THIS PROCEEDING.

A. In order to comply with the Commission's requirements, the calculation of Ameritech Illinois' merger-related savings to be shared with ratepayers must include all reductions in Ameritech Illinois' costs and expenses. I interpret the Commission's requirements to mean that all merger-related undertakings and events that reduce costs or expenses should be included, and that all economic ramifications of those savings should be quantified and included. I make several recommendations regarding the standards that are needed in order to develop merger savings consistent with the Commission's requirements.

SBC/Ameritech has used a "bottom up" approach to identify and quantify merger-related savings based on the work of *** *** merger teams with over *** *** identified initiatives and over *** *** identified sub-initiatives, and BWG has audited SBC/Ameritech's procedures and

[1] Order, Docket 98-0555, September 23, 1999 (Merger Order); Amendatory Order on Rehearing, November 15, 1999 (Amendatory Order); and Second Amendatory Order, November 23, 1999.

results based on this approach. I make a series of recommendations regarding how this "bottom up" approach can be improved to more accurately and more thoroughly capture savings due to merger-related undertakings and events. My recommendations include the following:

- ?? All reductions in economic costs and expenses should be captured, including direct costs, indirect costs, investment-related costs, and an allocation of corporate operations costs, overhead, and other loadings. Tax effects, reductions in capital costs, and improved cash flow benefits should be included. Costs required to achieve the merger-related savings should be calculated in the same manner as the savings.

- ?? Force reductions due to labor-related savings should be calculated on a full-time-equivalent basis if the amount of force reduction cannot be determined directly.

- ?? The economic effects of changes in the timing of costs or expenses should be captured, when those timing shifts reduce Ameritech Illinois' costs or expenses for at least a period of time and the overall effect is an increase in Ameritech Illinois' profitability.

- ?? In determining the amount of merger-related savings to be shared with ratepayers each year, the costs of a merger-related undertaking or event should be amortized over ten years after that undertaking or event first produces net savings.

I make the following recommendations regarding specific merger-related undertakings or events:

- ?? Non-Executive Committee severance payments and relocation expenses, and pre-merger costs should be excluded from the calculation of net merger savings, consistent with the Commission's previous determinations.

- ?? E-mail conversion costs should be excluded, because SBC/Ameritech has not identified merger-related savings directly related to these costs.

- ?? Pension expense savings due to the timing difference of the recognition of settlement gains should be included.

- ?? Savings due to all employees who left Ameritech Illinois due to the merger should be included, regardless of whether they left before or after the date of the merger.

- ?? Pension expense savings due to the conformance of Ameritech Illinois' actuarial assumptions with those of SBC should be included.

- ?? Any merger-related savings in the cost of collecting bad debts, and the reduction in bad debt expense due to merger-related initiatives should be included.

- ?? The compensation value of stock options that became exercisable due to the merger is a transaction cost and should be excluded.

- ?? Any merger-related savings in the cost of reducing reciprocal compensation expenses, and the reduction in reciprocal compensation expenses due to the merger-related audit program should be included.

- ?? If the Global Accounts merger initiative results in savings, those savings should be included.

Q. DO YOU SUGGEST ALTERNATIVES TO SBC/AMERITECH'S "BOTTOM UP" APPROACH?

A. Yes. SBC/Ameritech's "bottom up" approach has inherent flaws, both because it relies on the ability of the merger teams to quantify accurately the costs and savings of their identified initiatives, and because it does not capture any merger-related savings opportunities outside of those initiatives. The actual performance of Ameritech Illinois provides a "top down" assessment of the extent to which its costs have declined since the merger. BWG reports that Ameritech Illinois' operating expenses declined by 14% (a $94 million decrease in quarterly operating expenses) between the first quarter of 1999 and the first quarter of 2000, which is far in excess of Ameritech Illinois' reported net merger savings of only $6.73 million for <u>all</u> of 2000.[2]

Because of the large discrepancy between the decline in Ameritech Illinois' operating expenses and the "bottom up" assessments of the merger teams, I recommend that the

[2] Order, Docket 01-0302, June 27, 2001, p. 9.

Commission adopt the standard that a "top down" measurement of merger savings will be performed as a benchmark to assess whether the "bottom up" approach captures a reasonable amount of the expense reductions that Ameritech Illinois has actually experienced. As an example, for Uniform System of Accounts (USOA) accounts showing expense reductions that may be merger-related, methods such as regression or other trending analyses should be used to assess what costs would have been absent the merger. A comparison of those costs to actual post-merger costs would then provide an assessment of the amount by which costs have been reduced due to the merger.

Finally, to the extent that the Commission orders adjustments to SBC/Ameritech's merger-related savings calculations for 1999 and 2000, I recommend that Ameritech Illinois be instructed to reflect those adjustments in a detailed filing made no later than its annual alternative regulation filing for 2002, due March 31, 2002. I also recommend that the Commission provide for the accrual of interest at the legal rate on ratepayers' share of merger-related savings from the date of the annual alternative regulation adjustment (July 1) until the sharing actually occurs through rate reductions.

Q. HAVE YOU QUANTIFIED THE EFFECT OF YOUR RECOMMENDATIONS ON THE NET MERGER-RELATED SAVINGS TO BE SHARED WITH RATEPAYERS?

