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BELLSOUTH TELECOMMUNICATIONS, INC.

TESTIMONY OF WALTER S. REID

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NO.[redacted]-TP

AUGUST 12, 1996

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS, AND POSITION WITH BELLSOUTH TELECOMMUNICATIONS, INC.

A. My name is Walter S. Reid and my business address is 675 West Peachtree Street, Atlanta, Georgia. My position is Senior Director for the Finance Department of BellSouth Telecommunications, Inc. (hereinafter referred to as "BellSouth" or "the Company").

Q. BRIEFLY OUTLINE YOUR EDUCATIONAL BACKGROUND AND BUSINESS EXPERIENCE IN THE TELECOMMUNICATIONS INDUSTRY.

A. I received bachelor and master of science degrees in industrial engineering in 1969 and 1971, respectively, from the Georgia Institute of Technology. I was employed by BellSouth in November, 1971, as a management trainee in the Comptrollers Department in Jacksonville, Florida. Since that time, I have held various positions of increasing responsibility in the areas of budget and forecast preparation, cost accounting, separations, and regulatory matters. I was transferred to my current position at Company Headquarters in October, 1987. Overall, I have over 24 years experience dealing with the financial issues of the Company.

Q. WHAT ARE YOUR CURRENT RESPONSIBILITIES?

A. I am responsible for the preparation and analysis of the Company's financial results, the provision of accounting and cost information requested in proceedings before state regulatory commissions and the coordination of other regulatory activities.

Q. HAVE YOU TESTIFIED PREVIOUSLY REGARDING FINANCIAL ISSUES IN STATE REGULATORY PROCEEDINGS?

A. Yes. I have testified in numerous regulatory proceedings before this Commission, as well as the Commissions in Georgia, North Carolina, and South Carolina. Most recently, I testified in Georgia Docket No. 6352-U, "Petition of AT&T for the Commission to Establish Resale Rules, Rates, Terms and Conditions and the Initial Unbundling of Services". My testimony in that docket addressed an AT&T study used to support its proposed wholesale discount for total local service in Georgia.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. The purpose of my testimony in this proceeding is to address the appropriate methodology for use in determining BellSouth's retail costs which will be avoided when sales are made to resellers rather than to end user customers, and to present the study that calculates the appropriate wholesale discounts for the Company's Florida operations based on the determination of the costs that will be avoided. The study results for Florida are wholesale discounts of 19.0% for residential services and 12.2% for business services. A summary of BellSouth's study is included as Exhibit WSR-1 of my testimony.

In addition, my testimony will comment on the methodology used by AT&T in its "avoided retail cost study" for Florida. Details of AT&T's study are included as an attachment to AT&T's petition in this docket at Bates page numbers 700000 through 700248. This study calculates a wholesale discount for total local service in Florida equal to 41.7% based on "avoidable costs". AT&T also proposes additives to this wholesale discount that would further inflate the discount to 71.7% (AT&T petition at pages 22-24). This is an unreasonable result even before the additives are applied, and would certainly not allow BellSouth to recover its cost of providing the services which are being resold. Based on my review of AT&T's study presented in this docket, it is obvious that the mechanics of its "avoided retail cost model" are flawed, and that these flaws cause a significant overstatement of its proposed wholesale discount factor. The flaws in the mechanics of AT&T's model are inherent in its whole approach to the calculation of a wholesale discount factor and render its study unusable for determining wholesale prices in this proceeding.

Q. DOES YOUR TESTIMONY ADDRESS THE DIRECT TESTIMONY OF AT&T WITNESSES IN THIS PROCEEDING?

A. No. My testimony does not address the testimony which AT&T has filed subsequent to the filing of its petition. Responses to AT&T's testimony will be included in the Company's rebuttal testimony in this docket.

Q. HOW IS YOUR TESTIMONY ORGANIZED?

A. My testimony begins with an identification of the federal requirements included in the Telecommunications Act of 1996 (hereinafter referred to as "the Act") related to wholesale pricing. The subject of the testimony then focuses on the Company's methodology to fulfill the federal requirements and the computation of wholesale discounts specific to BellSouth's Florida operations. Finally, AT&T's proposed methodology for determining the wholesale discount is addressed.

