

Before the

**STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION**

SBC COMMUNICATIONS INC.,
SBC DELAWARE INC.,
AMERITECH CORPORATION,
ILLINOIS BELL TELEPHONE COMPANY
d/b/a AMERITECH ILLINOIS, and
AMERITECH ILLINOIS METRO, INC.

Joint Application for approval of the reorganization of Illinois Bell Telephone Company d/b/a Ameritech Illinois, and the reorganization of Ameritech Illinois Metro, Inc. in accordance with Section 7-204 of The Public Utilities Act and for all other appropriate relief.

Docket 98-0555

Direct Testimony on Re-Opening

of

LEE L. SELWYN

on behalf of the

Government and Consumer Intervenors (GCI):

Citizens Utility Board
Cook County State's Attorney
Attorney General of the State of Illinois

July 6, 1999

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If adopted by the FCC, the FCC Staff's proposed merger conditions, while perhaps a limited step in the right direction, may not satisfy the specific requirements of Section 7-204(b) and (c), and may provide the new SBC/Ameritech with the incentive and capability to engage in cross-subsidization of its out-of-region plans. 36

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DIRECT TESTIMONY ON RE-OPENING

Introduction

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

A. My name is Lee L. Selwyn. I am President of Economics and Technology, Inc., One Washington Mall, Boston, Massachusetts 02108.

Q. Dr. Selwyn, have you previously submitted testimony in this proceeding?

A. Yes. I submitted direct and rebuttal testimony in this proceeding on October 28, and December 18, 1998, respectively, on behalf of the Government and Consumer Intervenors (GCI), consisting of the Citizens Utility Board, the Cook County State’s Attorney, and the Attorney General of the State of Illinois.

Q. On whose behalf is this additional testimony being submitted?

A. This testimony is offered on behalf of these same intervenors.

Summary of testimony

Q. Dr. Selwyn, have you reviewed the Applicants' direct testimony on re-opening that was filed on June 16, 1999?

1 A. I reviewed the direct testimony on re-opening of SBC witness Mr. James Kahan and
2 Ameritech witness Mr. David Gebhardt, as these witnesses responded to questions posed
3 by the Commission¹ that are directly related to issues about which I have previously
4 testified in this proceeding.² I also reviewed SBC and Ameritech responses to data
5 requests relating to the reopening that had been filed as of this date.

6
7 Q. Please summarize the principal issues that are being addressed in your testimony at this
8 time.

9
10 A. My testimony will address issues raised by Mr. Kahan relative to the impact that this
11 merger and the creation of the affiliates designated to implement the Applicants' so-
12 called National-Local Strategy will have upon the prices charged by Ameritech Illinois
13 for the services it furnishes to Illinois consumers and businesses, as well as the correct
14 amount of merger-related savings that should be flowed to Illinois consumers as required
15 by Section 7-204(c) of the Illinois PUA, an issue that is addressed by Mr. Gebhardt.

16
17 Additionally, in the course of analyzing merger savings calculations associated with
18 Ameritech Indiana,³ I discovered that the Applicants had erred in their calculation of the

19 1. See Attachment A to Chairman Richard Mathias' letter of June 4, 1999 to Hearing
20 Examiners Mark Goldstein and Eve Moran.

21 2. See GCI Exhibit 1.0, filed on October 28, 1998 ("Selwyn Direct"), and GCI Exhibit 1.1,
22 filed on December 18, 1998 ("Selwyn Rebuttal").

23 3. I jointly filed direct testimony with Susan M. Baldwin, Senior Vice President of ETI, on
24 behalf of the Indiana Office of Utility Consumer Counselor in IURC Cause No. 41255, *In the*
25 *Matter of the Investigation on the Commission's Own Motion into All Matters Relating to the*
26 *Merger of Ameritech Corporation and SBC Communications, Inc.*

1 total merger benefits attributable to the consumers of Ameritech Indiana, specifically with
2 respect to the manner in which certain allocation factors were applied.⁴ This led me to
3 review the calculation of the “composite” allocation factor that I had used in deriving the
4 § 7-204(c) allocation.⁵ In doing so, and upon reviewing Mr. Gebhardt’s direct testimony
5 on re-opening, I discovered that I had made an error in my development of the
6 “composite” factor, which had the result of *understating* the amount of merger savings
7 allocable to Ameritech Illinois intrastate regulated services. In this testimony, I describe
8 the necessary adjustment to my previous calculations, and also discuss briefly some

9 4. Though Ameritech’s *method* for calculating the Ameritech Indiana portion of merger
10 savings is virtually identical to that used in Illinois, its *application* of the “Telco”, “Indiana”,
11 “Intrastate” and “Regulated” factors is different. For example, the flowchart appearing as
12 Schedule 1 of Mr. Gebhardt’s Direct testimony on re-opening in Illinois shows how the
13 savings attributed to Ameritech Corporate, after first being divided into four categories of
14 expense savings (Telco, Administrative, Support and Procurement), are apportioned to Illinois
15 intrastate regulated services through the application of four distinct factors (Telco, Illinois,
16 Intrastate and Regulated). Mr. Gebhardt’s calculations can be verified by beginning with the
17 total savings attributed to a particular category, and multiplying that amount by each of the
18 corresponding factors. A similar flowchart is included as Attachment 19 to the Direct testi-
19 mony of Mr. Kahan in the Indiana proceeding. The significant difference in Mr. Kahan’s
20 Indiana chart, however, is that by applying the appropriate four factors to the total expense
21 savings in the “Administrative” and “Procurement” categories, one *does not* arrive at the
22 subtotal reported by Mr. Kahan at the bottom of the chart. With respect to the “Administra-
23 tive” category in particular, rather than applying the “Telco” and “Indiana” factors of 72.8%
24 and 7.8%, respectively, multiplicatively, Mr. Kahan appears to have instead applied a factor
25 of 10.7%, which appears to be the result of *dividing* 7.8% by 72.8%. Interestingly, this
26 10.7% factor happens to be exactly the same as Ameritech Indiana’s share of the five
27 Ameritech BOC total switched access lines. See IURC Cause 41255, Direct Testimony of
28 James S. Kahan (SBC), at 82-90 and Attachment 19; Direct Testimony of Cheryl Wooley
29 (Ameritech), at 9-10 and Attachment CKW-1; 1998 Preliminary Statistics of Common
30 Carriers, Table 2.10. Not only did these inconsistencies cause me to reconsider my own
31 calculations, they bring into question the use of Mr. Gebhardt’s “Illinois” factor, which I
32 discuss at length at footnote 20, *infra*.

33 5. Selwyn (GCI), Direct at 84-85.

1 alternative methods that the Commission might consider for flowing a portion of the
2 merger savings to Ameritech-Illinois consumers in accordance with § 7-204(c).

3
4 Finally, on June 29, 1999, the FCC Staff released a general summary of proposed “condi-
5 tions” that, if accepted by the Applicants, could pave the way for FCC approval of the
6 proposed SBC-Ameritech merger. While many of the details relating to these “condi-
7 tions” were still not available at the time that this testimony was being prepared, I offer
8 some preliminary comments and reactions to the proposed list. In general, while the
9 FCC’s “conditions” appear to address at least some specific concerns, they do not by
10 themselves appear to be sufficient to satisfy all of the explicit requirements of § 7-204(b)
11 and (c).

