BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Determination of Prices, Terms, and Conditions of Certain Unbundled Network Elements.	)))	Case No. TO-2001-438

SOUTHWESTERN BELL TELEPHONE COMPANY'S
APPLICATION FOR RECONSIDERATION AND/OR REHEARING

Southwestern Bell Telephone Company,[1] pursuant to 4 CSR 240-2.160, respectfully requests reconsideration and/or rehearing of the Missouri Public Service Commission's August 6, 2002 Report and Order.

INTRODUCTION

Southwestern Bell recognizes the extraordinary amount of time and effort the Commission has dedicated to this case. Certainly, the number of issues identified for resolution by the Commission was overwhelming and unprecedented in Missouri. Southwestern Bell recognizes that the scope of the issues is taxing to the Commission's resources.

Although the majority of the Commission's rulings in this case were adverse from its perspective, Southwestern Bell will not further contest in this proceeding the vast majority of the Commission's determinations as applied to the unbundled network elements ("UNEs") being examined in this case. Southwestern Bell reserves the right, however, to seek appropriate resolution of these issues in future proceedings, particularly where the decision indicates a misunderstanding of the evidence or indicates the Commission's desire for additional evidence.

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[1] Southwestern Bell Telephone, L.P., d/b/a Southwestern Bell Telephone Company, will be referred to in this pleading as "Southwestern Bell" or "SWBT."

While SWBT will not seek rehearing on the majority of the decisions in this case, there are four core decisions that so significantly affect the rates that they must be revised to ensure proper application of Total Element Long Run Incremental Cost ("TELRIC") principles. If these decisions are not revised, the rates established will be substantially below those required by a proper application of the TELRIC methodology. The Commission's findings on these issues represent either a radical and unexplained departure from prior Commission determinations in such areas, and/or a misapplication of applicable FCC rules. As such, these determinations are unlawful, unjust and unreasonable. With respect to these issues, which are outlined below, Southwestern Bell would respectfully request the Commission to reconsider the findings and conclusions it made or to grant rehearing so that these matters may be further explored and an appropriate and lawful resolution reached.

Southwestern Bell also recommends that future proceedings be conducted in such a way that issues are identified in a manner which does not prejudice a party, In this case, Southwestern Bell was substantially prejudiced by the Commission's decision to accept a proposed list of 356 detailed issues after the period for prefiling testimony had closed. This issues list, which was opposed by Staff, OPC and SWBT, was seen (in draft form) for the first time only two days before surrebuttal testimony was due, and there simply was insufficient time to ensure that each matter identified was appropriately addressed in prefiled testimony.

ISSUES FOR RECONSIDERATION AND/OR REHEARING

Issue 46 Should SWBT use the latest FCC-approved asset lives?

In its August 6, 2002 Report and Order, the Commission radically departed from its prior determinations in the depreciation area by ordering use of the FCC's prescribed depreciation lives and other parameters[2], and improperly disregarding the FCC's rules requiring the use of economic depreciation. FCC prescribed depreciation parameters are not forward-looking and do not purport to be; the parameters are based on a backward-looking approach that does not comply with TELRIC principles.

This new depreciation decision represents a complete about-face from the Commission's prior determinations in Case No. TO-97-40, in which it explicitly rejected the FCC's prescribed lives and instead adopted a set of economic asset lives specifically for use in Missouri TELRIC cost studies. As the summary from the Commission's Costing and Pricing Report in that case reflects, the Commission grounded these economic lives on an exhaustive and thorough analysis of forward-looking economic depreciation performed by its Staff:

> Depreciation Use the economic asset lives proposed by Staff These economic lives are based predominately upon bench-marking a composite of SWBT's proposed depreciation rates against implied depreciation rates of 19 likely competitors and other companies using similar technologies as SWBT. All the implied rates indicate a large range, SWBT's economic depreciation rates puts SWBT sixth for the lowest in the pool of 19 bench-marked companies and 28 implied depreciation rates.

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[2] August 7, 2002 Report and Order, pp. 36-37.