A. No, I have not. Insufficient information is available at this time for me to provide a comprehensive assessment of the amount by which merger-related savings would increase as a result of my recommendations. I have provided cost and savings information, to the extent it is available, in discussions of each issue in this testimony.

II. Background

Q. PLEASE DESCRIBE YOUR UNDERSTANDING OF THE COMMISSION'S REQUIREMENTS FOR THE IDENTIFICATION AND SHARING OF MERGER SAVINGS.

A. The Commission's requirement that Ameritech Illinois share merger savings with ratepayers, contained in the Merger Order and clarified in the Amendatory Order, forms the basis for my assessment of SBC/Ameritech's savings calculations and the BWG audit. The Commission stated that the term "savings" refers to "an actual reduction in costs and expenses."[3] The Commission pointed to a dictionary definition of "save" to mean "to keep from being spent, expended or lost; avoid the loss or waste of," and "[t]o avoid waste, become economical." It also cited a law dictionary definition of "savings" to mean "economy in outlay; prevention of waste; something laid up or kept from being expended or lost," and stated that "Savings does not mean generating more revenue," rejecting the view that "savings" includes "revenue enhancements."[4]

The Commission determined that the netting of savings and costs is appropriate, stating that, "(t)o the extent that costs are incurred to produce savings and are shown to be both reasonable and directly related, we agree with the Joint Applicants that netting is appropriate."[5]

The Commission excluded merger transaction costs from the term "costs" under Section 7-204(c), as follows:[6]

> "[N]one of the merger 'transactional costs' shall constitute legitimate costs for present purposes. 'Transactional costs' shall be defined as those costs and expenses incurred in connection with the merger transaction and shall include but not be limited to fees and expenses of financial advisors and consultants and lawyers; filing fees; proxy costs; the costs of securing regulatory approval of the transaction; employee retention payments; employee change in control payments;

[3] Amendatory Order, p. 10.
[4] Merger Order, pp. 146-147.
[5] Merger Order, p. 148.
[6] Amendatory Order, p. 7.

> employee severance costs; employee relocation costs; the costs of third party auditing or technical assistance necessary to comply with the conditions imposed by the Commission in this Order; the administrative costs associated with the Consumer Education and Community Education funds; and the costs of penalties should conditions and benchmarks imposed by the Commission in this Order not be met. It is only these costs directly associated with AI's provision of service which qualify under Section 7-204(c). Hence we agree with Staff's position to allow recovery of only those costs directly associated with the utility's operation."

The Commission determined that merger costs and savings should be determined after the fact, stating as follows:

> "Given the Commission's strong preference for dealing in matters of certainty, we believe that both the savings and the costs of this transaction as well as their reasonableness, must be determined when actual data, as opposed to estimates, are available."[7]

Q. PLEASE EXPLAIN YOUR UNDERSTANDING OF THE PURPOSE AND SCOPE OF THIS PROCEEDING.

A. The Commission engaged BWG to develop and establish accounting standards to assist the Commission in identifying merger-related costs and savings, to assist the Commission in tracking and determining the amount of such costs and savings, and to audit Ameritech Illinois' revised Cost Allocation Manual (CAM). Upon completion of BWG's audit of 1999 results, the Commission opened this docket to explore the results of the audit of merger-related costs and savings and to implement savings sharing, if any. A separate audit is to be conducted of the 2000 results.

In initiating this proceeding, the Commission reiterated that no pre-merger costs, transaction costs (including employee severance and relocation costs), or costs of compliance

[7] Merger Order, p. 147.

should be netted against merger savings, and limited the scope of this proceeding to issues not previously addressed by the Commission.[8]

In Ameritech Illinois' annual alternative regulation proceeding for 2001, the Commission required the flow-through of net merger savings as reported by Ameritech Illinois for calendar year 2000. It provided that proposals by Staff and CUB/AG that would result in an increase in the net merger savings should be addressed separately, noting that the annual rate filing docket was not well-suited to address complex accounting and other merger-related savings issues. The deferred issues include the following:

?? Justification of costs identified by Ameritech Illinois as merger-related costs.

?? Whether merger costs can be netted against merger savings before they produce savings.

?? Whether costs associated with savings initiatives should be amortized over 10 years.

?? Whether data from 1999 should be included in the assessment of merger costs and savings for 2000.

I have included these issues in my assessment where they are relevant to the 1999 data and the BWG audit.

III. Standards for Determining Net Merger-related Savings

Q. PLEASE DESCRIBE YOUR APPROACH TO DEVELOPING STANDARDS FOR NET MERGER-RELATED SAVINGS TO BE SHARED WITH RATEPAYERS.

A. Before addressing the specific areas of costs and savings for which BWG suggested that Commission determinations are needed, it is helpful to take a broader perspective. Once overall

[8] Order, Docket 01-0128, February 7, 2001, pp. 2-3.

standards are established, they can provide guidance on how individual issues should be resolved.

Q. PLEASE DESCRIBE HOW NET MERGER SAVINGS SHOULD BE CALCULATED IF A "BOTTOM UP" APPROACH IS USED.

A. SBC/Ameritech should identify the full economic effects of each merger-related undertaking or event that results in cost or expense reductions. All merger-related undertakings and events that reduce costs or expenses in a way that enhances Ameritech Illinois' profitability should be included, and all economic ramifications of those items should be quantified and included. This requires measuring all of the savings and all of the costs required to produce those savings. Some savings and costs are relatively straightforward, e.g., salary savings due to personnel reductions and investment savings due to reduced capital outlays. Others are not as obvious or as easy to quantify.