FEDERAL REQUIREMENTS RELATED TO WHOLESALE PRICING

Q. WHAT DOES THE ACT REQUIRE AS IT RELATES TO THE DETERMINATION OF WHOLESALE RATES TO BE CHARGED BY BELLSOUTH?

A. Section 252(d)(3) of the Act under the caption, "WHOLESALE PRICES FOR TELECOMMUNICATIONS SERVICES", states:

"For the purposes of section 251(c)(4), a State commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier."

Q. DOES YOUR TESTIMONY ADDRESS THE RECENTLY ISSUED FEDERAL COMMUNICATIONS COMMISSION (FCC) RULES RELATED TO WHOLESALE PRICING?

A. No. The FCC's rules were not received in time to be incorporated into this testimony. Comments related to the impact of the FCC's rules will be included in subsequent testimony in this docket.

BELLSOUTH'S METHODOLOGY FOR DETERMINING WHOLESALE DISCOUNTS

Q. WHAT IS THE APPROPRIATE METHODOLOGY TO USE IN CALCULATING A WHOLESALE DISCOUNT?

A. The basic equation for calculating the discount is displayed on Exhibit WSR-2, page 1 of 2. The discount is based on the relationship between avoided costs and revenues and is calculated by dividing the 1995 costs that will be avoided by the amount of 1995 revenue subject to being discounted. Separate calculations are performed for residential service and business service. The result of applying this equation is that on average, for each residential customer that buys telecommunication service from a reseller, the costs that will be avoided as a percent of revenue equals a wholesale discount of 19.0%. Similarly, for business customers buying service from a reseller, the costs that will be avoided as a percent of revenue result in a wholesale discount of 12.2%. Using residential service as an example, if the customer consumes $20.00 (based on retail tariff rates) of local and toll services per month, then BellSouth will avoid $3.80 of costs on a monthly basis when the customer is served by a reseller. The Company would charge the reseller $16.20 ($20.00 less a discount of $3.80) for the same level of consumption of service for this customer.

Q. WHY DOES BELLSOUTH RECOMMEND SEPARATE DISCOUNTS FOR RESIDENCE AND BUSINESS RETAIL SERVICES IN DETERMINING WHOLESALE PRICES?

A. Because characteristics and levels of revenues and costs vary between residential and business customers, the Company is recommending two separate discounts. Inherent in the Company's methodology and application of the wholesale discounts is the assumption that residence or business customers that choose to go with a reseller will be average revenue customers for that class of service. To the extent that a reseller targets higher than average revenue customers, the monetary discount that the reseller will receive will logically exceed the costs that will be avoided by BellSouth.

An example of the calculations will demonstrate the impact that the loss of customers with differing average levels of monthly revenue will have on the Company. Assume a situation in which the Company would avoid approximately $3.45 in average retail costs for residential customers and the average monthly bill for residential customers is $18 per customer. Based on this information, the residential wholesale discount would be 19% (i.e., \$3.45/\$18). Also, assume that the Company will avoid approximately \$5.20 in average retail costs for business customers and the average monthly bill for business customers is \$42.75. Based on this information, the business wholesale discount would be approximately 12.2% (i.e., \$5.20/\$42.75). If residential customers represented 70% of total customers and business customers represented 30%, the composite discount for total customers would be 17% (i.e., 70% x 19% plus 30% x 12.2%). However, the use of the composite discount would give inappropriate results, because in the case of a business customer, the Company would give the reseller a discount of \$7.27 (i.e., the average monthly bill of \$42.75 times the wholesale discount of 17%), but the Company would only avoid \$5.20 of costs. Thus, in this example the Company would lose \$2.07 on a net basis from the resale transaction.

This effect is also present for customers within the residence and business categories who have different average monthly bills, but the Company has only addressed the disparity at the total residence and total business level. If resellers target high revenue customers within the residence and business categories, a likely scenario, then the Company's calculated wholesale discounts will generate more monetary discount for the reseller than the costs that will be avoided by the Company.