> Staff also recommends the use of MO-specific salvage values and the use of the Vintage Group (VG) method of depreciation recovery.[3]

And the Commission's firm rejection of AT&T's proposal to use FCC prescribed lives in that case[4] similarly rested on Staffs analysis that such rates did not reflect a forward-looking approach:

> Staff desires to caution the Commission from relying heavily, if at all, on the FCC's ranges to reach its decision in these depreciation matters based on how parameters underlying those ranges were determined. To derive the ranges, the FCC relied upon simple averages of the then approved parameters by all FCC regulated companies. The ranges were calculated by rounding to within one standard deviation plus and minus from the mean. From experience, Staff is aware that not all, and perhaps many, parameters the FCC used in its averages do not represent true plant mortality experience. Rather, those parameters are many times settled upon at triennial depreciation rate review meetings by the FCC Staff, PUC Staff, and company representatives for expediency, sometimes involving compromise, in order to reach mutual agreement.'

In its shift to the FCC's prescribed rates in this case, the Commission improperly focuses on the fact that "the FCC has continued to use those lives and parameters for its own purposes," and erroneously concludes that it can "be assumed that the FCC considers those depreciation lives and parameters to be reasonable."[6]

The Commission needs to be aware, however, that the FCC's use of prescribed lives has little bearing on Southwestern Bell's interstate access rates and no relationship to a proper

[3] See, Final Arbitration Order, Case No. TO-97-40 and TO-97-67, Issued July 3 1, 1997, Attachment C, Missouri Public Service Commission Costing and Pricing Report, p. 5, Summary of Staffs Proposed Modification to SWBT Cost Studies.

[4] The Commission recently reaffirmed this result both making the UNE rates determined in Case No. TO-97-40 the permanent rates for the M2A in Case No. TO-99-227 and in finding that those rates continued to be appropriate in the most recent AT&T Arbitration, Case No. TO-2001-455 (where AT&T's witness filed nearly the exact same testimony as in this case). Ex. 3, Naughton Surrebuttal, pp. 3-4.

[5] See, pp. 101-102 of the Costing and Pricing Report. which the Commission adopted in its July 3 1, 1997 Final Arbitration Order, quoted in Ex. 3, Naughton Surrebuttal, pp. 4-5.

[6] Report and Order, p. 36.

application of TELRIC. At the FCC, Southwestern Bell’s interstate access rates are not determined via an application of TELRIC principles, and the FCC does not prescribe depreciation rates based on TELRIC principles. In setting interstate rates, TELRIC is not the standard. And in fact, the FCC has not required states to use FCC prescribed depreciation lives in setting rates under Section 252 of the Act.[7]

Rather, in determining appropriate forward-looking economic cost under the TELRIC standard, the FCC stated, “the depreciation rates used in calculating forward-looking economic cost of elements shall be <u>economic</u> depreciation rates.“’ Most recently, in its Reply Brief filed at the U.S. Supreme Court in the TELRIC appeal, the FCC stated that it would defer to state commissions to “determine how best to adopt ‘specific depreciation rate adjustments that reflect expected asset values,’ including, where relevant ‘expected declines in the value of capital goods.“’ As is clear from its <u>Final Arbitration Order</u> in Case No. TO-97-40, the Commission did just that in setting Missouri-specific asset lives and other depreciation parameters.

However, in adopting a set of depreciation lives today that is longer than those previously adopted by the Commission five years ago, the Commission completely ignores all technological advancement in telecommunications equipment which drives such decreases in values. Technological obsolescence has shortened the useful life of telecommunications equipment such as circuit equipment and digital switches. Certainly, economic useful lives have not grown longer, as the Commission’s decision errantly presumes.

[7] Memorandum Opinion and Order, Joint Application by SBC Communications Inc., et al., for Provision of In-region, interLATA Services in Kansas and Oklahoma, CC Docket No. 00-217, FCC 01-29, ¶ 76 (rel. Jan 22, 2001).

[8] 47 C.F.R. Section 5 1.505(b)(3) (emphasis added).

