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March 3, 1998

Mrs. Blanca S. Bayo
Director, Division of Records and Reporting
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, Florida 32399

RE: Docket Nos. 960833-TP/960846-TP/960757-TP (Cost Dockets)

Dear Ms. Bayo:

Enclosed is an original and fifteen copies of BellSouth Telecommunications, Inc.'s Brief of the Evidence, which we ask that you file in the captioned matter.

A copy of this letter is enclosed. Please mark it to indicate that the original was filed and return the copy to me. Copies have been served on the parties shown on the attached Certificate of Service.

Sincerely,

Nancy B. White (KR)

Nancy B. White

- ACK
- AFA
- APP
- CAF
- CMU
- CTR
- EAG
- LEG
- LIN
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- RCH
- SEC
- WAS
- OTH

Enclosures

cc: All Parties of Record
A. M. Lombardo
R. G. Beatty
W. J. Ellenberg

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CERTIFICATE OF SERVICE
DOCKET NOS. 960833-TP, 960846-TP and 960757-TP

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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Petitions by AT&T)
 Communications of the Southern)
 States, Inc., and MCI)
 Telecommunications Corporation,)
 MCI Metro Access Transmission)
 Services, Inc., for arbitration)
 of certain terms and conditions)
 of a proposed agreement with)
 BellSouth Telecommunications,)
 Inc. concerning interconnection)
 and resale under the)
 Telecommunications Act of 1996)
)
 In the matter of)
)
 MFS Communications Company, Inc.)
)
 Petition for Arbitration Pursuant)
 to 47 U.S.C. § 252(b) of)
 Interconnection Rates, Terms, and)
 Conditions with BellSouth)
 Telecommunications, Inc.)
)
)

Docket No. 960833-TP

Docket No. 960846-TP

Docket No. 960757-TP

Filed: March 3, 1997

BELLSOUTH TELECOMMUNICATIONS, INC.'S BRIEF OF THE EVIDENCE

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STATEMENT OF THE CASE

Following the passage of the Telecommunications Act of 1996, 47 U.S.C. § 251, *et seq.* ("the Act"), BellSouth negotiated in good faith with a number of potential local service providers. Many of those negotiations were successfully concluded with the signing of interconnection agreements between the parties. For AT&T, MCI, and MFS (collectively referred to as "Petitioners"), the negotiations resulted in petitions for arbitration. In these proceedings, the Commission arbitrated issues between BellSouth and these companies and issued orders requiring that prices for UNEs and interconnection to be based on BellSouth's Total Service Long Run Incremental Cost ("TSLRIC") studies.

The Commission set permanent rates for most UNEs, except for those functions for which BellSouth did not provide a TSLRIC study. In those instances, the Commission set interim rates based on either the Hatfield study results with modifications or on BellSouth's tariff. The Commission found that TSLRIC is the "appropriate costing methodology" and ordered BellSouth to file TSLRIC cost studies for those rates for which interim rates were set. (December 31, 1996 Final Order on Arbitration for consolidated Docket Nos. 960833-TP (AT&T), 960846-TP (MCI) 960916-TP (ACSI), at page 33.

On November 13, 1997, BellSouth filed TSLRIC studies, reflecting updated information, as well as TSLRIC plus shared and common costs, for the provision of physical and virtual collocation, and for the following unbundled network elements:

- (a) Network Interface device (NID);
- (b) 2-Wire/4-Wire Loop distribution;
- (c) Directory Assistance;
- (d) Dedicated transport (Nonrecurring only);
- (e) 4-Wire analog port;
- (f) 2-Wire ADSL - compatible loop; and
- (g) 2-Wire/4-Wire HDSL - compatible loop.

In addition, BellSouth filed the residual recovery requirement ("RRR") for items (e), (f), and (g). BellSouth has proposed prices for the unbundled network elements based on these costs. BellSouth believes its proposal for pricing the various unbundled elements is consistent with the Act, with Florida Statutes, and with previous decisions by this Commission.¹

The Commission conducted formal hearings in this matter January 26-28, 1998. BellSouth presented the testimony of Alphonso Varner, Daonne Caldwell and William Zarakas, Eno Landry, Walter Reid, Daniel Baeza, David Garfield, Ellis Smith, Dorissa Redmond, David Cunningham, and Dr. Randall Billingsley. The hearing produced a transcript of 1,785 pages and 62 exhibits.