Q. HOW DID THE COMPANY DETERMINE WHICH RETAIL COSTS WILL BE AVOIDED WHEN THE COMPANY PROVIDES SERVICES ON A WHOLESALE BASIS?

A. To determine the costs that will be avoided, the Company analyzed the work functions that are currently being performed to provide retail services to the Company's customers. The Company has an internal accounting system that identifies the major work functions of the business and tracks the costs associated with various work functions being performed. The information from this system is used both for management of the business, as well as for input to the system that assigns costs between regulated and non-regulated operations. The Company analyzed each of its work functions for the categories of expense that would be impacted by a wholesale situation and identified, using 1995 Florida operating data, the level of expense for each work function that will be avoided with resale. A graphic representation of the approach is given on Exhibit WSR-2, page 2 of 2.

Q. PLEASE DESCRIBE THE NATURE OF THE COSTS THAT WILL BE AVOIDED.

A. The costs that will be avoided are included in the expense categories for customer services, billing, sales, uncollectibles, and advertising. These costs are volume sensitive amounts that are associated with the provision of regulated residential or business retail services. Further, the avoided costs are associated with work functions that directly relate to interaction between the Company and the customer, an interaction which will normally not occur under resale. For example, it is assumed that the Company will not mail a bill to customers of local service resellers and therefore, the costs of postage, paper, printing, labor, etc., associated with the customer billing work functions are identified as avoided costs for that customer.

If, however, the customer subscribes to any service from BellSouth, such as intraLATA toll, in addition to subscribing to service from a reseller, the avoided costs identified for billing are overstated because the interaction with the customer represented by the bill would not be avoided. In addition, to the extent billing costs are incurred to prepare the bill for the reseller, the amount of avoided billing costs and the wholesale discount are both overstated.

Q. HOW DID THE COMPANY DETERMINE THE AMOUNT OF CUSTOMER SERVICES COSTS THAT WILL BE AVOIDED?

A. The costs associated with customer services are recorded in Account 6623 under the FCC's Uniform System of Accounts ("USOA"). The Company's internal accounting system identifies and tracks the costs for numerous work functions which underlie the total charges to this account. The study examined the nature of each of these work functions in order to determine whether or not that function would continue to be performed for the customer under resale. The functions that will not be performed for the resold accounts include remittance operations, service representative training, service order entry, collections, account inquiry, demand sales, address information, and customer payment operations. Many functions in Account 6623 will continue to be performed for the resold accounts. Therefore, the costs associated with those functions will not be avoided. These functions include, for example, local and toll message processing, accounts operations, message investigation, support and indirect supervision.

Q. WHAT ARE THE BILLING COSTS THAT WILL BE AVOIDED?

A. The costs for billing are also recorded in Account 6623. The only billing costs that will be avoided due to resale are the costs associated with printing and mailing a bill to the customer. These costs are captured in a unique job function code underlying the charges to Account 6623. The Company will still be maintaining a customer record for each customer served by a reseller. BellSouth will record and maintain usage and service characteristics of each customer so that it can render a bill to the reseller. While the Company will incur an additional cost in sorting, printing and mailing the customer bill information to the reseller, the Company did not include costs for this additional work in its study.

Q. WHAT ARE THE SALES EXPENSES THAT WILL BE AVOIDED?

A. The Company's sales expenses are recorded in Account 6612. The Company's study assumes sales expenses for customers that choose to buy service from a reseller will not be incurred. In this regard, the Company identified all regulated residential and business sales expenses in Account 6612 as avoided costs.

Q. DID THE COMPANY IDENTIFY ANY PRODUCT MANAGEMENT OR ADVERTISING COSTS AS AVOIDED COSTS?

A. The Company identified some advertising costs associated with bill inserts as an avoided cost. Because the Company will not be sending the customer of the reseller a bill, it follows that this type of advertising will also be avoided. Product management and advertising costs, other than through bill inserts, will not be avoided however, because these costs are not volume sensitive. The level of these costs is not dependent on whether an individual customer obtains service from a reseller or from BellSouth.

