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
REPLY TO JOINT SPONSORS

Southwestern Bell Telephone Company,[1] respectfully submits this Reply to the August 26, 2002 Response filed by the Joint Sponsors to Southwestern Bell's Application for Reconsideration and/or Rehearing of the Missouri Public Service Commission's August 6, 2002 Report and Order.

In their Response to Southwestern Bell's Application, the Joint Sponsors generally claim, "there is no reason for any reconsideration or rehearing at this time."[2] To the contrary, however, the Commission's findings on the four core issues Southwestern Bell raised in its Application for Reconsideration and/or Rehearing[3] 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 remain substantially below those required by a proper application of the TELRIC methodology.

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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."

[2] E.g., see, Joint Sponsors' Response, pp. 1, 3, and 9.

[3] SWBT's Application for Reconsideration and/or Rehearing focused on Issue 46 (Should SWBT use the latest FCC-approved asset lives?); Issue 85 (What target capital structure should be used for the UNE leasing business?); Issues 140 & 183 (Fiber Fill Factor) and Issue 305 (Fall Out Rate for Automated Systems).

In its Application, Southwestern Bell set out in detail how the Commission's determinations on these four issues - - and particularly on the depreciation and cost of capital issues - - represent a very abrupt and unexplained departure from prior Commission determinations, and/or a misapplication of applicable FCC rules.

With respect to depreciation, the Commission previously recognized that the FCC's prescribed depreciation lives and other parameters were neither forward-looking nor developed for use in TELRIC studies. Consequently, 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.[4] The Commission's decision to now adopt the FCC's depreciation lives represents a complete and unexplained about-face from the Commission's prior determinations 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[5] and specifically state that embedded book values are <u>not</u> to be considered.[6] The 46% debt to 54% equity capital structure proposed by Staff's outside consultant, however, disregards these standards as it is rooted in embedded book value in

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[4] <u>See</u>, <u>Final Arbitration Order</u>, Case No. TO-97-40 and TO-97-67, Issued July 31, 1997, Attachment C, Missouri Public Service Commission Costing and Pricing Report, p. 5, Summary of Staff's Proposed Modification to SWBT Cost Studies.

[5] 47 C.F.R. Sec. 51.505(b)(2).

[6] 47 C.F.R. Sec. 51.505(d)(1).

violation of the FCC's TELRIC.[7] Adoption of this capital structure caused the resulting cost of capital (10.32%) to be even lower than the 10.36% cost of capital the Commission set in Case No. TO-97-40. Clearly, 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. The Joint Sponsors attempt to defend the capital structure adopted in this case, explaining that it represented the outside consultant's approximation of the capital structure of a hypothetical company solely engaged in the business of leasing UNEs to CLECs.[8] But even the Joint Sponsors recognized that simply using book value capital structure as a surrogate was inappropriate, as they developed their approximation of the target capital structure for this same hypothetical entity by taking the midpoint between the market value capital structure and book

[7] The August 6, 2002 Report and Order, p. 69, states:

> Staff's 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 modern 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. (emphasis added)

[8] Joint Sponsor's Response, p. 4.

value capital structure (which resulted in a 34.5% debt to 65.5% equity ratio).[9]

It is wholly inappropriate to utilize forward-looking technology and assumptions to reduce UNE rates, while at the same time using backward-looking analysis to reduce the cost of capital and deprecation costs to push UNE rates even lower. These determinations are unlawful, unjust and unreasonable and fully support the grant of reconsideration or rehearing so that these matters may be further explored and an appropriate and lawful resolution reached.

Respectfully submitted,

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[9] See, Ex. 29, Hirshleifer Rebuttal, pp. 4, 36-37.

CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing document were served to all parties on the Service List by e-mail on September 3, 2002.

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