The classifications BWG describes for affiliate transaction costs (V-2 and V-3)[9] are equally applicable to merger-related costs and savings:

?? Primary costs, including direct costs (salary and wages, benefits, rents, and other expenses attributable to personnel performing the work) and indirect costs (applicable loadings applied to direct costs);

?? Corporate operations costs (management, financial, and other expenses incurred for the general management and administration of the business as a whole, applied as a loading to primary costs);

?? Investment-related costs (network and general support and administration expenses such as return on net investment, miscellaneous taxes, depreciation and amortization expense, maintenance costs, network power, network administration, and testing expenses, applied as loadings to direct costs), and

[9] Cites in parentheses are to the BWG final audit report.

- ?? Overhead and other loadings (costs that are not direct or supporting, including gross receipts tax, motor vehicle, aircraft, garage work equipment, land and building, and office equipment, and a "float charge" to cover the use of working capital).

In calculating merger savings, all reductions in economic costs and expenses should be captured, including direct and indirect costs, investment-related costs, and an allocation of corporate operations costs, overhead, and other loadings. Since it may not be possible to quantify with precision the extent to which, for example, merger initiatives aimed at reducing direct costs may also lead indirectly to reductions in overhead, standard allocations used in the calculation of fully distributed costs would generally be appropriate. Costs associated with merger-related undertakings or events should be calculated in the same manner as savings. In particular, it is important that the same method of allocating corporate operations, overhead, and other loadings be used for both merger-related savings and related costs. It appears, however, that this standard has not been followed in SBC/Ameritech's calculations.

To be complete, an assessment of each merger initiative should include any resulting reductions in capital costs (both interest and return on equity), the effects of any improvements in cash flow (including any effects on working capital requirements, and including improvements due to both cost savings and reduced capital expenditures), and any tax effects. Even if it is difficult to measure some of these effects, measurement difficulties do not excuse the obligation to share the savings with ratepayers.

Recognizing that the sharing process itself may affect components such as taxes and improvements in cash flow, the sharing amount to be allocated to ratepayers should be adjusted so that shareholders and ratepayers receive equal benefits, in order to be consistent with the Commission's requirements. This is a different approach than that taken by SBC/Ameritech, which takes the position that interest expense savings due to positive cash flow effects should not be subject to <u>any</u> sharing requirement (IX-12). SBC/Ameritech's approach would result in the company retaining more than half of the merger savings.

Q. HOW SHOULD LABOR SAVINGS BE QUANTIFIED?

A. In general, I recommend that labor savings be quantified on the basis of full-time-equivalent force reductions, with the savings reflecting the full effects of such force reductions, including pension and non-wage expense reductions.

BWG reports that 17 of the 35 sub-initiatives it selected for testing are expected to produce labor-related savings, and notes that SBC uses a variety of methods for determining labor-related savings (VIII-42 through VIII-44). Of the 17 sub-initiatives producing labor savings, SBC claims that only six will result in actual force reductions. For five of the initiatives, savings are calculated based on the productive hourly wage rate (including overtime pay but excluding vacation, sick, holidays, etc., and excluding savings for trailing expenses). For four initiatives, the labor savings are based on actual wages (including overtime, apparently including vacation, sick, holidays, etc., but excluding trailing expenses).

While BWG seems to find SBC's general approach acceptable, I disagree. Any initiative that creates significant labor savings is also likely, in some way, to reduce the number of employees that would be needed otherwise. If an initiative allows an employee to fulfill job requirements more productively, that person becomes available to do something else with the "found" time. As a result, fewer employees may be needed elsewhere in the organization, or existing vacancies may not need to be filled. Even if none of the employees most directly affected by a merger-related initiative are "down-sized," it is incorrect to assume as a general matter that no force reductions will occur. There may be isolated situations in which labor needs are reduced without force reductions, for example, if a work force routinely works overtime and an initiative only reduces the amount of overtime that is needed. Absent a conclusive demonstration of such an exception, I recommend that SBC/Ameritech be required to calculate force reductions due to labor-related savings on a full-time-equivalent basis.

Q. SHOULD AN ASSESSMENT OF MERGER-RELATED SAVINGS RECOGNIZE EXPENSE SAVINGS DUE TO CHANGES IN THE TIMING OF EVENTS?

A. Yes. The economic effects of changes in the timing of costs or expenses should be captured, when those timing shifts reduce Ameritech Illinois' costs or expenses for at least a period of time and the overall effect is an increase in Ameritech Illinois' profitability. As an example, expenses for 1999 were reduced due to pension plan settlement gains recorded in 1999 due to merger-related terminations. I discuss the inclusion and quantification of such effects in more detail later in this testimony.

Q. PLEASE ADDRESS THE TREATMENT OF MERGER-RELATED INITIATIVES THAT HAVE NOT YET PRODUCED SAVINGS IN EXCESS OF COSTS.

A. In its audit report, BWG recommends that the Commission develop guidelines for reporting costs for sub-initiatives that have not produced savings in excess of costs, noting this issue "involves the question of the time period and level of detail for which the Company must demonstrate that the costs of its merger initiatives are producing savings." (I-12). The Commission deferred this issue when it was raised in Docket 01-0302 regarding Ameritech Illinois' annual alternative regulation filing for 2001.