1 ALLOCATION OF MERGER SAVINGS PURSUANT TO ILLINOIS PUA § 7-204(c)

2
3 **The Applicants' responses to the Commission's questions offer no new or expanded**
4 **proposal regarding the calculation of the Section 7-204(c) allocation, such that the**
5 **Applicants' conditional offer of \$31-million to Illinois ratepayers does not even come**
6 **close to satisfying the statutory requirement.**
7

8 Q. Have the Applicants amended their previous calculation of the Illinois allocation of
9 merger savings that is required to be flowed through to Ameritech Illinois ratepayers
10 pursuant to Section 7-204(c) of the Illinois Public Utilities Act?
11

12 A. No, they have not. According to the direct testimony on re-opening by witnesses Kahan
13 (SBC) and Gebhardt (Ameritech), the Applicants stand by their previous calculation of
14 \$31-million in Illinois regulated intrastate net merger expense savings,⁶ while at the same
15 time continuing to maintain that Section 7-204(c) does not apply to the subject
16 transaction.⁷
17

18 Q. Have the Applicants provided the ICC with the savings calculation as requested in the
19 Commission's Question (8) in its June 4 list of issues?
20

21 A. No. The Commission had requested "a total and complete breakdown detailing the Joint
22 Applicants' estimate of the costs and savings associated with this merger," and then
23 proceeded to itemize the specific points of clarification it requested with respect to the

24 6. Kahan (SBC), Direct on re-opening at Attachment 3 (proprietary); Gebhardt
25 (Ameritech), Direct on re-opening at 13.

26 7. Gebhardt (Ameritech), Direct on re-opening at 14.

1 calculation of merger savings and costs, and the apportionment of those savings and costs
2 among SBC, Ameritech Corporation, and Ameritech Illinois.⁸ The simple fact that this
3 question was even posed by the Commission underscores the fact that the prior testimony
4 supplied by the Applicants was lacking in sufficient detail on the method for assigning
5 savings and costs to the various post-merger entities. That notwithstanding, neither Mr.
6 Kahan nor Mr. Gebhardt have supplied additional details or new supporting workpapers
7 to assist in clarifying this issue; rather, these witnesses have simply reiterated the
8 discussion contained in their direct testimony. They even failed to respond to clarifying
9 data requests from the ICC Staff by announcing “SBC reiterates that it has not evaluated
10 merger savings on a state-specific basis for any state.”⁹ Such action amounts to ignoring
11 the Commission’s specific requests for information that has led to this re-opening.

12
13 Q. In your opinion, are the Applicants capable of developing a projection of merger savings
14 that would be responsive to the Commission’s request?

15
16 A. Yes. Clearly the two companies were able to develop detailed savings projections that
17 they themselves considered to be sufficiently credible to support a transaction in which
18 SBC was to pay Ameritech shareholders more than \$15-billion over the pre-announce-
19 ment market value of Ameritech stock to acquire the company. The “present value”
20 method of determining merger savings, which I had employed in my direct testimony and
21 which I discuss below, relies specifically upon these same savings projections. There can

22 8. See Question (8) in Attachment A to Chairman Richard Mathias’ letter of June 4, 1999
23 to Hearing Examiners Mark Goldstein and Eve Moran.

24 9. SBC’s response to Staff R JRM 2.01.

1 be little question but that the data and methodology that both of the Applicants
2 themselves relied upon in negotiating and structuring their \$62-billion deal¹⁰ should be
3 more than adequate for purposes of supporting the § 7-204(c) allocation. More to the
4 point, projections that are used to support an arm's length business transaction between
5 two highly sophisticated and knowledgeable corporations certainly deserve substantially
6 more weight than the highly truncated and inadequately documented calculation that has
7 been offered by Mr. Gebhardt for the *sole purpose* of minimizing the Applicants'
8 financial exposure under the Illinois statute. In short, the savings projections that are
9 good enough to satisfy the needs of the Applicants' respective shareholders must certainly
10 be more than sufficient to satisfy the needs of, and be acceptable to, this Commission in
11 determining the portion of merger savings to be allocated to Illinois consumers.

12
13 Q. Do you agree with the Applicants' recommendations regarding the applicability of
14 Section 7-204(c), and the manner in which the amount of savings under Section 7-204(c)
15 should be calculated?

16
17 A. No, I do not. I have already discussed, both in my direct and rebuttal testimony, the
18 applicability of Section 7-204(c) and the utter vacancy of the Applicants' efforts to
19 dissociate themselves from this unambiguous statutory obligation, and so will not reiterate
20 it here. With respect to the Applicants' calculation of merger savings allocable to
21 Ameritech Illinois ratepayers, the Applicants have inappropriately truncated their analysis
22 in several material respects. First, they only consider net expense and capital savings

23 10. See Selwyn (GCI), Direct at 9.

1 over the initial three-year time frame, when in fact their own financial advisers have
2 based their respective valuations of the transaction and fairness opinions upon the
3 continuation of such savings for a protracted and indefinite period of time.¹¹ Second,
4 they have failed entirely to recognize the net decrease in the unit cost of providing
5 regulated Ameritech Illinois services that will result from the projected expansion of
6 output of *competitive and nonregulated services*. The elimination of all savings projected
7 to be realized beyond the end of the third year following the effective date of the merger,
8 and the failure to recognize the efficiency gains attributable to expanded output,
9 individually and collectively result in a gross understatement of the actual merger savings
10 that will inure to Ameritech Illinois:

- 11
- 12 • The Applicants' calculation only considers savings in the initial three years following
13 approval of the proposed merger. At that time, the Applicants suggest that all of
14 Ameritech Illinois' services will be deregulated, and that no explicit flow-through
15 will be required. Given the lack of effective local competition in the Illinois market
16 today, it is extremely unlikely that competition sufficient to justify such deregulation
17 will have developed in so short a period, if indeed it ever develops at all.
- 18
- 19 • The Applicants' savings calculation is limited entirely to expense and capital savings,
20 and gives no consideration to other significant synergy benefits, such as the increased
21 productivity of Ameritech Illinois' network, or to the allocation of certain Ameritech

22 11. Amended Joint Proxy Statement, September 21, 1998, at 35.

1 Illinois costs to competitive and nonregulated services, including services to be
2 furnished by other SBC affiliates.

- 3
- 4 • Although the Applicants would confine their projection of merger savings to only the
5 initial three years, they have nonetheless included all merger implementation costs as
6 an offset against such initial years' savings, despite the fact that those
7 implementation expenditures will continue to produce returns in the form of *ongoing*
8 savings well beyond the end of the first three years.

9

10 Each of these issues are discussed at length in my direct testimony,¹² and so I will not
11 reiterate them here. In any event, the Applicants have offered no new evidence to
12 support the grossly understated projection of merger savings that resulted from
13 application of their highly biased allocation methodology.

14

15 **The correct value for the Illinois intrastate allocation of total merger savings is \$1.86-**
16 **billion, which translates into a pre-tax rate decrease of \$472-million that should remain**
17 **in place for the initial ten years following the implementation of the merger.**
18

19 Q. How should the § 7-204(c) merger savings allocation be calculated?

20

21 A. The Commission should use the *present value* method of calculating Ameritech Illinois'
22 share of the merger benefits that I have described in my direct testimony. In this
23 manner, the Ameritech Corporation's share of the \$18.3-billion in total estimated merger
24 benefits net of implementation costs is calculated to be \$15.4-billion. A "composite"

25 12. Selwyn (GCI), Direct at 80-82.

1 allocation factor is then applied in order to determine the amount of merger savings
2 allocable to Ameritech Illinois' intrastate regulated services,¹³ to derive the present value
3 of the merger savings allocable to Illinois ratepayers under § 7-204(c). Finally, this
4 present value is converted into an annual pre-tax ratemaking adjustment the adoption of
5 which will assure the full flow-through of merger savings to Illinois ratepayers, as
6 required by the statute.

7
8 Q. Please explain the error that you have discovered in your earlier calculation, and indicate
9 the effect of the correction that you have made.

10
11 A. As I stated earlier, while reviewing the construction of the "composite" factor that is used
12 in the net present value methodology to allocate total merger savings specifically to
13 Illinois, I discovered an error that I had made in my original calculation as presented in
14 my October 28, 1998 direct testimony, the effect of which had been to *understate* the
15 correct § 7-204(c) Illinois allocation of total merger savings.

16
17 Q. Please describe the source of the error and the specific correction that you have made to
18 the "composite" allocation factor for Ameritech Illinois.

19
20 A. In calculating the "composite" factor in my direct testimony, I applied a factor of 73.8%
21 that was attributed by Salomon Smith Barney to noncompetitive services within

22 13. *Id.*, at 83-88.