This Brief of the Evidence is submitted in accordance with the post-hearing procedures of Rule 25-22.056, Florida Administrative Code. A summary of BellSouth's position on the issues to be resolved in this docket is set forth in the following pages and marked with an asterisk.

STATEMENT OF BASIC POSITION

Based on the evidence presented at the hearing, the Commission should adopt BellSouth's recommended rates for the unbundled network elements ("UNEs") that are the subject of this proceeding. The rates proposed by BellSouth derived from its cost studies comply with all the requirements of the 1996 Act. Specifically, BellSouth's proposed rates are "just and reasonable," are "based on cost," and are "nondiscriminatory." These rates, and the cost studies upon which they are based, recognize the actual costs BellSouth is expected

¹ On December 9, 1997, BellSouth filed a motion for leave to file revised testimony and exhibits to reflect two revisions to BellSouth's cost studies. These revisions were made in light of questions raised in hearings in a cost proceeding in Tennessee the week of November 16, 1997.

to incur in providing service on a going-forward basis. Such rates will fairly and adequately compensate BellSouth for the services, functions, and facilities it is required to provide to ALECs, while facilitating competition in the local exchange market in Florida.

STATEMENT OF POSITION ON THE ISSUES

Issue 1: What are the appropriate permanent recurring and nonrecurring rates for collocation and the following unbundled network elements?

****Position**: BellSouth proposes that prices that cover total cost be set for the following elements: (a) Network Interface Device, (b) 2-Wire/4-Wire loop distribution (c) Virtual collocation, (d) Physical collocation, (e) Directory Assistance, (f) Dedicated transport (g) 4-Wire analog port, (h) 2-Wire ADSL Compatible loop (i) 2-Wire and 4-wire HDSL Compatible loop. The rates for these UNEs and collocation should be set at the rates proposed by BellSouth on Exhibit AJV-1 to the Direct Testimony of A. Varner (Hearing Exhibit 9).

Given the number and complexity of the issues involved, BellSouth will not attempt to address every issue raised by the testimony and evidence submitted at the hearing. Rather, this Brief has three primary purposes: (1) it will outline the pertinent legal standards and discuss how the prices proposed by BellSouth are consistent with those standards; (2) it will explain the sound public policy reasons for establishing BellSouth's prices based on the costs BellSouth is expected to incur in providing service in Florida; and (3) it will identify some of the key substantive issues in this proceeding and demonstrate why BellSouth's position on these issues should be adopted.

The need for interconnection, unbundling and collocation rates results from the decision to open the local telecommunications markets to competition. In order to facilitate

the transition to local competition, the 1996 Act, 47 U.S.C. § 251, *et seq.*, establishes several means by which an Alternative Local Exchange Carrier (“ALEC”) can make use of BellSouth’s network in order to provide local telephone service. First, an ALEC can elect to purchase BellSouth’s services at wholesale rates and resell them at retail.² Second, an ALEC can purchase UNEs from BellSouth and combine them with its own network elements or with other elements purchased from BellSouth in order to provide service. Finally, an ALEC can build its own facilities-based network and interconnect with BellSouth’s network.

The primary purpose of this docket is to set the prices for certain UNEs and for collocation (which occurs when an ALEC shares space with BellSouth in order to provide services). There are serious repercussions that will flow from setting prices that are artificially high as well as setting prices that are artificially low. This Commission’s task is to strike the right balance.

The disparity in the prices proposed by the parties is the result of fundamentally different approaches in this case. BellSouth’s goal in this proceeding is to have prices established that will fairly and adequately compensate BellSouth for the services, functions and facilities that it is required to provide to ALECs and that will facilitate competition in the future. BellSouth has submitted detailed cost studies that document the costs it estimates that it will actually incur to provide network elements, interconnection, and collocation on a forward-looking basis. In preparing its studies, BellSouth has not ignored the network it has in place, but has modified it as appropriate to reflect least cost technology on a going forward basis.

² The Commission set the wholesale rate for these resold services in Order No. 96-1579, in which it directed BellSouth to provide services for resale at a discount of 21.83% (business) and 16.81% (residence) off of current tariffed retail rates.