For merger-related initiatives that SBC currently shows as having net costs, Ameritech Illinois asks that the Commission "trust" that they will eventually produce savings. However, Ameritech Illinois has already recognized that the merger savings may not be as large as initially projected. As a result, it would be risky for the Commission to approve the netting of the costs of "below water" initiatives against the savings of successful merger-related initiatives. In order to ensure that ratepayers do not inadvertently pay for initiatives that never produce net savings, I recommend that Ameritech Illinois not be allowed to net the costs for sub-initiatives until they have produced savings in excess of costs.

Q. SHOULD COSTS OF MERGER INITIATIVES BE NETTED AGAINST SAVINGS IN THE YEAR THEY ARE INCURRED OR OVER A LONGER PERIOD OF TIME?

A. Because the costs to implement merger initiatives are essentially an investment that is expected to yield returns over a period of years, I recommend that the costs be amortized against savings. Allowing Ameritech Illinois to delay sharing merger-related savings by netting all of the front-loaded costs as they are incurred would be inequitable and unfair to current ratepayers. I recommend that, in determining the amount of merger-related savings to be shared with ratepayers each year, the costs of each merger-related undertaking or event be amortized over ten years, starting with the first year after that undertaking or event first produces net savings. The ten-year amortization period is based on SBC and Ameritech's calculations during the merger proceeding that synergies would continue to increase for at least ten years, and is consistent with the Staff's recommendation in that proceeding that costs related to merger savings be amortized over ten years.[10]

[10] Merger Order, p. 143.

Q. SHOULD DATA FROM 1999 AND 2000 BE COMBINED IN THE ASSESSMENT OF MERGER COSTS AND SAVINGS?

A. Ideally, net savings should be determined each year and shared promptly with ratepayers. However, in light of the time that it has taken to develop standards for the establishment of net savings, the combination of 1999 and 2000 data in calculating the effects of standards adopted in this proceeding appears reasonable. If the Commission orders adjustments to SBC/Ameritech's prior calculations for 1999 and 2000, I recommend that the Commission instruct Ameritech Illinois to reflect those adjustments in a detailed filing made no later than March 31, 2002, submitted for review by auditors and other interested parties in conjunction with the review of the 2000 data. Ameritech Illinois should also be instructed to make its calculation of net merger savings for 2001, to be included in its alternative regulation filing due March 31, 2002, consistent with any determinations in this proceeding.

Q. HOW SHOULD THE COMMISSION HANDLE THE DELAY IN SHARING SAVINGS WITH RATEPAYERS THAT HAS RESULTED FROM THE DECISION TO WAIT UNTIL ACTUAL DATA BECAME AVAILABLE?

A. Because of the time that it is taking to evaluate the reported data and to develop standards for assessing merger-related savings, ratepayers are losing a portion of the value of those savings. I recommend that the Commission provide for the accrual of interest on ratepayers' share of merger-related savings until the sharing actually occurs through rate reductions. I recommend that interest accrue at the legal rate, beginning from the date price cap adjustments become effective each year following the annual submission of the savings data.

Q. DOES THE BWG AUDIT REPORT CONTAIN AUDIT FINDINGS THAT CALL INTO QUESTION HOW MUCH THE COMMISSION CAN DEPEND ON AMERITECH ILLINOIS' "BOTTOM UP" ANALYSIS OF NET MERGER SAVINGS?

A. Yes, it does. As examples, BWG expresses the following concerns:

?? The methodology for the calculation of merger costs and savings is inherently complex and sometimes relies upon assumptions that are not subject to verification. Confidence in the accuracy of the calculated cost and savings amounts varies considerably depending upon the sources of data elements and the use of estimates and assumptions (I-7).

?? SBC/Ameritech did not have sufficient procedures or training programs in place to ensure that merger transaction costs were not charged to merger implementation tracking codes, and as a result had to rely on an after-the-fact review of charges by SBC personnel (I-5, VII-27).

?? The stand-alone Oracle database used to accumulate and report merger costs and savings does not have adequate controls to ensure consistency and accuracy (I-11, VIII-23, VIII-44, etc.)

?? There are no readily accessible auditing tools available to test the allocation of costs between regulated and non-regulated accounts (I-3, IV-9, IV-13). Allocation factors have not been adjusted to reflect the organizational and operational changes that have occurred due to the merger (I-3, V-13).

?? BWG evaluated SBC/Ameritech's results for 35 merger team sub-initiatives, containing 41% of the planned 2000 savings (VIII-17 through VIII-19) and concluded that the effort was a work in progress with appreciable distance to go (I-7, VIII-37 through VIII-41). BWG was satisfied with only 18 of the sub-initiatives as of November 10, 2000 (VIII-38). As a result of the audit, SBC acknowledged the need to update Oracle information and make adjustments to 25 of the 35 sub-initiatives (VIII-22).

Mr. Stroub expresses other concerns with SBC/Ameritech's procedures and the BWG audit.

Q. DID BWG PERFORM A "REALITY CHECK" TO COMPARE SBC/AMERITECH'S REPORTED MERGER-RELATED SAVINGS TO AMERITECH ILLINOIS' ACTUAL PERFORMANCE?