1 Ameritech's intrastate operations.¹⁴ This factor was derived from a market segment
2 valuation performed by Salomon Smith Barney and described in the Amended Joint
3 Proxy Statement,¹⁵ and was the only factor in the calculation that had not been formally
4 introduced by Ameritech's witness David Gebhardt.¹⁶ At the time that my direct
5 testimony was filed, I believed that the application of this factor was necessary in order
6 to distinguish noncompetitive intrastate telco services from competitive intrastate telco
7 services. However, upon reviewing the merger savings calculations associated with
8 Ameritech Indiana¹⁷ and the direct testimony on re-opening of Mr. Gebhardt,¹⁸ it has
9 now become clear to me that the factor of 73.8% that I had employed and the "Telco"
10 factor of 72.8% applied by Mr. Gebhardt in fact effectively accomplish the same thing or,
11 put another way, by applying both factors, I had effectively made the same adjustment
12 twice. As such, it is necessary to eliminate one of these factors from the algorithm. I
13 have chosen to replace Mr. Gebhardt's "Telco" factor of 72.8% with the market segment
14 valuation factor of 73.8%, because the segment valuation factor correctly includes Telco
15 and Directory revenues, and it is unclear how Directory has been treated by Mr. Gebhardt
16 due to the fact that no mention of it is made in his pre-filed testimony.¹⁹

17 14. *Id.*, at 83-85.

18 15. Amended Joint Proxy Statement, September 21, 1998, at 30-32.

19 16. Gebhardt (Ameritech), Direct at Schedule 1.

20 17. *See* footnote 4, *supra*.

21 18. Gebhardt (Ameritech), Direct on re-opening at 10-11.

22 19. Given the small difference between these two figures, it would seem that Mr.
23 Gebhardt's factor also includes at least some amount of Directory as intrastate regulated
24 services.

1 Q. Have you recalculated the Illinois “composite” factor?

2

3 A. Yes, I have. The correct “composite” allocation factor for Ameritech Illinois is 12.05%,
4 the derivation of which appears in Table 1 below.²⁰ This factor is then applied to the
5 \$15.4-billion in total merger synergies allocable to Ameritech Corporation, which results

6 20. There is a possibility that the “Illinois” factor of 25.3% supplied by Mr. Gebhardt and
7 relied upon in my calculation is incorrect. See footnote 4, *supra*. Ameritech Illinois
8 represents 33.5% of total Ameritech Corporate switched access lines. 1998 Preliminary
9 Statistics of Common Carriers, Table 2.10. Hence, the 25.3% factor, which is based upon
10 expenses, appears somewhat low. Mr. Gebhardt’s testimony relating to this factor further
11 confuses the issue. In his Direct testimony on re-opening, Mr. Gebhardt claims that “[o]f the
12 72.8% allocated to the [Ameritech] BOCs, 25.3% is allocated to Ameritech Illinois.”
13 Gebhardt (Ameritech), Direct on re-opening at 11. Based upon this statement, Ameritech
14 Illinois as a percent of total Ameritech Corporation would be 18.4% (i.e., 72.8% x 25.3%).
15 However, in the workpapers filed with both his Direct testimony and Direct testimony on re-
16 opening, Mr. Gebhardt claims that “Ameritech Illinois percentage of total Ameritech =
17 18.38%/72.78% = 25.3%”. Workpapers of D.H. Gebhardt for Schedule 1 of his Direct
18 testimony, at Bates page 005-05025; Workpapers of D.H. Gebhardt for Exhibit 3.3 of his
19 Direct testimony on re-opening. That notwithstanding, Mr. Gebhardt uses the 18.4% factor in
20 his savings calculation. These two statements are obviously inconsistent, as the former
21 appears to apply the 72.8% “Telco” factor twice. In the event that Mr. Gebhardt’s 18.4%
22 factor is incorrect and the 25.3% should have been used instead, his current savings projection
23 is correspondingly understated. Likewise, the correct “composite” factor that I incorporate in
24 my calculation would increase from the 12.05% that I have used to 16.3% (i.e., 25.3%
25 [AI/AC] x 77.3% [intrastate factor] x 83.5% [regulated factor]), and the resulting amount of
26 merger savings attributable to Ameritech Illinois intrastate regulated services would need to
27 be increased to \$639-million.

28 My inability to replicate and corroborate the Applicants’ factors that are used in
29 calculating their \$31-million of merger savings attributable to Ameritech Illinois intrastate
30 regulated services is further reason to reject the Applicants’ methodology, and to adopt
31 instead the *present value* method of determining the Section 7-204(c) allocation that I
32 recommend. One could argue that any doubt that now surrounds the application of these
33 factors could have been resolved had Mr. Gebhardt’s June 16, 1999 testimony provided the
34 additional details relating to the calculation and apportionment of savings that were sought by
35 the Commission in its June 4 letter, or had the Applicants provided detailed rather than
36 dismissive responses to Staff’s recent data requests on these same issues. See SBC’s response
37 to Staff R JRM 2.01-2.03; Ameritech’s response to Staff R JRM 2.01-2.03.

1 in a total synergy benefit allocable to Ameritech Illinois' intrastate regulated services of
 2 \$1.86-billion.²¹ From this net present value amount, we then calculate the annual
 3 ratemaking adjustment that should be made as required by § 7-204(c).

Table 1

Derivation of Revised Illinois "Composite" Allocation Factor

8			
9	<u>line</u>		
10	(1) Percentage of Ameritech represented by all telco operations		73.8%
11	(2) Percentage of Ameritech telco operations represented by Ameritech	x	25.3%
12	Illinois		
13	(3) Percentage of Ameritech Illinois telco operations that is jurisdictionally	x	77.3%
14	intrastate		
15	(4) Percentage of Ameritech Illinois intrastate telco operations that are	x	83.5%
16	associated with regulated services		
17			
18	(5) Share of aggregate merger synergies allocable to Ameritech Illinois	=	12.05%
19	regulated intrastate services		
20	<i>Sources:</i>		
21	(1) Telecommunications (and Directory) as a percent of total Ameritech Corporation.		
22	Segment valuation performed by Salomon Smith Barney, Amended Joint Proxy		
23	Statement, September 21, 1998, at 29-33. See also Selwyn (GCI), Direct at 84.		
24	(2) Gebhardt (Ameritech), Direct at Schedule 1.		
25	(3) Gebhardt (Ameritech), Direct at Schedule 1.		
26	(4) Gebhardt (Ameritech), Direct at Schedule 1.		
27	(5) Line (1) x line (2) x line (3) x line (4)		

29 Q. What fraction of total company Ameritech Illinois merger savings does the \$1.86-billion
 30 § 7-204(c) ratepayer allocation represent?
 31

32 21. \$15.4-billion x 12.05% = 1.86-billion.

1 A. Using the appropriate factors from Table 1, the portion of the \$15.4-billion in total
2 merger synergies that has been allocated by the two Applicants to Ameritech Illinois can
3 be calculated. The amount of total company Ameritech Illinois benefits is derived by
4 applying the “Telco” factor (derived from the Joint Proxy Statement) and Mr. Gebhardt’s
5 “Illinois” factor to the total merger synergies value. This results in an allocation of
6 \$2.88-billion to Ameritech Illinois.²² As shown in Table 2, roughly 65% of that
7 amount, i.e., \$1.86-billion, is the amount that corresponds to Ameritech Illinois’ intrastate
8 regulated services and is required to be allocated to ratepayers, and the remaining 35%
9 would flow to shareholders.

10

11 22. $73.8\% \times 25.3\% \times \$15.4\text{-billion} = \$2.88\text{-billion}$. See Amended Joint Proxy Statement,
12 September 21, 1998, at 30-32; Gebhardt (Ameritech), Direct on re-opening at 11.