The activities associated with product management span functions that include research and development, product introduction, tariff application, methods and procedures, and product delivery. The level of costs associated with these functions is not sensitive to whether or not the services will be resold. In addition, product advertising costs, which are associated with individual products or families of products, are not sensitive to the volume of customers and will not decrease with customer migration to resellers. Therefore, these costs do not represent avoided costs, and it would be inappropriate to include them in the calculation of the wholesale discount.

Q. HOW DID THE COMPANY TREAT UNCOLLECTIBLES IN ITS STUDY?

A. For purposes of this study, the Company assumed that uncollectibles from customers who buy from resellers will be avoided by BellSouth. The reseller is responsible for absorbing any bad debt on the part of its customers. If BellSouth experiences reseller related uncollectibles, then it may be appropriate to reduce the level of avoided costs by the amount of reseller uncollectibles and decrease the wholesale discount.

COMMENTS RELATED TO AT&T'S PROPOSED WHOLESALE DISCOUNT

Q. PLEASE DESCRIBE YOUR UNDERSTANDING OF THE FINANCIAL MECHANICS OF AT&T'S STUDY.

A. According to AT&T's petition in this docket, AT&T's study utilized, as a data source, the 1995 booked revenues and expenses/costs data for the Company's

Florida operations. This data was obtained by AT&T from certain Automated Report Management Information System (ARMIS) reports filed by BellSouth with the FCC. AT&T then used its own methodologies to assign these Company revenues and expenses/costs to various product categories. Based on the amounts which it allocated to selected product categories, AT&T derived amounts it attributes to BellSouth's total local exchange service revenues and costs for its Florida operations.

It is obvious from the reported results of AT&T's study that a substantial portion of the costs that AT&T is attributing to BellSouth's local business operations are not covered by the revenue streams the Company is receiving from all local tariff rates. A comparison of the total local expenses/costs of $2,198,378,000 shown on Bates page 700111 of AT&T's study with the local revenues of $1,495,388,000 shown on Bates page 700110 results in a revenue shortfall for BellSouth of approximately $703 million. I will explain later in my testimony how AT&T's study results distort the calculation of a wholesale discount factor.

The next step in AT&T's approach was to attempt to identify, through arbitrary assignments, components of local exchange service expenses/costs which it characterized as the "avoided retail amount". AT&T then calculated its proposed wholesale discount factor based on the relationship between its totals for the avoided retail amount and local revenues.

Q. WHAT ARE THE MAJOR FLAWS YOU SEE IN THE MECHANICS OF AT&T'S AVOIDED RETAIL COST STUDY?

A. AT&T's approach for the calculation of a wholesale discount factor overstates the calculated discount in at least three broad areas. The first area of overstatement is caused by the procedures AT&T used to assign amounts for expenses/costs to local exchange service. These amounts are reflected under the column heading "Total Local BU" (business unit) on Bates pages 700110 and 700111 of AT&T's study. The second area of overstatement is caused by AT&T's arbitrary identification of avoided retail costs. The third area of overstatement is caused by the limited revenue base (AT&T's revenue base does not include intraLATA toll revenue) which AT&T uses to divide into the avoided costs from its study.

Q. PLEASE ELABORATE ON THE FIRST BROAD AREA OF OVERSTATEMENT OF THE DISCOUNT FACTOR WHICH YOU HAVE IDENTIFIED.

A. The nature of the first overstatement problem can be demonstrated by referring to the data in the first column (headed "Total Local BU") of AT&T's study at Bates page 700111. The total local service expense which AT&T identifies in this column is $2,198,378,000. In addition to these local expenses, AT&T identified local net other interest deductions of $21,426,000, income taxes of $156,257,000 and local return requirements of $435,243,000. Based on these local expense/cost assignments, one can calculate that local revenues should be $2,811,304,000 (the sum of each of the amounts previously described) in order to cover all local expenses/costs including a return on assets. This is not the revenue amount which AT&T assigns to local service, however. As shown on the first line of Bates page 700110 AT&T has only attributed $1,495,388,000 to local service revenues.