A. Yes. Ameritech Illinois' actual operating expenses have declined by a far greater amount than has been explained by its reported merger-related savings. BWG reported that Ameritech Illinois' operating expenses were fairly constant from 1997 to 1999 but declined sharply thereafter. Exhibit ASP-9 (IX-18) indicates that Ameritech Illinois' annual operating expenses increased 1.25% (a $31 million increase in annual operating expenses) between 1997 and 1998 and that Ameritech Illinois' quarterly operating expenses then decreased by 14% (a $94 million decrease in quarterly operating expenses) between 1Q99 and 1Q00. In contrast to the $94 million decrease in Ameritech Illinois' actual quarterly operating expenses, SBC/Ameritech reported net merger-related savings for all of SBC of only *** *** for 1Q00 (Confidential IX-17), and Ameritech Illinois reported net merger-related savings of only $6.73 million for all of 2000.[11]

Despite the discrepancy between Ameritech Illinois' actual expense reductions and SBC/Ameritech's calculation of merger savings, BWG was unable to identify specific causes of merger-related savings not already reported by SBC/Ameritech, other than the pension-related expense reductions discussed elsewhere in this testimony. Because merger-related savings are small in comparison to total operating expenses, BWG noted that it is difficult to isolate merger-related savings from other expense changes. However, BWG identified a number of USOA accounts with significant variances between 1Q99 and 1Q00, and provided the company's explanation of the primary cause and BWG's own assessment of whether the variance is merger-related (Confidential IX-19 and IX-20). BWG reports that many of the decreases in operating expenses are related to decreases in personnel-related costs and decreases in parent company and ASI service billing, and that BWG believes that these decreases are primarily merger related (IX-18).

Q. IN LIGHT OF THESE CONCERNS, DO YOU HAVE ANY FURTHER RECOMMENDATIONS REGARDING RELIANCE ON SBC/AMERITECH'S "BOTTOM UP" APPROACH?

A. Yes, I do. As noted by BWG and discussed further by Mr. Stroub, SBC/Ameritech's "bottom up" approach has inherent flaws, both because it relies on the ability of the merger teams to quantify accurately the costs and savings of their identified initiatives, and because it does not capture any merger-related savings opportunities outside of those initiatives. These concerns point to the likelihood that a "bottom up" analysis may never yield reliable results, even if adjusted for standards that may be adopted in this proceeding.

Because of this concern, I recommend that the Commission utilize a "top down" measurement to ensure that adopted changes to the "bottom up" approach capture a reasonable amount of the expense reductions that Ameritech Illinois has actually experienced. The Commission should establish this general principle at this time, with instructions to Ameritech Illinois and/or Commission-selected auditors to utilize a "top down" approach as a benchmark against which to compare the "bottom up" results. As an example, for USOA accounts showing expense reductions that may be merger-related, methods such as regression or other trending analyses should be used to assess what costs would have been absent the merger. Comparing this result to actual costs would provide an assessment of the amount by which expenses have

[11] Order, Docket 01-0302, June 27, 2001, p. 9.

been reduced due to the merger. If discrepancies exist between the "bottom up" and "top down" approaches, the Commission could then utilize whichever approach it deems to be more reliable. As an alternative, pre-merger savings estimates could be relied upon by the Commission as a substitute for or to check the "bottom up" result if the Commission finds them to be a more most reliable quantification of the savings due to a particular undertaking or event.

Q. IN YOUR OPINION, WOULD A "TOP DOWN" ANALYSIS OR RELIANCE ON PRE-MERGER ESTIMATES BE CONSISTENT WITH THE COMMISSION'S DIRECTIVES IN ITS MERGER ORDERS REGARDING SHARING OF MERGER-RELATED SAVINGS?

A. Yes. The Commission did not specify whether a "bottom up" or a "top down" approach would be used to quantify merger savings. Further, while stating that net savings would be determined after actual data are available, the Commission did not rule out the option of relying on pre-merger forecasts after a review of the actual data, if the forecasts are more certain or more reliable than the reported "actual" data. The Commission only declined to adopt a forecasted approach before actual data were available for review. Now that the actual data has been reviewed and found lacking, the Commission should rely on whatever approach provides the most credible assessment of net merger-related savings.

IV. Identified Areas of Potential Net Merger-related Savings

A. Non-Executive Committee Severance Payments and Relocation Costs

Q. PLEASE DESCRIBE THE ISSUE RAISED BY BWG REGARDING NON-EXECUTIVE COMMITTEE SEVERANCE PAYMENTS AND RELOCATION COSTS.

A. BWG reports that SBC/Ameritech treated non-Executive Committee severance payments and relocation costs as merger-related costs and netted these costs against savings (VII-11 through VII-20, VII-28-29). BWG notes that this may be inconsistent with the Merger Order. BWG questions $651,000 in 1999 severance costs and $19,000 in relocation costs allocated to Ameritech Illinois and reports that the effect in 2000 will be over ten times the 1999 effect.

Q. SHOULD AMERITECH ILLINOIS BE ALLOWED TO NET NON-EXECUTIVE COMMITTEE SEVERANCE PAYMENTS AND RELOCATION COSTS AGAINST SAVING?