Petitioners, on the other hand, seek to compel BellSouth to provide service below its cost so that BellSouth subsidizes ALEC entry into the local exchange market in Florida. To that end, the Petitioners have submitted cost studies that bear no relationship to BellSouth's existing network, forward looking or otherwise. For example, the Collocation Model used by AT&T and MCI assumes a hypothetical central office building that they propose be used to determine the costs that BellSouth will incur when providing collocation to ALECs. Of course, the collocation of the ALECs will take place in BellSouth's actual central offices, not in the hypothetical offices conjured up by AT&T and MCI. AT&T and MCI do not pretend otherwise. It is obvious that the only purpose for the hypothetical central office is to persuade this Commission to set low rates for collocation.

Adopting a cost methodology that ignores the actual costs BellSouth is expected to incur in providing service with its real network, in favor of a hypothetical one, also would adversely affect Florida consumers. Although the Petitioners' consistent theme in this case is that the lower the rates ALECs pay for UNEs and collocation, the better off everyone will be, there is no basis for believing any reductions associated with artificially low prices for UNEs and collocation will be passed on to the ALEC's customers and every reason to believe otherwise. This Commission does not dictate the ALECs' end user rates. The most likely scenario is that ALECs will price their retail services at or slightly below BellSouth's existing rates and simply pocket the difference in an attempt to increase their profit margins.³

Furthermore, setting rates for UNEs and collocation that are below BellSouth's costs of providing service on a going forward basis is unsound as a matter of public policy because

³ Indeed, ALEC tariffs typically concur with or mirror -- that is, are identical to -- BellSouth's existing retail rates. Therefore, the steeper the discount offered to ALECs, the steeper the profits to ALECs and their shareholders. Thus, the long sought-after benefits to consumers may not materialize under the Petitioners' pricing proposal.

it would: (1) provide an unwarranted subsidy to BellSouth's competitors; (2) destroy an incentive for facilities-based competition; and (3) impose unwarranted business risks on BellSouth without offering any corresponding compensation. All of these factors weigh in favor of setting rates for collocation and UNEs that fairly compensate BellSouth for the reasonable costs it will actually incur in providing service to ALECs. This is consistent with the Commission's duty to ensure just and reasonable rates.

ARGUMENT

A. BellSouth's Cost Studies Comply With All Applicable Legal Standards.

BellSouth submitted cost studies for physical and virtual collocation and for the following unbundled network elements:

- (a) Network Interface device (NID);
- (b) 2-Wire/4-Wire Loop distribution;
- (c) Directory Assistance;
- (d) Dedicated transport (Nonrecurring only);
- (e) 4-Wire analog port;
- (f) 2-Wire ADSL - compatible loop; and
- (g) 2-Wire/4-Wire HDSL - compatible loop.

(Tr. p. 300).

As explained by Ms. Caldwell and Mr. Zarakas, BellSouth presented the Commission with the results of both TSLRIC and TELRIC studies. (Tr. p. 301). The TELRIC results are the same as the TSLRIC results, except that TELRIC results include a contribution toward shared and common costs. (Tr. p. 301). Thus, although the Commission literally required BellSouth to file only TSLRIC studies in this proceeding, the TELRIC results must be considered if the Commission believes, as it said in the Final Arbitration Order, that rates should "provide some contribution toward joint and common costs." (Tr. p. 301-302).

BellSouth's costs studies were Florida specific, forward-looking, and based on the

long run costs that BellSouth -- not a hypothetical proxy company -- would expect to incur in providing interconnection and network elements using the least cost, most efficient technology currently available. (Tr. p. 360). BellSouth modeled the network elements and used inputs from: (1) a BellSouth-developed Loop Model, to identify the specific characteristics of an average loop in Florida; (2) the Switching Cost Information System ("SCIS") model developed by Bell Communications Research, Inc. ("Bellcore") to establish switching costs; and (3) three specialized price calculators -- the SONET Price Calculator, the Loop Multiplexer Price Calculator, and the DLC Price Calculator. (Tr. pp. 317-18. The inputs from the various sources were used by BellSouth's TELRIC calculator to compute the cost of the UNEs. The cost studies that BellSouth has submitted are based on the theory that costs should be long run, forward looking, reflect least cost, efficient technologies, and include directly attributable costs which are determined based on cost causation (Tr. pp. 365-66).