In abruptly and without explanation shifting to the FCC's prescribed asset lives and other depreciation parameters in its August 6, 2002 Report and Order, the Commission unjustly and unreasonably departed from fundamental determinations it previously made and unlawfully ignored mandatory FCC rules regarding the application of the TELRIC methodology. The decision is unreasonable in that it is not based on substantial and competent evidence, and is arbitrary and capricious in departing from prior determinations that were based on thorough independent analysis without adequate explanation. The Commission's present ruling is without an adequate basis or explanation. Southwestern Bell would respectfully request the Commission to reconsider its requirement to now move to FCC prescribed asset lives and to instead reaffirm the continued appropriateness of economic lives as previously established by the Commission.

Issue 85 What target capital structure should be used for the UNE leasing business?

In adopting the book value capital structure proposed by Staffs outside consultant,[9] the Commission in its August 6, 2002 Report and Order, improperly disregarded the forward-looking mandates of the FCC's TELRIC rules. The resulting cost of capital of 10.32% is even lower than the 10.36% cost of capital the Commission set in Case No. TO-97-40. Clearly, ILECs bear much of the increased risk that has befallen the telecommunications sector in recent years. It is beyond reason for the Commission to adopt a cost of capital value reflecting lower (or even comparable) risk than the value approved in Case No. TO-97-40.

With respect to cost of capital, the FCC's TELRIC rules unequivocally require the use of a forward-looking methodology: "The forward-looking cost of capital shall be used in

[9] August 6, 2002 Report and Order, p. 69.

calculating the total element long-run incremental cost of an element.“” And the FCC’s rules explicitly state that embedded book values are not to be considered:

> Factors that may not be considered. The following factors shall not be considered in a calculation of the forward-looking economic cost of an element:
>
> (1) Embedded Costs. Embedded costs are the costs that the incumbent LEC incurred in the past and that are recorded in the incumbent LEC’s books of account.[11]

But that is exactly what the Commission did in adopting the 46% debt to 54% equity ratio proposed by Staffs outside consultant in this case:

> Staffs witness, Dr. Ben Johnson, testified that an appropriate capital structure for the hypothetical UNE wholesale provider could best be determined by using book value rather than market value for SBC’s equity. This has the advantage of measuring the value of the equity that has actually been invested in SBC’s telephone network rather than more recent market fluctuations. The use of a book value capital structure permits the approximation of a capital structure that more closely reflects the monopolistic wholesale provisioning of UNEs rather than the riskier business undertaken by telephone holding companies in the modem competitive environment. Using this method, Johnson arrived at a 46 percent debt to 54 percent equity ratio. The Commission concludes that the use of the 46 percent debt to 54 percent equity ratio advocated by Staff is appropriate.[12]

On its face, this capital structure determination is unlawful, unjust and unreasonable because it is rooted in embedded book value in violation of the FCC’s TELRIC rules. Moreover, the decision is unreasonable in that it is not based on substantial and competent evidence, and is arbitrary and capricious.

Consistent with the FCC’s TELRIC rules, Southwestern Bell cost of capital witness Dr. William Avera explained why use of embedded book value is inappropriate for determining the proper capital structure of companies in competitive markets. As Dr. Avera testified, capital is

[10] 47 C.F.R. Sec. 51.505(b)(2).

[11] 47 C.F.R. Sec. 51.505(d)(l).

[12] August 6, 2002 Report and Order, p. 69, internal citations omitted, and emphasis added.

raised in the market, where the value of a company’s equity is not tied to book value. Accordingly, he based Southwestern Bell’s 12.19% cost of capital on market-value capital structure weights of 86% equity and 14% debt, which is the average capital structure for a group of comparable LECs for which market data is available.[13]

Not surprisingly, the 12.19% weighted average cost of capital Dr. Avera proposes here is an increase from the 10.69% he supported for use in Southwestern Bell’s 1996 studies (which the Commission, based on an extensive analysis by Staff, reduced slightly to 10.36%).[14] That increase has been driven by increased risk and competition, which has been detailed in numerous investor reports and national investor publications such as “Standard & Poor’s,” and “Value Line”[15] and which is even clearer today.[16] As Dr. Avera explained, the transition to competition has greatly amplified the perceptions of risk already created by the profound technological and regulatory changes in the telecommunications industry. Investors have many choices when deploying their capital. When the risk and uncertainty of a business increase as dramatically as they have for LECs, then those services must offer returns commensurate with that risk. Otherwise, investors will move their capital elsewhere.”[17] Dr. Avera’s capital structure analysis is forward-looking and has appropriately taken investor’s perception of this risk into account.