A. No. The Amendatory Order expressly identified severance payments and relocation costs as transaction costs and determined that they should be excluded in assessing net merger-related savings to be shared with ratepayers. Further, in its Order initiating this proceeding, the Commission reiterated its earlier ruling and excluded consideration of severance payments and relocation costs from this proceeding.

B. Pre-merger Costs

Q. PLEASE DESCRIBE THE ISSUE RAISED BY BWG REGARDING PRE-MERGER COSTS.

A. BWG questions the netting of about $25,000 of pre-merger costs against Ameritech Illinois' 1999 merger-related savings (VII-31). BWG notes that the Merger Order explicitly authorized Ameritech Illinois to track costs and savings beginning on the date the merger is consummated (VII-31).

Q. SHOULD AMERITECH ILLINOIS BE ALLOWED TO NET PRE-MERGER COSTS AGAINST MERGER SAVINGS?

A. No. The Merger Order expressly allowed Ameritech Illinois to track only costs incurred after the merger. Further, in its Order initiating this proceeding, the Commission reiterated its earlier ruling and excluded the consideration of pre-merger costs from this proceeding.

C. E-mail Conversion Costs

Q. PLEASE DESCRIBE THE ISSUE RAISED BY BWG REGARDING E-MAIL CONVERSION COSTS.

A. BWG reports that SBC/Ameritech netted the costs of conversion to a common SBC/Ameritech e-mail system against merger savings, with $528,000 of those costs allocated to Ameritech Illinois. BWG notes that inclusion of e-mail conversion costs is not clearly supported by the Commission orders since SBC has identified no savings directly related to these costs and the Merger Order requires allowable costs to be directly related to savings (I-5, VII-24, VII-31, VII-32).

Q. SHOULD AMERITECH ILLINOIS BE ALLOWED TO NET E-MAIL CONVERSION COSTS AGAINST MERGER-RELATED COST SAVINGS?

A. No. Since SBC has identified no savings directly related to the e-mail conversion, the related costs do not meet the Commission's standard that allowable costs must be directly related to savings. As a result, the company should not be allowed to net e-mail conversion costs against merger-related savings.

D. Pension-related Expense Reductions Due to Settlement Gains

Q. PLEASE DESCRIBE THE ISSUE THAT BWG RAISES REGARDING PENSION-RELATED EXPENSE REDUCTIONS DUE TO SETTLEMENT GAINS.

A. BWG describes that SBC recorded a $119.9 million credit to pension expense in 1999 for settlement gains resulting from lump-sum payments made to employees whose employment was terminated that year. BWG reports that at least $6.8 million (total company) of the credit arose due to merger-related terminations, and recommends that the Commission determine whether the pension plan settlement gains are merger-related and that the Commission develop appropriate guidelines and reporting requirements. SBC asserts that merger-related activity did not create the settlement gains but merely accelerated recognition of the gains (IX-8), and opposes inclusion of any portion of the gains in a merger-related savings calculation.

These pension settlement gains reflect pension gains (increases in the value of the pension funds) that occurred in previous periods but had been deferred in accordance with FAS 87 accounting requirements. BWG explains that FAS 88 requires immediate recognition of the deferred gains when a pension obligation is settled and that a settlement gain reduces the annual expense for the fiscal year in which the settlement occurred (IX-6-9, IX-14-16).

Q. SHOULD EFFECTS OF THE PENSION PLAN SETTLEMENT GAINS BE INCLUDED IN MERGER-RELATED NET SAVINGS?

A. Yes. While the gains themselves may not be due to the merger, the *timing* of their recognition for accounting purposes is certainly due to the merger. As BWG explains, recognition of the settlement gains reduces current-year expenses. As a result, this expense savings should be recognized as a merger-related savings to be shared with ratepayers.

The fact that settlement gains have been recognized now may cause Ameritech Illinois' pension expenses to be higher in future years than they would have been in those years if the merger had not occurred. This is because, if the merger had not occurred and if the (now-terminated) employees had stayed with Ameritech Illinois and took lump-sum payments when they eventually retired, settlement gains may have occurred at that time, thus reducing Ameritech Illinois' expenses at that future date. In calculating the savings to Ameritech Illinois due to the current recognition of settlement gains, it may be reasonable to reflect that, if the merger had not taken place, some expense reductions may have occurred eventually anyway. While this effect is somewhat speculative, it could be captured in the savings calculation, for example, by amortizing, over a reasonable period, the present value of the likely year-by-year differences in pension expenses with and without the merger. However, absent a convincing showing that such an approach would yield reliable results, I recommend that only the known reductions in Ameritech Illinois' expenses due to the merger-related recognition of settlement gains be reflected in the savings calculation.

E. Savings Due to Other Employees Who Left Due to the Merger

Q. DID SBC/AMERITECH REPORT ANY MERGER-RELATED SAVINGS DUE TO EMPLOYEES WHO LEFT EMPLOYMENT IN 1999 IN ANTICIPATION OF THE MERGER?

A. No. SBC's position is that no terminations prior to the merger are considered merger-related (IX-15). SBC has stated that approximately two-thirds of the employees leaving SBC in 1999 did so prior to the merger. While the audit report did not report the total number of terminations during 1999, it did state that 5,604 employees who left the company took lump sum pension payments in 1999, and that this number of lump sum payments was 4.6 times the average during the prior three years. SBC considers 363 terminations during 1999 to be merger-related (IX-15).