1. The Telecommunications Act of 1996

Section 251(c) of the 1996 Act imposes certain obligations on ILECs, including the obligation to provide: (1) interconnection with the ILEC's network; (2) access to unbundled elements of the ILEC's network, and (3) collocated space in the ILEC's premises (where available) where the ALEC can locate its equipment. Section 251 does not impose any pricing rules for these services other than the requirement that the rates be just, reasonable and non-discriminatory.

The pricing rules for unbundled network elements are contained in Section 252(d) of the 1996 Act. Several important points can be gleaned from this provision. First, the cost-based pricing rules apply to UNEs, but there is no mandate that collocation be provided on

cost-based rates. Second, although this provision mandates cost-based rates, the provision does not mandate any specific pricing methodology. Finally, the statement in Section 252(d)(1)(B) that prices “may include a reasonable profit” indicates that, at a minimum, Congress contemplated that prices would at least cover the actual costs of the incumbent’s network; if that were not the case, there would be no reason for the reasonable profit opportunity to exist.

There is no merit to the Petitioners’ argument that BellSouth’s cost studies run afoul of Section 252(d)(1)(A)(ii) because the studies do not totally ignore BellSouth’s existing network. (*See, e.g.*, Tr. pp. 1716-20). Section 252(d)(1)(A)(ii) prohibits certain ratemaking methods, *i.e.*, traditional rate-of-return or rate based proceedings. However, contrary to the Petitioners’ arguments, the parenthetical phrase in Section 252(d)(1)(A)(ii) does not prohibit consideration of a company’s actual or embedded costs. Even if such costs were considered in past rate-of-return proceedings, these costs were not products of such proceedings. Although Petitioners would have this Commission believe that any historical data that existed at the time of rate-of-return regulation is somehow “tainted” and can never be referred to again, nothing in the 1996 Act supports such a contention.

Under traditional rate-of-return regulation, revenue requirements were established based on the utility’s overall operations; costs were not determined service by service. Therefore, when implementing rates, the Commission had great latitude in rate design and sometimes set rates for some services below cost, while allowing the telephone company to make up for this by pricing other services above cost. This form of traditional ratemaking created a system of implicit subsidies between types of service. Congress sought to replace these implicit subsidies with the explicit Universal Service subsidy established by Section

254. See Conference Report 104-458 for the Telecommunications Act of 1996, at 131 (“To the extent possible, the conferees intend that any support mechanisms continued or created under new section 254 should be explicit, rather than implicit as many support mechanisms are today.”).

Thus, the parenthetical phrase in Section 252(d) prohibits traditional rate of return regulation in order to avoid implicit subsidies; the states are instead to focus on the cost of each individual network element or service. It also recognizes that many states had already moved from traditional rate of return regulation to alternative forms of regulation, such as price regulations. Congress did not want the 1996 Act to be a vehicle for returning to out-dated methods of regulation.

The prohibition of implicit subsidies and out-dated methodologies does not mean that the Commission is prohibited from looking at historical data, even if the Commission also looked at the same data when it was engaged in traditional rate-of return regulation. For example, a switch that cost \$100,000 would still cost \$100,000 regardless of the former rate-making methodology. Thus, if the switch price is relevant to this proceeding, there is no reason why the Commission cannot consider it, even if it had considered the same switch price in a prior rate-of-return proceeding.

The Petitioners’ argument that Section 252(d)(1)(A)(ii) prohibits consideration of a company’s actual or embedded costs is not supported by the FCC’s interpretation of that statutory language. According to the FCC, “... the parenthetical, ‘(determined without reference to a rate-of-return or other rate-based proceeding),’ does not further define the type of costs that may be considered, but rather specifies a type of proceeding that may not be employed to determine the costs of interconnection and unbundled network elements.” FCC

Order 96-325, ¶ 704. Thus, nothing in the 1996 Act precludes the Commission from establishing prices based on BellSouth's actual cost of providing service in Florida on a going forward basis, notwithstanding the Petitioners' arguments to the contrary.