Because AT&T is arbitrarily assigning amounts to avoidable expenses/costs from a potential allocable pool of expenses/costs of $2,811,304,000 and then dividing by revenues of only $1,495,388,000, it is obvious that the resulting discount factor will be significantly inflated. Another way to demonstrate this problem is to compute the percent of non-avoided local expenses to total local revenues from AT&T's study. This can be computed by subtracting AT&T's total avoided retail expenses/costs of $624,305,000 from its total local expenses/costs of $2,811,304,000 and dividing this result by their local revenues of $1,495,388,000. This computation indicates that the non-avoided local costs from AT&T's study are 146.3% of the total local revenues.

Based on AT&T's model, the discount factor could even exceed 100% if the avoidable local expenses/costs amounted to 53.2% or greater of total local expense/cost. Stated another way, using the AT&T model, if one calculated that

BellSouth could avoid 90% of its retail local costs in a wholesale transaction, the resulting wholesale discount factor would be 169% of the tariff rate (i.e., the Company would have to pay AT&T 69% of the tariff rates in a resale situation). This is an unreasonable result, demonstrating the inherent bias in AT&T's approach.

Q. ARE THERE OTHER INDICATIONS THAT THE AT&T ANALYSIS IS UNRELIABLE?

A. Yes. Even a cursory review of AT&T's assignment of expenses to the local business unit raises serious doubts about the reliability of its cost assignments. For instance, a category of expense for directory assistance services assigned by AT&T to the local business unit reflects a total, $55,640,000, which equals the entire amount of both interstate and intrastate directory assistance (DA) expense and intercept expense reported by the Company to the FCC on ARMIS Report 43-04 for 1995. There is no logical justification why all of this expense would be assigned to local service. Certainly, a portion of these expenditures are related to the toll and access services provided by the Company. In fact, the Company reported on the ARMIS Report 43-04 that the FCC's Part 36 and Part 69 Rules would assign over $6 million of directory assistance expense to the interstate information element of access expense. AT&T's methodology obviously reassigns this expense to the local service category, with no explanation. In addition, the Company collects over $2 million in intrastate directory assistance revenues related to intrastate toll calls in Florida. AT&T has treated all of the directory expenses as local and has ignored the fact that current cost assignments and revenue recoveries treat some of this directory assistance expense as access or toll. AT&T's treatment of this expense demonstrably shows the overstatement bias inherent in its proposed discount factor. By overstating expense categories that it has treated as 100% avoided, AT&T distorts the resulting relationship between avoided expense and local revenues.

Regarding the treatment of uncollectible expense, AT&T has assigned $41,943,000, or approximately 95%, of the Company's total intrastate regulated uncollectible expense of $44,272,000 (ARMIS Report 43-04, page 17.1 of 30.3) to the local category. AT&T then treats 100% of this local uncollectible amount as an avoided cost. This is not a reasonable calculation. AT&T claims that local revenues are $1,495,388,000, which is approximately 59% of total intrastate revenue. Even if intrastate access revenue is excluded from total intrastate revenue, AT&T's local revenue amount is only about 67% of total intrastate revenue. These relationships certainly call into question a 95% assignment of uncollectibles to local.

In another category of expense, marketing, AT&T's assignment of approximately $110.5 million of the Company's product management, sales, and advertising expenses to the local business unit exceeds the amount of $96.3 million reported by the Company on the ARMIS Report 43-04 for the total intrastate jurisdiction by approximately $14 million. This is not a reasonable result and is further evidence that the AT&T analysis of "avoidable" retail costs is flawed and should not be relied upon in this proceeding.

AT&T's cost assignments also do not meet overall reasonableness tests. The total amount of 1995 local exchange service expenses/costs which AT&T identified in its study, $2,811,304,000, exceeds the total intrastate revenues BellSouth reported for 1995 (see BellSouth's 1995 Surveillance Report) from all sources (local, toll, access and miscellaneous), by over $268 million. This test indicates that AT&T's cost assignments to local service are unreasonable.