Q. HOW DID SBC/AMERITECH DETERMINE WHICH POST-MERGER TERMINATIONS WERE MERGER-RELATED?

A. The audit report does not specify how SBC/Ameritech made this determination. Because of the large number of lump sum payments in 1999, I recommend that SWB/Ameritech be required to justify its assertion that only 363 terminations in 1999 were due to the merger.

Q. SHOULD MERGER-RELATED SAVINGS BE ASSESSED FOR EMPLOYEES WHO CEASED EMPLOYMENT DUE TO THE MERGER, EVEN IF THEY LEFT BEFORE THE MERGER WAS CONSUMMATED?

A. Yes. For employees who ceased employment due to the merger—whether before or after the date of the merger--the resulting savings are merger-related and should be shared with ratepayers. BWG recommends that the Commission determine through a subsequent audit the number of employees who left the company in 1999 in anticipation of the merger, suggesting review of exit interviews or other information in personnel files (IX-15). I agree that such an effort should be pursued, since it could yield important information regarding the reasons for employees leaving the company. However the audit should cover the entire year, not just the period before the merger. This would provide a larger and more complete analysis of employee terminations.

BWG recommends that merger-related pension plan settlement gains be recomputed to include gains associated with employees who left in anticipation of the merger (IX-22, labeled as X-22). However, recognition of only the effect on settlement gains would understate the savings due to those employees leaving the company. The full savings of all employees leaving the company due to the merger should be shared with ratepayers, not just the savings due to settlement gains.

F. Pension-related Expense Reductions Due to Conformance of Actuarial Assumptions

Q. PLEASE DESCRIBE THIS ISSUE RAISED BY BWG.

A. BWG notes that Ameritech amended its pension plans to conform certain actuarial assumptions with those of SBC. BWG reported that Ameritech's pension expense for 1999 was reduced due to the changes in actuarial assumptions. BWG identifies a need for the Commission to determine whether expense reductions attributable to changes in actuarial assumptions to conform SBC and Ameritech pension plans are merger-related and for the Commission to develop appropriate guidelines and reporting requirements. (I-8-9; IX-4, IX-16-17, IX-21 labeled as X-21).

Q. PLEASE COMMENT ON WHETHER THE EFFECTS OF THIS CONFORMANCE SHOULD BE CONSIDERED A MERGER SAVINGS.

A. The changes in Ameritech's actuarial assumptions that were made in order to conform them with SBC's actuarial assumptions are clearly merger-related. Like the settlement gains discussed above, these changes affect Ameritech Illinois' expenses and increase Ameritech Illinois' profitability. The timing of the actuarial changes was merger-related and, as a result, the ensuing expense reductions should be shared with ratepayers. There is no evidence that Ameritech would have changed its actuarial assumptions or that it would have made the changes at the time it did, in the absence of the merger. Even if Ameritech Illinois were to establish that it would have changed its actuarial assumptions eventually, the savings precipitated by the merger should still be subject to sharing.

G. Bad Debts Expense

Q. PLEASE DESCRIBE THE ISSUE THAT BWG HAS IDENTIFIED REGARDING BAD DEBTS EXPENSE.

A. BWG reports that SBC/Ameritech excludes the results of the merger sub-initiative to reduce bad debts expenses on the basis that a reduction in bad debt is a revenue enhancement. BWG recommends that the Commission review the company's position (VIII-41).

Q. WHAT IS YOUR ASSESSMENT OF THIS ISSUE?

A. A merger-related reduction in the cost of collecting bad debts would be a cost savings that, per Commission directive, should be shared with ratepayers. Additionally, I disagree with SBC/Ameritech's treatment of bad debt reduction as a revenue enhancement. A reduction in bad debts would not enhance revenues beyond what customers already owe. For Illinois regulatory ratemaking purposes, bad debts (uncollectibles) are treated as an operating expense,[12] and they should be treated as an operating expense in assessing savings.

Further, while the USOA may classify uncollectibles as a contra-revenue account, the incumbent local exchange carriers apparently take a different view. In recent comments to the Federal Communications Commission (FCC) regarding proposed changes to the USOA, the

[12] See, Order, Dockets 92-0448/93-0239 Consolidated, October 11, 1994, Appendix B, Schedule 2.

United States Telecom Association (USTA, of which SBC is a member) recommends that the USOA be modified to classify uncollectibles as an expense account:[13]

> The consolidated [uncollectible] accounts 5301 and 5302 should be given an expense rather than a contra-revenue classification. This recommendation will bring the accounting classification in line with generally accepted accounting principles (GAAP). The [FCC's] Public Notice [asking for comments] proposes that incumbent LECs record uncollectibles in account 5301, which is a contra-revenue account, instead of recognizing under GAAP that it is a debit to an operating expense account. The Public Notice will require incumbent LECs to continue to make an adjusting entry to correctly reflect uncollectibles for external reporting.

In an attachment to its FCC comments, USTA explains its position that the current USOA accounts for uncollectibles (5300, 5301, and 5302) should be eliminated and that uncollectibles should be included in USOA account 6720, Other General and Administrative Expenses.[14]

In its comments filed concurrently in the FCC's proceeding (Exhibit 1.3 to this testimony), SBC states that, "SBC generally supports the comments of the United States Telecom Association (USTA) filed in this phase of the proceeding,"[15] although SBC did not explicitly address the USOA treatment of uncollectibles in its comments.