Table 2		
Allocation of Ameritech Illinois Merger Savings Between Ratepayers and Shareholders		
<u>line</u>		
(1)	Share of aggregate merger synergies allocable to Ameritech Illinois regulated intrastate services	12.05%
(2)	Percentage of benefits attributable to Ameritech Illinois	÷ 18.67%
(3)	Portion of Ameritech Illinois synergy benefits attributable to Ameritech Illinois intrastate regulated Services	= 64.5%
(4)	Portion of Ameritech Illinois synergy benefits attributable to Ameritech shareholders	35.5%
<i>Sources:</i>		
(1)	Table 1, line (5)	
(2)	Table 1, line (1) x line (2)	
(3)	Line (1) ÷ line (2)	
(4)	100% - line (3)	

Q. What is the revised annual amount of merger savings required to be shared with Illinois consumers?

A. The \$1.86-billion net present value of merger savings should be flowed through to Illinois consumers ratably over a ten-year period, amortized at a discount rate of 9.5%.²³ This calculation results in an annual after-tax amount of \$296-million that, when adjusted to a pre-tax basis, should be reflected in a one-time rate decrease of \$472-million that should be applied to all noncompetitive Ameritech Illinois services in the manner discussed in my direct testimony, and that would remain in effect for the full ten year

23. Selwyn (GCI), Direct at 90-91; *see also* Gebhardt (Ameritech), Direct at 31; Gebhardt (Ameritech), Direct on re-opening, at 13.

1 amortization period.²⁴ As I discussed in my direct and rebuttal testimony, certain
2 appropriate accounting adjustments, including transfer payments from other SBC affiliates
3 for their use of Ameritech Illinois best practices, may also be necessary.²⁵ Table 3
4 below walks through the recommended “present value” calculations in a step-by-step
5 manner.

6

7 24. These services include wholesale, access, UNEs, transport and termination, and should
8 be applied “in a manner that fairly apportions the merger synergies across all noncompetitive
9 services and avoids the creation of a price squeeze between [Ameritech Illinois] retail services
10 and services furnished to competitive carriers.” Selwyn (GCI), Direct at 91.

11 25. Selwyn (GCI), Direct at 91, Rebuttal at 56.

Table 3

Derivation of Synergy Benefits Allocable to Ameritech Illinois Consumers
in Accordance with Section 7-204(c) Using the "Present Value" Method

Total shares for combined SBC/AIT (post merger)	3,323,444,000
Forecasted post-merger increase in SBC stock	\$ 5.51
Total forecasted post-merger synergies	\$ 18,312,176,440
Premium over market value paid by SBC for AIT	\$ 13,186,564,500
Forecasted post-merger synergies net of premium paid for AIT	\$ 5,125,611,940
Percentage of AIT shares in post-merger SBC/AIT	44%
Additional post-merger synergies received by AIT shareholders	\$ 2,250,840,872
Total merger benefits reaped by AIT shareholders	\$ 15,437,405,372
Total merger benefits reaped by SBC shareholders	\$ 2,874,771,068
Illinois "Composite" allocation factor	12.05%
Synergy benefit for Ameritech Illinois intrastate regulated services	\$ 1,860,446,394
Discount rate	9.5%
No. of payment periods (years)	10
Annual synergy benefit to Ameritech Illinois consumers	\$ (296,306,137)
Composite tax rate	37%
Pre-tax annual rate reduction	\$ (471,584,762)

Sources:

Amended Joint Proxy Statement, September 21, 1998
Table 1

1 **While the specific ten-year net present value amortization approach that I have**
2 **recommended is reasonable and fully consistent with § 7-204(c), certain other flow-**
3 **through arrangements may also satisfy the statutory requirement.**
4

5 Q. Is there any other manner in which the \$1.86-billion in merger savings allocable to
6 Ameritech Illinois' intrastate regulated services can be flowed through to Illinois
7 consumers via a rate adjustment?
8

9 A. While I believe that the ten-year amortization approach that I have recommended is
10 reasonable and fully consistent with § 7-204(c), other flow-through arrangements could
11 also be evaluated. These would generally involve either modifying the period over which
12 rates are to be adjusted, or applying an additional allocation of the § 7-204(c) savings
13 between ratepayers and shareholders.
14

15 Q. What alternatives exist with respect to the rate adjustment period?
16

17 A. The Commission could adopt a different (longer or shorter) period over which the full
18 present value of merger savings would be amortized for flow-through purposes. For
19 example, if the amortization period were set at 20 years (as opposed to my recommended
20 10 year period), and holding all else equal, the pre-tax annual rate reduction would be
21 \$336-million.
22

23 Q. What alternatives exist relative to the 65%/35% ratepayer/shareholder allocation that you
24 have calculated?
25

1 A. The Commission could also determine that the 65%/35% allocation of Ameritech Illinois
2 merger savings between ratepayers and shareholders, respectively, should be adjusted.
3 The specific 65%/35% split that I am recommending is based upon the Salomon Smith
4 Barney segment valuations of Ameritech Illinois jurisdictional (intrastate) regulated
5 services (65%) vs. all other Ameritech Illinois activities (35%). While I believe that this
6 is the specific “allocation of any savings resulting from the proposed reorganization” that
7 is expressly referred to at § 7-204(c), the Commission could, for example, find that
8 ratepayers are entitled to something less than the full 65% share. For example, the
9 corresponding California statute, § 854(b)(2) of the California Public Utility Code,
10 requires that the California PUC

11
12 Equitably allocate[], where the commission has ratemaking authority, the
13 total short-term and long-term forecasted economic benefits, as determined
14 by the commission, of the proposed merger, acquisition, or control, between
15 shareholders and ratepayers. Ratepayers shall receive not less than 50
16 percent of those benefits.
17

18 The \$1.86-billion represents the portion of total merger savings that apply to Ameritech
19 Illinois services over which the Illinois Commerce Commission has ratemaking authority.
20 Applying the California “not less than 50 percent of those benefits” standard, the
21 minimum ratepayer share would thus be \$983-million on a present value basis, or a \$236-
22 million rate decrease to remain in place for ten years.

23
24 Q. Have any other utilities sought a similar 50/50 allocation of merger savings as between
25 ratepayers and shareholders?
26

1 A. Yes. A similar 50/50 split of net merger savings between ratepayers and shareholders
2 was proposed by parties in the UE/CIPS merger, on the grounds that the proposal “is
3 inherently fair and equitable in the sense that it shares net savings equally between
4 stockholders and customers....[i]t also comes reasonably close to making shareholders
5 whole...”.²⁶ While I believe that the correct “allocation” referred to at § 7-204(c)
6 embraces *all* of the savings associated with intrastate regulated services, alternate
7 interpretations may provide the Commission with a certain amount of discretion in this
8 regard.

9
10 Q. Would adoption of an alternate flow-through period still be consistent with your
11 interpretation of the merger savings allocation that is required by § 7-204(c)?

12
13 A. Yes. The “present value” method of calculating the total merger benefits inuring to
14 Ameritech Corporation, together with the application of the “composite” factor for
15 allocating those benefits to Illinois intrastate regulated services, is the correct method for
16 determining the *total estimated benefits allocable to Ameritech Illinois intrastate*
17 *regulated services for the life of the merger*, and this method remains intact. While I
18 believe that a ten-year amortization period is appropriate given existing market and
19 competitive conditions, adoption of a different flow-through period can also satisfy the
20 statutory flow-through requirement, provided that there is some assurance that, in the end,
21 the full present value of jurisdictional merger savings will be flowed through to

22 26. See Illinois ICC Docket No. 95-0551, Direct Testimony of Gary L. Rainwater, GLR-1
23 at 15-16. It is also important to note that the total merger savings that had been proposed by
24 the Applicants in this combination of two electric utilities was calculated over a period of ten
25 years. *Id.*

1 ratepayers. While the Applicants may argue that the development of competition will
2 assure this outcome, they offer nothing concrete in support of this speculation. The
3 Commission could, for example, adopt a 10- or even a 20-year flow-through period and
4 periodically revisit its necessity in light of market developments; if the Commission finds,
5 at some point in the future, that actual, price-constraining competition has truly developed
6 in the Illinois local services market, it can at that time modify or even discontinue the
7 explicit flow-through. On the other hand, if the Commission adopts an unduly attenuated
8 flow-through period, such as the three years that the Applicants propose, and actual,
9 price-constraining competition fails to develop as the Applicants speculate, there will be
10 no means for satisfying the savings allocation requirements of the statute. Accordingly,
11 and based upon the record in this proceeding, the correct and prudent course of action is
12 for the Commission to apply the full net present value method and to use a flow-through
13 amortization period of at least ten years.