Accepted legal and economic standards require that a regulated utility be allowed an opportunity to earn a return sufficient to fairly compensate capital investment, attract new capital,

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[13] Ex. 1, Avera Direct, Sch. 2, pp. 16-17, 21-22.

[14] See, Final Arbitration Order, Case No. TO-97-40, issued July 31, 1997, Attachment C, pp. 5, 90-96.

[15] Ex. 2, Avera Surrebuttal, pp. 23-25.

[16] For example, SBC’s ratings have recently come under watch by rating agencies, largely attributable to the effect of regulatory decisions. See, “Moody’s May Downgrade SBC’s Ratings,” by Christine Richard, Dow Jones Newswires, August 13, 2002.

[17] Ex. 1, Avera Direct, Sch. 2, p. 4.

and maintain financial integrity. These same standards apply to regulatory decisions on cost of capital in the environment mandated by the Act. As Dr. Avera testified, if the company is not allowed a return sufficient to attract investors -- who necessarily measure their investment in the company on market value -- the legal and economic standards will not be met. e r e the market value of company's equity differs significantly from its book value, the standards require the regulatory authority to base its cost-of-capital determination on the market value of the company's capital. [18]

Accordingly, Southwestern Bell would respectfully request the Commission to reconsider its adoption of the book value capital structure proposed by Staffs outside consultant and instead direct the use of a market value capital structure approach consistent with the FCC's TELRIC rules.

Issues 140 & 183 **Fiber Fill Factor**

The Commission inappropriately increased Southwestern Bell's fill factor for fiber interoffice facilities from 40% to 90%.[19] The higher fill factor could result in higher per line costs for CLECs seeking to lease the lines because increasing fiber utilization to 90% will have severe impacts on Southwestern Bell's ability to provision service and the cost of providing such service.

Operating at a 90% utilization would cause significant provisioning and maintenance issues because Southwestern Bell's fiber networks are currently engineered to have extra capacity for maintenance and provisioning purposes. If Southwestern Bell were to be required to move to

[18] Ex. 1, Avera Direct, Sch. 2, p. 5.

[19] August 6, 2002 Report and Order, p. 93.

a 90% utilization, it would no longer have an efficient level of spare fiber strands on hand to perform maintenance or provide timely provisioning of service.

Operating at a 90% utilization would also increase the provisioning intervals for service that require fiber facilities because the probability of receiving an order for service where there are no facilities available will greatly increase. As the FCC recognized, "[I]f a fill factor is set too high, the particular element will have insufficient capacity to accommodate anticipated increases in demand or service outages."[20]

It will also make certain UNEs unavailable to Southwestern Bell's wholesale CLEC customers. If Southwestern Bell is required to operate its facilities at a utilization level where there is not even enough capacity left in the network to perform maintenance, there certainly would be insufficient facilities available to provide service either to Southwestern Bell's retail or wholesale customers.

Operating at a 90% utilization would further increase the per fiber strand investment necessary for provisioning services that require fiber. The per strand investment will increase because a large portion of the cost of fiber is the manual cost of placing the cable and does not vary greatly by the number of fibers in the cable. If Southwestern Bell will only be able to recover approximately 10% extra fibers for each service order that it receives to maintain the high 90% utilization factor, there would be far fewer fibers placed per construction job. Forcing a firm to operate at a 90% utilization would increase fiber cost because the cables would no longer be efficiently sized to account for future growth.

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[20] Ex. 6, Schilling, Sur-rebuttal, p. 15, citing the Kansas/Oklahoma 271 Order at para. 78.