2. The FCC Interconnection Order

Establishing prices based on BellSouth's actual cost of providing service in Florida on a going forward basis is not precluded by the FCC's August 8, 1996 Interconnection Order, in which the FCC adopted a TELRIC methodology for pricing UNEs. FCC Order 96-325, ¶¶ 672 et seq. First, any support that the FCC's Order provided to Petitioners' view that the costs associated with BellSouth's existing network should be disregarded was diminished significantly when the United States Court of Appeals for the Eighth Circuit vacated the pricing provisions of the FCC's Order. *Iowa Utilities Board, et al v. Federal Communications Commission*, 120 F.3d 753 (8th Cir. 1997).

Second, although the FCC's methodology requires that TELRIC costs be established for a forward-looking network, the FCC recognized that this forward-looking network should bear some resemblance to the incumbent's existing network. Specifically, the FCC's method assumed that wire centers and central offices would be located in their present location. *Id.* ¶¶ 685 & 690. According to the FCC:

This approach mitigates incumbent LECs' concerns that a forward-looking pricing methodology ignores existing network design, while basing prices on efficient, new technology that is compatible with the existing infrastructure. This benchmark of forward-looking cost and existing network design most closely represents the incremental costs that incumbents actually expect to incur in making network elements available to entrants.

Id. ¶ 685 (emphasis added). Thus, not everything that exists currently in BellSouth's network is automatically ineligible for "forward-looking" status, as the Petitioners would have the Commission believe.⁴

B. BellSouth's Inputs Were Appropriate.

As set forth in the preceding section, BellSouth's studies are the appropriate starting point for any analysis of the costs to provide telecommunications services using the least-cost, forward-looking, currently available technology. If the Commission agrees that BellSouth's studies should be used to set permanent rates in this proceeding, the parties nevertheless disagree about the proper inputs to those studies.⁵ The major areas of disagreement concern switching costs, shared and common costs, cost of capital, and depreciation. Sections C, D, and E below address BellSouth's proposals for non-recurring costs, collocation rates and the residual recovery requirement.

1. Switching issues

The Switching Cost Information System ("SCIS") is a software program development by Bellcore to determine the central office switching investment required to provide telephone subscribers with services and features. This program was not specifically developed for BellSouth or for its cost studies; it is widely used by a number of the regional

⁴ That an incumbent's existing network may be considered forward-looking is underscored by the FCC's recent decision to reaffirm the retention of an incumbent LEC's existing wire centers for purposes of establishing forward-looking economic costs. *See Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Report and Order ¶ 250 (May 7, 1993). Indeed, the FCC went on to note that in a forward-looking cost study "[w]ire center line counts should equal *actual* ILEC wire center line counts, and the study's or model's average loop length should reflect the incumbent carrier's *actual* average loop length." *Id.* (emphasis added).

⁵ The Petitioners apparently concede that BellSouth's studies are the appropriate starting point to set rates in Florida because, unlike other state proceedings, AT&T and MCI did not file the Hatfield Model into the record for consideration by the Commission. Moreover, this Commission has already rejected the Hatfield Model for setting permanent UNE rates.

Bell Operating Companies to determine switching costs and has been found reasonable by the FCC. (Tr. pp. 685-87). BellSouth used this program to get many of the switching costs used in its cost models because it produces accurate, state-specific results at the granular level required for UNEs. (Tr. p. 324). SCIS is the most appropriate tool for computing switching costs in BellSouth's cost study. Several other states Commissions, including those in Connecticut and Delaware, have already adopted the use of SCIS, including the SCIS/IN feature methodology, for determining the TELRIC of unbundled switching elements. (Tr. pp. 685-86).

AT&T sponsored the testimony of Ms. Catherine Petzinger, an AT&T employee, who criticized the inputs BellSouth used with the SCIS model. Essentially, Ms. Petzinger contends that BellSouth's inputs incorrectly inflated the switching costs produced by SCIS. (Tr. pp. 1614-16). But, Ms. Petzinger limited her analysis to the price per line for the initial placement of the switch, disregarding the per line costs associated with growth of the switch. (Tr. p. 1632).