14
15 Q. Doesn't the three-year flow-through period that the Applicants propose represent simply
16 another alternative amortization period for flow-through of merger savings?

17
18 A. No, because the Applicants' methodology is fundamentally different. Under the present
19 value method that I am recommending, the totality of the merger savings allocable to
20 Illinois intrastate regulated services is determined over the entire time frame within which
21 those savings would continue to be realized by the Applicants. This amount is then
22 converted to a pre-tax annual rate reduction for the period of the amortization. Under the
23 Applicants' approach, merger savings realized by the Applicants beyond the third year
24 following implementation of the merger *are ignored entirely*; no attempt is ever made to

1 establish the present value of all future merger-driven savings. There is nothing in the
2 statute or in its application that would permit this sort of truncation, and for that reason
3 (as well as its fundamental unfairness to Illinois ratepayers) the Applicants' approach
4 must be rejected.

5
6 **Under the present value amortization flow-through approach, the Commission retains**
7 **the ability to discontinue the explicit flow-through at any time that it determines that**
8 **effective, price-constraining competition has actually developed in the Illinois local**
9 **exchange market.**

10
11 Q. Is there any process by which the explicit flow-through rate adjustment could be
12 discontinued prior to the expiration of the adopted amortization period?

13
14 A. Yes. As discussed in my direct testimony, the Commission can (and should) periodically
15 revisit the annual merger-related rate adjustments.²⁷ If at some point in the future
16 competition in the local market has developed such that the Commission is satisfied that
17 merger savings are being flowed to Illinois consumers through market forces, it has the
18 authority and the ability at that time to discontinue the explicit flow-through. If effective,
19 price-constraining competition fails to emerge in Illinois prior to the completion of the
20 full flow-through period, then those payments should continue.

21
22 On the other hand, were the Commission to adopt the extremely limited and truncated
23 flow-through being offered by the Applicants (and only then if the Commission rejects
24 their bedrock contention that § 7-204(c) does not apply to this merger transaction) and if

25 27. Selwyn (GCI), Direct at 92.

1 effective, price-constraining competition fails to develop at the end of the initial three-
2 year period, the Commission will likely encounter extreme difficulty in assuring that
3 Illinois consumers realize any merger savings. Since any projection as to the extent of
4 local competition at any given point in the future is at best highly speculative at this
5 point, the Commission should clearly adopt a policy that is reversible in the event that
6 market conditions actually change from those extant at the present time. The use of the
7 present value method with an extended amortization period is entirely reversible if
8 competition actually develops as the Applicants contend that it will; by contrast, the
9 Applicants' meager three-year limited savings allocation would terminate at the end of
10 that time frame *whether or not any effective competition is actually present at that time.*

1 THE EFFECTS OF THE NLS ON INTRASTATE REGULATED RATES

2
3 **The merged entities' pursuit of their "National-Local Strategy" has the potential to**
4 **increase prices to Illinois consumers for Ameritech's services.**
5

6 Q. Dr. Selwyn, item (9) in the Commission's list of questions propounded to SBC and
7 Ameritech asks the Applicants to provide "[a] clear explanation of the National Local
8 Subsidiary, as used in this docket, and the impact that this subsidiary would have on
9 retail rates. Explain what happens to AI's retail rates should the applicants transfer the
10 top-revenue customers to this subsidiary for telecommunications services. Explain what
11 the revenue impact would be for Ameritech Illinois if the top customers are shifted to the
12 National Local Subsidiary. Explain if the National Local Subsidiary would provide local
13 service for its customers in Illinois. Explain whether the National Local Subsidiary
14 would be certified as a CLEC in Illinois. Explain whether the National Local Subsidiary
15 would be treated an any other CLEC would be treated in its interactions with AI."²⁸ Do
16 you believe that the Applicants have provided a satisfactory response to this issue?
17

18 A. No, I do not. Although Mr. Kahan responds to some of the issues raised by the
19 Commission in his direct testimony on re-opening,²⁹ he fails entirely to address the
20 Commission's most basic concern, *viz.*, the impact that the NLS will have upon retail
21 local telephone rates in Illinois. Mr. Kahan appears to gloss over the broad scope of the
22 Commission's initial concern in favor of addressing the more specific questions. For

23 28. See Question (9) in Attachment A to Chairman Richard Mathias' letter of June 4, 1999
24 to Hearing Examiners Mark Goldstein and Eve Moran.

25 29. Kahan (SBC), Direct on re-opening at 17-22.

1 example, Mr. Kahan attempts to assuage the Commission's concerns simply by repeating
2 the otherwise entirely unsubstantiated contention that the National-Local subsidiary will
3 not require certification in Illinois and will not itself provide local exchange services in
4 Illinois,³⁰ and further commits "not to seek local exchange certification for their
5 National-Local Subsidiary in Illinois prior to January 1, 2001."³¹ Mr. Kahan also makes
6 the sweeping claim that "the use of a National-Local subsidiary out-of-region will have
7 absolutely no impact on the operations of Ameritech Illinois or on its retail rates."³²

8
9 Mr. Kahan's conclusive statements are dismissive, and certainly fail entirely to explain
10 why his own prior statements regarding the relationship of the National-Local Subsidiary
11 to the core in-region local exchange carrier entities should now be ignored. Contrary to
12 Mr. Kahan's persistent protests, there can be little question but that the post-merger
13 SBC's pursuit of large out-of-region customers will materially and adversely affect
14 Ameritech Illinois rates.

15
16 Q. Please explain.

17
18 A. Mr. Kahan and other SBC/Ameritech witnesses have explained that the foundation of the
19 National-Local Strategy is the ability to offer large, decentralized companies that are
20 headquartered within the 13-state SBC/Pacific/SNET/Ameritech region the ability to use

21 30. *Id.*, at 21.

22 31. *Id.*, at 21-22.

23 32. *Id.*, at 18.

1 SBC local services at their out-of-region sites.³³ This type of marketing strategy will
2 almost surely require some sort of *national* pricing or volume discount structure, e.g., a
3 company headquartered in Chicago would be permitted to combine its Illinois and other
4 in-region local service purchases with out-of-region services acquired from the SBC
5 National-Local subsidiary under a single national pricing/contracting arrangement. In that
6 circumstance, Ameritech Illinois revenues from such national customers could be
7 sacrificed in order to offer a national pricing and volume discount program.

8
9 This concern is heightened by the possibility that SBC could divert many Ameritech
10 Illinois customers to an Illinois CLEC associated with its National-Local subsidiary. As I
11 noted earlier, Mr. Kahan has stated that SBC/Ameritech commit “not to seek local
12 exchange certification for their National-Local Subsidiary in Illinois prior to January 1,
13 2001.”³⁴ Inasmuch as Mr. Kahan has forecast a 10-year break-even time frame for the
14 National-Local initiative and will probably not even get seriously organized prior to
15 January, 2001, this “commitment” is basically a vacant gesture with no operative effect.

16
17 Q. Why is it reasonable to expect that SBC intends to finance its National-Local subsidiary
18 from profits generated from its core basic services, including those provided by
19 Ameritech Illinois?
20

21 33. Kahan (SBC), FCC Affidavit at ¶¶ 13, 27-36; Carlton (SBC), FCC Affidavit at ¶¶ 14-
22 16.

23 34. Kahan (SBC), Direct on re-opening at 21-22.