Consistent with long-standing Illinois ratemaking practices and the position that USTA and SBC are currently taking before the FCC, I recommend that uncollectibles be treated as an operating expense for purposes of calculating merger-related savings, and that any reduction in the amount of uncollectibles due to merger-related initiatives be shared with ratepayers.

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[13] Comments of the United States Telecom Association, CC Docket No. 00-199, July 16, 2001, pp. 2-3. USTA's comments, without attachments, are included as Exhibit 1.2 to this testimony. The attachments can be accessed via the Electronic Comment Filing System on the FCC's website, http://www.fcc.gov.
[14] Id., Attachment 1, p. 10.
[15] Comments of SBC Communications Inc., CC Docket No. 00-199, July 16, 2001, p. 2.

H. Stock Options

Q. PLEASE DESCRIBE THE ISSUE REGARDING STOCK OPTIONS IDENTIFIED BY BWG.

A. BWG reports that, as a result of Change in Control Agreements, approximately 19 million optioned shares of Ameritech stock became immediately exercisable at the date of the merger (I-5-6, VII-20-21, VII-38-39). SBC claimed a merger savings offset for Illinois based on its assessment that the stock options were worth $419 million (VII-20). BWG recommends that the Commission review this sub-initiative because of SBC's treatment of the value of the granted stock options as a merger savings offset (VIII-41).

Q. PLEASE COMMENT ON THIS ISSUE.

A. The Commission has determined that "employee change in control payments" are to be treated as transaction costs and excluded from the net savings calculation. Both severance payments and the early ability to exercise stock options occurred due to provisions in Change in Control Agreements that were triggered as a result of the merger (VII-14-21). Just as for severance payments, the costs to Ameritech Illinois due to the early vesting of stock options were incurred in connection with the merger transaction. As a result, they are properly considered to fall within the Commission's definition of transaction costs to be excluded from an assessment of net merger savings to be shared with ratepayers.

In addition, the compensation expense due to the stock options does not appear to be a cost that would qualify to offset merger-related savings, even if it were not a transaction cost. The audit report does not specify that the stock options were vested in order to produce savings in excess of the value of the stock options, as required by the Commission in order to offset savings.

I. Reciprocal Compensation

Q. PLEASE DESCRIBE THE ISSUE REGARDING RECIPROCAL COMPENSATION RAISED BY BWG.

A. BWG recommends that the Commission review the sub-initiative regarding reciprocal compensation. From the description in the audit report, this sub-initiative is an audit program that results in lower payments to competitive local exchange carriers (CLECs). SBC/Ameritech proposes that no merger-related savings be allocated to Illinois on the basis that the sub-initiative corrects an error and is an enforcement action relating to existing interconnection agreements approved by the Commission (VIII-41).

Q. PLEASE COMMENT ON THE PROPER TREATMENT OF THE RECIPROCAL COMPENSATION AUDIT PROGRAM.

A. Reciprocal compensation payments made to CLECs are an expense that Ameritech Illinois incurs in the normal course of its operations. They are similar to other expenses that may be incurred pursuant to contracts, e.g., equipment or building maintenance contracts. The fact that interconnection agreements are approved by the Commission is irrelevant to an assessment of whether a reduction in this expense is a merger-related savings to be shared with ratepayers.

If audits (or other efforts) to reduce reciprocal compensation payments that would have been undertaken absent the merger are performed more efficiently as a result of the merger, the merger-related reduction in audit costs would be a merger-related savings to be shared with ratepayers. The audit report does not address such potential efficiency gains for reciprocal compensation.

Additionally, if reciprocal compensation payments are reduced due to audits (or other efforts) undertaken as a result of the merger, the resulting savings in reciprocal compensation expenses also fit the definition of merger savings established by the Commission as "an actual reduction in costs and expenses." As a result, if the reciprocal compensation expense reduction exceeds the audit costs, the net savings should be shared with ratepayers.

J. Global Accounts

Q. PLEASE DESCRIBE THE GLOBAL ACCOUNTS MERGER INTEGRATION TEAM.

A. BWG reports that SBC/Ameritech considers the Global Accounts merger team, among others, to be outside the scope of the audit and not subject to the sharing of merger-related savings with ratepayers (IX-12). BWG stated that this team, while within the regulated Ameritech Illinois enterprise, developed no merger savings initiatives and does not require further review (IX-13).

Q. DO YOU AGREE WITH SBC/AMERITECH'S ASSESSMENT?

A. No. While SBC reported no savings in 1999 due to this merger initiative, that may not always be the case. The confidential Exhibit ASP-5 describes that this merger initiative *** *** (Confidential IX-14). Although SBC/Ameritech stated in response to BWG document request No. DPV-13 that the Global Accounts merger team *** ***, I agree with BWG that the Global Accounts merger team addresses regulated activities, based on the description in Exhibit ASP-5. While SBC/Ameritech did not report cost savings at this time due to this initiative, if net cost savings do develop after 1999, they should be shared with Illinois ratepayers.

Q. DOES THIS COMPLETE YOUR PREPARED DIRECT TESTIMONY IN THIS PROCEEDING?

A. Yes, it does.