Contrary to Ms. Petzinger's statements, BellSouth used the actual discounted switch prices as an input into SCIS. (Tr. p. 325). BellSouth's approach takes into consideration both initial placement and growth of a switch. The failure by Ms. Petzinger to consider growth of a switch in her analysis is a significant omission. According to the Northern Business Information⁶ study introduced at the hearing (Exhibit 59), one of the strategies that switch suppliers pursue is to cut prices on the initial placement of a switch to "guarantee high-margin sales of add-on hardware and software." (Tr. p. 1628; Exh. 59). Suppliers can command higher prices on growth costs because, according to Northern Business

⁶ Northern Business Information publishes information on which the industry (switch vendors and suppliers) rely. (Tr. p. 1627).

Information, once a switch supplier sells a switch, "it has a nearly captive customer"; a telephone company "can only grow a switch by buying add-on lines from the manufacturer of that switch." (Tr. p. 1628; Exh. 59). Thus, any analysis of switch prices that ignores growth costs (as Ms. Petzinger's did) significantly understates the true cost of a switch.

2. Shared and common cost factors

BellSouth submitted a separate study that developed forward-looking shared and common cost factors for use in its cost studies. (Tr. at p. 548). While requiring BellSouth to file TSLRIC studies in this docket, the Commission has previously recognized that "some contribution toward joint and common costs" is appropriate when setting rates for UNEs. *See Order No. PSC-96-1579-FOF-TP*. BellSouth's calculation of shared and common costs (5.39%) is reasonable and should be adopted.

Any doubts as to the reasonableness of BellSouth's common cost factor might have been resolved by the simple comparison of its 5.39% factor to the common cost factor of 10.4% used by AT&T and MCI in their Non-Recurring Cost Model, and derived ultimately from the Hatfield Model. (Tr. p. 1574). However, the 10.4% factor is developed from 1994 AT&T embedded operating data and some of the expense accounts that BellSouth treated as shared costs are treated as common costs in the Hatfield Model's formula. In order to make an "apples to apples" comparison, therefore, Mr. Reid performed a calculation comparing the Hatfield common factor to BellSouth's factoring treat all expense accounts as they are treated by the Hatfield Model's formula. The resulting calculation, reflected in WSR Surrebuttal Exhibit 6, shows that a common cost factor calculated using the Hatfield formula and BellSouth's forward-looking projections of expense underlying its shared and common cost

factors, produces an equivalent factor of only 6.4%, which is higher than the 5.39% factor proposed by BellSouth! (Tr. p. 1586-87).

Moreover, Mr. Lerma's contention that BellSouth's overhead expenses should experience a 27% reduction over current levels (Tr. p. 1560) is undercut by the additional calculation that Mr. Reid performed on WSR-6, comparing AT&T 1994 data with BellSouth 1994 data. Using the same categories of data, Mr. Reid demonstrated that, if BellSouth's data were used instead of AT&T's data, the 10.4% figure would be lowered to 9.7%. (Tr. pp. 1585-86.) The significance of Mr. Reid's exercise is that it shows that, at least in 1994, BellSouth -- the alleged "fat monopoly" -- actually performed better than AT&T -- the alleged "lean competitive firm." Thus, Mr. Lerma's expectation that overhead expenses will be reduced by yet another 27% in the competitive market is wholly unrealistic.

BellSouth's proposed shared and common cost factors are already 32% and 31%, respectively, lower than historical levels, and thus reflect significant productivity beyond that which BellSouth has historically experienced. (Tr. p. 564). BellSouth's methodology for treating shared and common costs is a forward-looking procedure that utilizes cost causative principles to develop appropriate shared and common cost factors. The Commission should adopt BellSouth's proposals.

3. Cost of Capital

All parties agree that BellSouth is entitled to earn a reasonable return on its investment in the forward-looking network. The reference in 47 U.S.C. §252(d)(1)(B) to a "reasonable profit" means a profit that is over and above the recovery of all costs, including the cost of capital. BellSouth has not specifically sought a profit in addition to its cost of

capital, on the expectation that it will be treated fairly on its cost of capital, depreciation and other costs. Thus, BellSouth's requested rates are conservative.

The FCC concluded "that the currently authorized rate of return at the federal or state level is a reasonable starting point for TELRIC calculations" FCC Order 96-325 at ¶702.⁷ BellSouth accepted the FCC suggestion and based its cost studies on the currently authorized FCC return on investment, 11.25 %.⁸ Based on a capital structure of 40% debt and 60% equity, this would translate to a return on equity of 13.42% and a cost of debt of 8%.