1 A. As I have discussed in my direct testimony,³⁵ Mr. Kahan has unambiguously stated that
2 SBC *requires* the revenues derived from its in-region core noncompetitive service
3 markets *to finance and support the National-Local Strategy* and other out-of-region
4 competitive ventures:

5
6 *... SBC will experience significant earnings dilution and increased risk as a result of*
7 *the start-up costs and losses during the earlier years of the National-Local Strategy.*
8 This dilution cannot be borne by SBC alone. By spreading that dilution and risk
9 across a broader base of shareholders, the combined SBC/Ameritech can continue to
10 provide investors with appropriate returns notwithstanding the costly National-Local
11 Strategy. SBC would not, on its own, expose its smaller base of shareholders to the
12 dilution and extensive risk of the National-Local Strategy.
13

14 Indeed, the business plan contemplates having a cumulative negative cash flow
15 for nearly ten years. *The remaining business operations of the new SBC must carry*
16 *these negative cash flows while we continue to grow our existing business, grow our*
17 *customer base, compete in the market where we are the incumbent, maintain and*
18 *enhance our existing networks and fund dividends.* In fact, a significant percentage
19 of the projected positive net present value in the business plan is a result of favorable
20 results in the later years of the plan. Again, SBC on a stand-alone basis could not
21 reasonably accept those short-term and medium-term losses, particularly given the
22 rapidly changing nature of the industry that makes more distant gains less certain.³⁶
23

24 Drs. Schmalensee and Taylor, who provided affidavits to the FCC on behalf of the
25 Applicants in their merger application, corroborate Mr. Kahan's linkage between the
26 current base of noncompetitive revenues and the financial support of the National-Local
27 Strategy:

28
29 Managing a strategy of entering geographically-dispersed markets initially to serve a
30 relatively narrow base of customers requires a large, flexible pool of management
31 and employee skills if such entry is to be cost-effective. *A substantial base of*

32 35. Selwyn (GCI), Direct at 54-57.

33 36. Kahan (SBC), FCC Affidavit at ¶¶ 79-80, emphasis supplied.

1 *current customers and revenues is necessary to maintain earnings growth and spread*
2 *risk while following customers into out-of-region local markets. ...*³⁷
3

4 SBC has established, by its own admission, that the Ameritech acquisition is *necessary* in
5 order to provide a *core revenue base* for the National-Local Strategy. In the case of
6 Illinois, that core revenue base will come from the extensive noncompetitive services that
7 Ameritech Illinois will continue to provide and dominate within its operating areas.
8 There can be no denying the pressure for rate increases on Ameritech Illinois services
9 that must exist in order to subsidize the ten-year money-losing National-Local Strategy,
10 and any such increases must be recognized by the Commission as the “unjustified
11 subsidization of non-utility activities” that are expressly prohibited from any utility
12 reorganization by § 7-204(b)(2) of the Illinois PUA.³⁸
13

14 Q. How might those rate increases be pursued by the Applicants?
15

16 A. As discussed in my direct testimony, Ameritech Illinois rate increases might be
17 propagated by the Applicants’ seeking to decrease or to eliminate altogether the X-factor
18 from Ameritech Illinois’ current price cap formula.³⁹ SBC has sought these kinds of

19 37. Schmalensee/Taylor (SBC/Ameritech), FCC Affidavit, at ¶ 16, emphasis supplied.

20 38. Other forms of cross-subsidization effected by the proposed merger would be 1) the
21 transfer of Ameritech Illinois employees, which (along with other SBC and Ameritech
22 subsidiaries) are to be relied upon to staff the NLS venture; and 2) the increase in Ameritech
23 Illinois’ cost of capital that results from the increased portfolio risk of the new SBC (due to
24 the high-risk NLS venture), which could lead to an increase in rates for Ameritech Illinois
25 services. See Selwyn (GCI), Direct at 61-65.

26 39. Elimination of the X-factor could have the effect of channeling approximately one-half
27 (continued...)

1 revisions to the preexisting price cap-based regulatory framework in California; if all of
2 SBC's positions are ultimately adopted, the result would be the elimination of most, if
3 not all, ratepayer protection that had been built into the original "New Regulatory
4 Framework" that had been adopted by the California PUC.⁴⁰

5
6 What is more likely, however, would be for the Applicants to seek rate increases for
7 services that are *declared* (by Ameritech Illinois) to be "competitive" yet which do not in
8 reality face effective, price constraining competition, a practice with which Ameritech
9 Illinois is already very familiar. As addressed in a report issued on November 25, 1998
10 by the Commission's Telecommunications Division Staff and discussed at length in my
11 rebuttal testimony, between March, 1997 and November, 1998, numerous Ameritech
12 Illinois services were reclassified from noncompetitive to competitive status via tariff
13 filings on one day's notice. Following reclassification, Ameritech Illinois proceeded to
14 *increase* the retail and wholesale rates for some of these services, an action that
15 undermines the most basic economic concept of competition and virtually confirms the
16 lack of existence of competitive alternatives for those services.

17
18 Illinois is not alone in experiencing the underhanded attempt at rate increases in the
19 Ameritech serving area. Ameritech Indiana has also imposed or attempted to impose
20 similar rate increases for services that are supposed to face competitive market forces.

21 39. (...continued)
22 billion dollars out of the Illinois economy and into SBC's out-of-region National-Local
23 Strategy. *Id.*, at 56-57.

24 40. *Id.*, at 57-60.

1 As discussed in the Comments filed at the FCC on June 16, 1999 by the Indiana Utility
2 Regulatory Commission (“IURC”) in regard to the SBC/Ameritech merger, Ameritech
3 Indiana raised its rates for monthly Centrex service despite the fact that Centrex service
4 is considered to be a “competitive” service.⁴¹ On investigation, an IURC staff report
5 found that “[r]aising rates, in what Ameritech contends is a competitive market, without
6 cost justification, violates basic principles of economics. We believe this is an exercise
7 in monopoly power.”⁴² A copy of these Comments is included as Appendix 2 to this
8 testimony.

9
10 The actions of Ameritech Illinois fly in the face of the comments that Mr. Kahan has set
11 before the Commission with regard to the effect of the NLS upon Ameritech Illinois
12 rates. While Mr. Kahan has claimed that “[w]e’re in an alt reg plan. We cannot raise
13 prices in Illinois. ... The risk of national local is only on the shareholders, not on the
14 customers, regulated customers, in Illinois,”⁴³ he is conveniently sidestepping the
15 manner in which rate increases *were actually imposed* by Ameritech Illinois regardless of
16 the alternative regulation plan currently in existence. Thus, Ameritech Illinois has a

17
18 58. CC Docket No. 98-141, *In the Matter of GTE Corporation, Transferor, and Bell*
19 *Atlantic Corporation, Transferee, For Consent to Transfer of Control*, Exhibit A, “BA/GTE
20 Public Interest Statement,” at 6-7.

21 59. Schmalensee/Taylor (SBC/Ameritech), FCC Affidavit, at ¶ 16, emphasis supplied.

1 history of creating ways to increase prices for services previously bound by a price cap
2 formula and, following approval of the proposed merger, the expectation of ten years of
3 negative cash flow from the NLS will certainly create an incentive to increase revenue
4 from the “substantial base of current customers and revenues” relied on by the Applicants
5 in pursuing the national-local entry strategy.

6
7 **SBC will have the ability to flow excess Ameritech Illinois profits to support its**
8 **National-Local subsidiary.**
9

10 Q. What mechanism could SBC use to flow excess profits from Ameritech Illinois to fund
11 its National-Local subsidiary?

12
13 A. Ameritech Illinois is able to operate without any effective constraints on its intrastate
14 earnings. The Commission’s price cap plan does not impose any earnings cap or
15 requirement for sharing of excess earnings; the only limit comes from price increase
16 constraints imposed by the price cap rate adjustment mechanism. Once Ameritech
17 Illinois successfully declares a service to be competitive (which it is permitted to do
18 unless the Commission acts to suspend and investigate such a declaration, something that
19 up to now has rarely occurred), there is neither a pricing nor an earnings constraint.