Q. WHAT ARE YOUR COMMENTS RELATIVE TO YOUR SECOND AREA OF CONCERN, AT&T'S ASSIGNMENT OF LOCAL EXPENSES/COSTS TO ITS TOTAL AVOIDED RETAIL AMOUNT?

A. My second area of concern with the AT&T study is with the arbitrary and unreasonable approach they used in identifying avoided retail amounts. In one category of expense, Product Management, AT&T treated 100% of this expense as avoided. Product Management expense, per the USOA, includes costs incurred in performing administrative activities related to marketing products and services. This includes competitive analysis, product and service identification and specification, test market planning, demand forecasting, product life cycle analysis, pricing analysis, and identification and establishment of distribution channels. The nature of this expense is not volume sensitive. Therefore, resale of some quantity of the Company's services should not result in avoided product management expenses. In fact, resellers will just be one of the distribution channels considered in the management of the service. In addition resellers will benefit due to the fact that the Company is offering a particular service because they will be able to resell it to their customers. It is unreasonable to treat this expense as avoided.

In another category of expense, which AT&T entitled G&A (General & Administrative), it arbitrarily allocated 27.5% of the amount they assigned to local expenses to the total avoided retail amount even though the nature of these expenses is such that the Company does not expect to see reductions due to resale. For example, 24% of the total G&A expense category is related to Account 6724, Information Management expense. Account 6724 includes costs incurred in planning, developing, testing, implementing and maintaining data bases and application systems for general purpose computers. The Company has not identified any data bases or application systems that it will eliminate due to the existence of resellers. In fact it is more likely that enhancements or new systems will have to be developed to meet the special needs of resellers. AT&T's

arbitrary approach treats 27.5% of this expense as avoided, however. These are just a few examples of the unreasonable components in AT&T's study.

Q. PLEASE EXPLAIN YOUR THIRD AREA OF CONCERN WITH THE AT&T STUDY.

A. In AT&T's study, the revenue base they utilized in Florida to divide into identified avoided costs was limited to basic local revenues including local vertical services. In BellSouth's study, the Company included both local and intraLATA toll revenues in the revenue base, because some costs such as billing costs, are shared among customer services and will not be avoided unless the entire customer contact is broken. AT&T's approach raises many problems, all of which seem to result in an overstated discount factor. For instance, as I have previously pointed out, AT&T's assignment of cost to local service far exceeds the local revenues identified. This means, inherently, that it is attributing heavy amounts of contribution to cover local costs from other services, including intraLATA toll. When, under AT&T's approach, a BellSouth customer switches to AT&T under resale, if AT&T also displaces BellSouth as that customer's intraLATA toll provider, the Company loses twice and AT&T wins twice. Using AT&T's discount calculation, BellSouth would give AT&T a local discount that includes costs that are actually being recovered through intraLATA toll revenues.

Then, as a second bite, AT&T would take away the intraLATA toll revenues that were providing the contribution toward local costs.

Q. WHAT IS YOUR OVERALL OPINION OF AT&T'S ANALYSIS?

A. My testimony highlights only a few of the more glaring flaws in AT&T's analysis. I believe these flaws demonstrate that the analysis is so biased and illogical as to render it unusable for this proceeding. Based on the amount of expense, income tax, and return requirements that AT&T has assigned to local exchange service in Florida, it would take more than the total intrastate revenues (local, toll, access and miscellaneous) to cover these identified expense and cost requirements. The relationship which AT&T develops between the portion of these expenses and costs that AT&T portrays as avoided and the local service revenues it has identified is unreasonable. Therefore, AT&T's request for a 41.7% wholesale discount factor should be rejected.

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. BellSouth's methodology for calculating wholesale discounts for residence and business services is a reasonable approach which meets the federal requirements of the act. The study is generous to resellers in at least three areas: 1) the study does not include increases in cost that the Company may incur to serve resellers;

2) the study does not include any uncollectibles related to resellers; 3) the study assumes that resellers will serve average revenue customers even though it is likely that high revenue customers will be targeted. AT&T's study which was included in their petition is demonstrably biased, arbitrary and unusable for this proceeding.

Q. DOES THIS COMPLETE YOUR TESTIMONY?

A. Yes.