The Commission's determination requiring use of a 90% fill factor on interoffice fiber is unlawful, arbitrary and unreasonable. Accordingly, Southwestern Bell respectfully requests the Commission to reconsider its adoption of a 90% fiber fill factor and to instead adopt Southwestern Bell's proposed 40% fill factor which is an appropriate forward-looking fiber fill factor that provides reasonable and efficient capacity to accommodate maintenance needs and future demand for service.

Issue 305 **Fall Out Rate for Automated Systems**

The Commission inappropriately reduced fall out rates in Southwestern Bell's cost for automated systems to 2%. As reflected in the August 6, 2002 Report and Order, the Commission based this determination on the Joint Sponsors' claim that the fall out rate for UNE service orders should be similar to the fallout rate Southwestern Bell experiences with its Easy Access Sales Environment ("EASE") system,[21] which the Commission characterizes as "SWBT's most efficient ordering system."[22]

The Commission's reliance on the performance of Southwestern Bell's EASE system to determine fallout for UNE service orders is misplaced. First, none of the service order related TELRIC studies submitted in this proceeding use EASE. EASE is not used for the end-to-end service provisioning of UNEs either currently or on a forward-looking basis. CLECs place orders for UNEs through either the LEX system or the ED1 Gateway.[23]

Second, even on the retail side, automated ordering systems do not -- and on a forward-looking basis will not -- exist to handle the more complex orders like UNE orders that involve

[21] Ex. 27, Turner Rebuttal, p. 126-128.

[22] August 6, 2002 Report and Order, p. 142.

[23] Ex. 5, McNiel Surrebuttal, p. 3-5.

coordination and engineering with a mere 2% fallout rate. As the Commission is aware, EASE is a very sophisticated and mature ordering system that has been in use for many years. But it can only be used, both on the retail and wholesale side, for residential customers having fewer than five lines on a single order and business customers possessing no more than 30 lines. Those residential or business customer orders handled by EASE usually involve simple migration orders, new connects, disconnects, feature change activity, and suspend and restore orders. They do not involve the coordination and engineering necessary for complex services and UNEs.[24]

Third, if the Commission is not comfortable with the forward-looking fallout percentages Southwestern Bell has proposed, which are associated with its LEX and EDI ordering systems (the systems that CLECs actually use to place UNE service orders), it should look to Performance Measure ("PM") 13.1 as the appropriate benchmark for determining forward-looking fallout and flow through percentages.[25] As the Commission is aware, PM 13.1 (as well as the other PMs) were established on a collaborative basis between Southwestern Bell, the CLEC users of Southwestern Bell's ordering systems, and various state public utility commission staffs. And not only have these PMs received considerable scrutiny at the state level, they have been thoroughly examined by the FCC during various 271 proceedings. These PMs serve as the benchmark against which Southwestern Bell's future performance is measured and for which significant monetary penalties are assessed when the measures are not met.

The Commission's adoption of a much higher 2% standard, based on the performance of an unrelated system that handles unrelated activities, is unlawful, arbitrary and unreasonable. Accordingly, Southwestern Bell respectfully requests the Commission to reconsider its

[24] Id.

[25] Ex. 5, McNiel Surrebuttal, p. 4.

requirement to reduce the fallout rate for automated UNE orders to **2%,** and to instead adopt either Southwestern Bell's proposed forward-looking fallout rates or a rate based on the established performance measures that have been accepted both at the state and federal levels as the benchmark for future performance.

CONCLUSION

In this Application, Southwestern Bell is seeking reconsideration and/or rehearing on four core decisions concerning depreciation, cost of capital, fiber fill and fallout in the Commission's August 6, 2002 Report and Order that so significantly affect the rates set in this proceeding that these decisions need to be revised to ensure proper application of TELRIC principles. If these decisions are not revised, the rates established will be substantially below those required by a proper application of the TELRIC methodology, Southwestern Bell respectfully requests the Commission to reconsider these findings and conclusions on these issues, or to grant rehearing so that these matters may be further explored and an appropriate and lawful resolution reached.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing document were served to all parties on the Service List by e-mail or hand-delivery on August 15, 2002.

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