20
21 SBC can divert these excess Illinois earnings to provide precisely the kind of financial
22 support for the National-Local subsidiary that Mr. Kahan has described merely by paying
23 the excess Ameritech Illinois profit as a dividend to SBC. SBC is then free to use the
24 dividends in any way it wishes, which could (and likely would) include funding the
25 National-Local subsidiary.

1 THE IMPLICATIONS OF APPROVING THE MERGER “WITH CONDITIONS”

2
3 **SBC and Ameritech have poor track records in meeting specific commitments made to**
4 **regulatory agencies in exchange for some desired concession or approval.**
5

6 Q. Is there any cause for concern relative to the Commission approving this merger “with
7 conditions?”

8
9 A. Yes, there certainly is. If the Commission chooses to approve this merger and intends to
10 impose certain conditions upon the Applicants, it must be aware of two important
11 occurrences relative to this matter. First, following approval of the merger, the
12 Commission might find itself without the necessary authority to ensure that the individual
13 conditions are being met. For example, when the Maine Public Utilities Commission
14 gave its consent to the Bell Atlantic/NYNEX merger, it ordered the merged entity to
15 comply with Section 271 of the *1996 Act within eight months of the decision approving*
16 *the merger* (i.e., by September 30, 1997). When this did not occur, the Maine PUC had
17 no effective alternative conditions or sanctions, and the requirement was essentially
18 ignored.⁴⁴

19
20 Second, and perhaps of greatest immediate concern, the Commission needs to be aware
21 of various specific instances where SBC or Ameritech (or companies that SBC had
22 acquired) had made express commitments to state regulators and then subsequently either

23 44. State of Maine Public Utilities Commission, Docket No. 96-338, *Order* (Part II),
24 September 30, 1997 (substituted a reporting requirement for the condition requiring checklist
25 compliance). As of the date of this testimony, Bell Atlantic has still not satisfied its Section
26 271 requirements in Maine or, for that matter, anywhere else.

1 failed to meet the commitment or affirmatively sought to modify it. A case in point is
2 SBC's current attempt to escape certain franchise requirements it had assumed by its
3 takeover of the Southern New England Telephone Corporation ("SNET") relative to
4 SNET's subsidiary cable operation, SNET Personal Vision ("SPV").⁴⁵ In its order
5 approving this merger, the Connecticut Department of Public Utility Control ("DPUC")
6 responded to concerns expressed by several intervenors that SBC had no interest in
7 fulfilling SPV's franchise obligations by requiring SBC "to commit to maintaining the
8 SNET/SBC current level of capital investment, staffing, marketing, research and facility
9 deployment proposed and accepted by the Department in Personal Vision's franchise
10 agreement Decision in Docket No. 96-01-24."⁴⁶ Nonetheless, in a recent application,
11 which I have attached as Appendix 3, SBC/SNET has requested permission to modify its
12 statewide franchise obligations in several ways, including reducing its facility deployment
13 from the entirety of Connecticut's 169 towns, as stipulated in the franchise agreement, to
14 only the 26 it currently or will soon serve.⁴⁷ In that application (which is currently
15 under review), SBC/SNET attempts to mask its lack of interest in fulfilling its obligation
16 to serve by arguing that there has been a "deterioration of HFC [a hybrid fiber coaxial
17 network] for telephony, [since] SPV filed its application with the Department for a

18 45. Connecticut Department of Public Utility Control Docket No. 99-04-02, *Evaluation*
19 *and Application to Modify Franchise Agreement by SBC Communications Inc., Southern New*
20 *England Telecommunications Corporation, and SNET Personal Vision, Inc.*

21 46. Connecticut DPUC Docket No. 96-01-24, *Application of SNET Personal Vision, Inc.*
22 *for a Certificate of Public Convenience and Necessity to Provide Community Antenna*
23 *Television Service*, September 25, 1996, at 59.

24 47. Connecticut DPUC Docket No. 99-04-02, *Evaluation and Application to Modify*
25 *Franchise Agreement by SBC Communications, Inc., Southern New England*
26 *Telecommunications Corporation and SNET Personal Vision, Inc.*, April 1, 1999, at 25-26.

1 statewide cable franchise”⁴⁸ and that “the marketplace and technology changes in HFC
2 since 1994 have turned the [SPV] business case on its head.”⁴⁹ These arguments are
3 disingenuous because the changes in the marketplace and technology that are being
4 referred to in the SBC/SNET application were widely known prior to the submission of
5 the original SPV franchise application.⁵⁰

6
7 A similar situation has recently presented itself in Indiana, but in this case it is Ameritech
8 who is at fault for failing to comply with previously agreed-upon conditions. As
9 discussed in the IURC’s FCC Comments submitted in CC Docket 98-141, in return for
10 relaxed regulatory standards as part of its “Opportunity Indiana” alternative regulatory
11 plan, Ameritech Indiana agreed to spend \$20-million annually for six years to connect
12 Indiana schools, hospitals and government centers to a high-capacity two-way learning
13 network under the express understanding that the Company would be unable to recover
14 these investments through end user charges.⁵¹ Careful review by the IURC of the

15 48. *Id.*, at 11.

16 49. *Id.*, at 16.

17 50. See Docket No. 99-04-02, *Evaluation and Application to Modify Franchise Agreement*
18 *by SBC Communications, Inc., Southern New England Telecommunications Corporation and*
19 *SNET Personal Vision, Inc.*, Direct Testimony of Lee L. Selwyn and Patricia D. Kravtin, June
20 21, 1999, at 23-29.

21 51. IURC Cause No. 39705, *In the Matter of the Petition of Indiana Bell Telephone*
22 *Company, Incorporated for the Commission to Decline to Exercise in Part its Jurisdiction*
23 *over Petitioner’s Provision of Basic Local Exchange Service and Carrier Access Service, to*
24 *Utilize Alternative Regulatory Procedures for Petitioner’s Provision of Basic Local Exchange*
25 *Service and Carrier Access Service, and to Decline to Exercise Whole its Jurisdiction over All*
26 *Other Aspects of Petitioner and its Provision of All Other Telecommunications Service and*
27 *Equipment, Pursuant to I.C. 8-1-2.6.*

1 substantiating numbers provided by Ameritech Indiana revealed that the Company had
2 included investments to retail stores, an amusement park, an industrial plant, and a hotel
3 in its accounting of expenditures that were meant for the aforementioned qualifying
4 institutions, and that the Company's investments that were applicable under the prior
5 agreement totalled a mere \$17.9-million, roughly \$62-million less than promised.⁵²

6 Though ordered to file a detailed expenditure plan that would account for the balance of
7 the infrastructure investments, Ameritech Indiana's minuscule report filed with the IURC
8 on May 28, 1999 contained few specifics as to how these investments would be made.⁵³

9
10 This Commission should not lightly dismiss or ignore SBC's and Ameritech's actions in
11 Connecticut, Indiana or elsewhere when contemplating approval of this merger, particu-
12 larly with regard to any conditions it might see fit to impose upon the Applicants, and the
13 dubious credibility of the Applicants' commitments to fulfill such conditions as may be
14 imposed.

16 52. IURC FCC Comments, at 4.

17 53. *Id.*

1 **If adopted by the FCC, the FCC Staff's proposed merger conditions, while perhaps a**
2 **limited step in the right direction, may not satisfy the specific requirements of Section 7-**
3 **204(b) and (c), and may provide the new SBC/Ameritech with the incentive and**
4 **capability to engage in cross-subsidization of its out-of-region plans.**
5

6 Q. Dr. Selwyn, are you familiar with the FCC Staff's set of proposed conditions on the
7 SBC/Ameritech merger?

8
9 A. Yes, I have reviewed the FCC Staff's summary of these proposed conditions, which was
10 released for public comment on June 29, 1999. The full report of the proposed
11 conditions, which is in excess of 100 pages, was made available on the FCC's website on
12 July 2, 1999. Given the large volume of information contained in this report and the
13 close proximity of its release with the finalization of this testimony, I am unable to
14 comment on anything more than the summary conditions at this time. Absent a detailed
15 review of the full report, I am not able to determine whether the Applicants' acceptance
16 of these conditions would also satisfy the various requirements set forth at Sections 7-
17 204(b) and (c) of the Illinois PUA.

18
19 Q. Based on your present understanding, do the FCC Staff's proposed conditions appear to
20 satisfy any of the concerns you have expressed as to the potential anticompetitive effects
21 of the merger?

22
23 A. If adopted by the FCC, it would appear that the FCC Staff's proposed conditions may
24 address some, although certainly far from all, of these concerns. However, in many cases
25 the specific obligations being assumed by the merged entity would be extremely limited
26 both in scope and in time. For example, one condition would require the "wholesale

1 discount” on bundled residential basic service to be increased to an average of 32%, but
2 this requirement would be limited to a specific quantity of lines in each of the 13
3 SBC/Ameritech states and would terminate after three years. Similarly, UNE platforms
4 for residential service will be offered in the SBC/Ameritech states “for a specific period”
5 subject to state-specific caps limiting the number of UNE platform lines that must be
6 provided. Given the enormous increase in overall market concentration that will result
7 from this merger, these express limitations on the potential for competitive market
8 penetration at the retail level would do little if anything to counter the anticompetitive
9 consequences of increased concentration, and may create a false interpretation of
10 competitors’ actual market responses that could lead to an inaccurate portrayal of the
11 status of competition in the local market.

12
13 One specific attribute of the FCC’s proposed conditions involves the imposition of
14 specific penalties upon SBC for its failure to comply fully with individual obligations.
15 However, even these penalties are ultimately capped on a state-by-state basis, with an
16 aggregate maximum of \$2-billion. While this may appear on its face to be a large sum
17 of money, it is a small fraction (slightly over 10%) of the gross \$18.3-billion in merger
18 gains projected by Salomon Smith Barney and, in any event, must be evaluated against
19 the economic benefit to the post-merger SBC of its non-compliance. We have already
20 had testimony in this record, for example, that Ameritech Illinois has deliberately elected
21 not to comply with the Commission’s service quality requirement, because the 0.25%
22 price cap penalty is less than it would cost the Company to meet the service quality

1 standard.⁵⁴ In evaluating whether or not it will comply with the FCC Staff's
2 requirements, it is reasonable to assume and expect that SBC will go through comparable
3 cost/benefit analyses. Indeed, Illinois' share of the \$2-billion in potential penalties is
4 only about \$241-million,⁵⁵ or less than 13% of the \$1.86-billion in merger savings that
5 the Applicants should be required to flow-through to Illinois ratepayers pursuant to § 7-
6 204(c).⁵⁶

7
8 The summary of the FCC Staff's proposed conditions addresses the idea of fostering out-
9 of-region competition, potentially subjecting the post-merger SBC entity to some \$1.2-
10 billion in penalties for failing to meet rigorous entry timetables. Specifically, proposed
11 Condition Number 19 requires that:

12
13 SBC-Ameritech will compete for residential and business customers in 30
14 new markets outside their traditional operating regions within 30 months.
15 SBC-Ameritech has delineated five verifiable steps that it will take as part
16 of its entry into each of these new markets. SBC-Ameritech will pay \$40
17 million per market (up to \$1.2 billion total) for missing any of those steps
18 within the time period specified for each.⁵⁷
19

20 Entry by the post-merger SBC into these 30 out-of-region markets will benefit Illinois
21 ratepayers *if and only if* there is retaliatory entry by another comparably large ILEC;

22 54. Tr. at 815-817.

23 55. Based on the fact that Ameritech Illinois represents only 12.03% of the total combined
24 Ameritech/SBC switched access lines (6,865,260 ÷ 57,055,697). 1998 ARMIS 43-08, Table
25 2.

26 56. \$241-million ÷ 1.86-billion

27 57. "Summary of SBC/Ameritech Proposed Conditions," June 29, 1999.

1 following the merger, the only other comparably large ILEC will be a merged Bell
2 Atlantic/GTE entity. One can, of course, presume that, should the FCC Staff's proposed
3 conditions be adopted, the FCC will impose similar conditions regarding out-of-region
4 entry upon a post-merger BA/GTE, but the only Illinois community in which BA/GTE
5 has indicated any intention to enter is Chicago,⁵⁸ and as of now we do not know
6 precisely what impact BA/GTE's entry will have on the Chicago market. Thus, this
7 merger may very well do nothing to create, promote or foster additional competition
8 outside of the specific Illinois geographic footprint that BA/GTE elects to pursue.

9
10 Encouraging the Applicants to compete out-of-region is an appropriate public policy goal
11 only to the extent that such entry does not rely upon the financial, managerial or other
12 resource support from the post-merger SBC's core ILEC operations, which would consti-
13 tute an anticompetitive cross-subsidization of these out-of-region CLEC activities.

14 Unfortunately, and as I have noted above and in my earlier testimony, SBC's Mr. Kahan
15 has stated *explicitly* that the National-Local Strategy, which he claims cannot even be
16 pursued without the merger of SBC and Ameritech, depends critically upon its access to
17 the post-merger SBC's core home-region regulated operations for financial, managerial
18 and other resource support.

19
20 Managing a strategy of entering geographically-dispersed markets initially to serve a
21 relatively narrow base of customers requires a large, flexible pool of management
22 and employee skills if such entry is to be cost-effective. *A substantial base of*

23 58. CC Docket No. 98-141, *In the Matter of GTE Corporation, Transferor, and Bell*
24 *Atlantic Corporation, Transferee, For Consent to Transfer of Control*, Exhibit A, "BA/GTE
25 Public Interest Statement," at 6-7.

1 *current customers and revenues is necessary to maintain earnings growth and spread*
2 *risk while following customers into out-of-region local markets. ...*⁵⁹
3

4 If the post-merger SBC fails to deliver the promised competition, it will face penalties.
5 Under the FCC Staff's proposal, the Applicants *must* enter 30 new markets within 30
6 months. The requirement to enter one market per month places substantial pressure on the
7 Applicants and creates a corresponding pressure to divert home region resources and
8 synergies to the fulfillment of out-of-region commitments, which would represent an
9 express violation of § 7-204(b)(2)

10
11 Diversion of Ameritech Illinois capital, management and other resources to fuel SBC's
12 out-of-region entry program may also run counter to § 7-204(b)(1), which requires the
13 Commission to find that "the proposed reorganization will not diminish the utility's
14 ability to provide adequate, reliable, efficient, safe and least-cost public utility service."
15 And, as I have discussed earlier in response to the Commission's specific question, the
16 diversion of Ameritech Illinois resources — and the potential sacrifice of Ameritech
17 Illinois revenues — to support SBC's out-of-region entry clearly raises concerns with
18 respect to § 7-204(b)(7), which requires the Commission to find that "the proposed
19 reorganization is not likely to result in any adverse rate impacts on retail customers."
20 Thus, while fostering out-of-region entry is certainly a reasonable concern on the part of
21 the FCC Staff, unless these out-of-region CLEC ventures are profitable — and Mr. Kahan
22 has conceded that they won't be for many years⁶⁰ — the detrimental impact upon

23 59. Schmalensee/Taylor (SBC/Ameritech), FCC Affidavit, at ¶ 16, emphasis supplied.

24 60. Kahan (SBC), FCC Affidavit at ¶ 80.

1 Illinois ratepayers will almost certainly outweigh what are at best extremely indirect and
2 highly limited benefits.

3
4 Strict adherence to § 7-204(c) and 7-204(b)(3), which form the basis for the specific
5 merger savings allocation that I am recommending be adopted, will work to protect
6 Illinois consumers both from the potential for increased retail prices and the diversion of
7 excess Ameritech Illinois profits and other resources to support the National-Local out-of-
8 region entry affiliates. The potential adverse effects of the FCC Staff's proposed
9 conditions, as I understand them today, serve only to underscore the importance of
10 adopting an adequate allocation of merger savings for flow-through to Illinois consumers.

11
12 Q. Does this conclude your direct testimony on re-opening at this time?

13
14 A. Yes, it does.