Dr. Randall Billingsley filed testimony supporting the reasonableness of BellSouth's use of an overall cost of capital of 11.25% in its cost studies. Dr. Billingsley used three approaches to determine the cost of capital, the Discounted Cash Flow (DCF) Model, the Capital Asset Pricing Model (CAPM), and the Risk Premium Analysis (Tr. p. 892). Dr. Billingsley also discussed the many factors that have increased the business risk in the telecommunications industry over the last several years. Both actual and potential competition have increased and the business risk of the industry has consequently increased. (Tr. p. 894-98). Investor's expectations of competition and its impact on risk is what is reflected in the company's cost of capital.

Applying the three methodologies identified above, Dr. Billingsley concludes that the current cost of equity for BellSouth is within the range of 14.72% to 15.20% (Tr. p. 893).

⁷ The FCC acknowledged that an adjustment to the cost of capital might be necessary because of the risk that ILECs would not recover all their sunk costs when prices are based on forward looking costs. FCC Order 96-325 at ¶¶686, 703.

⁸ Although the FCC suggested that the current authorized state return could be used, there is no Florida rate of return applicable to BellSouth since it has been under price cap regulation.

Dr. Billingsley also calculated the forward looking cost of debt as at least 7.25%.⁹ (Tr. p. 925). He then applied two tests to determine the reasonableness of an overall cost of capital of 11.25% as used in the cost studies. Using either BellSouth's actual capital structure (58.84% equity/41.16% debt/6.46% embedded cost of debt) or an alternative capital structure (60% equity/40% debt/7.25% current cost of debt), both are consistent with overall cost of capital of 11.25% (Tr. p. 893-94).

AT&T and MCI sponsored the testimony of Professor Bradford Cornell. Dr. Cornell presented a three-stage DCF model, which is complex, subjective, and uses growth rate forecasts reflecting his own -- rather than the investment community's -- opinions. (Tr. p. 898). Dr. Cornell also limited his list of comparable companies to other telephone companies. (Tr. p. 904-05). That is, Dr. Cornell simply assumed that the companies he selected were comparable, rather than performing any analysis to determine whether they were, in fact, comparable to BellSouth. Moreover, errors and inconsistencies in Professor Cornell's DCF and CAPM analysis of BellSouth's cost of equity capital, his cost of debt estimation, and his misunderstanding of the nature and significance of the riskiness of investing in the telecommunications industry make his conclusions unreliable. (Tr. pp. 913-14).

4. Depreciation

BellSouth's depreciation lives are by far the most reasonable and appropriate proposal before the Commission. The proposed lives used in BellSouth's cost studies are based on

⁹ If the TELRIC or TSLRIC analysis is based on the assumption that new technology is installed "from scratch," to be consistent, it should be accompanied by an assumption that the money raised to pay for that new technology should be raised "from scratch." Accordingly, the cost of debt should be based on what it would cost BellSouth if it had to obtain new debt all at once. This would cost more than simply issuing additional amounts of incremental debt.

BellSouth's 1995 and 1996 Depreciation Studies, which provide detailed explanations of methodology, data and analysis that support the asset lives and other depreciation parameters presented in the studies. (Tr. p. 848 and attached Depreciation Studies). These studies contain thousands of pages of data and analysis supporting BellSouth assessment of appropriate lives. No party to this docket did a similar analysis of plant lives or derived an independent and current assessment of appropriate lives. Instead, Petitioners criticize BellSouth's studies and contend, for example, that the lives are "much shorter than the projection lives underlying the FCC's 1995 prescription" (Tr. p. 1517), and that this Commission should therefore look backwards and rely on lives set by the FCC in 1995. (Tr. p. 1507). Use of these "backwards-looking" lives is inappropriate. The rapid changes in technology which BellSouth must embrace to stay competitive in the new environment created by the Telecommunications Act shorten asset lives significantly beyond what the FCC prescribed in 1995.

There is nothing unusual or unreasonable about allowing BellSouth to set its own depreciation rates in a competitive environment. BellSouth is operating pursuant to price regulation in Florida. *See Fla. Stat. Ann. § 364.051.* Under price regulation, a company is entitled to manage its own depreciation. BellSouth's competitors, including AT&T and MCI, have been authorized for years to manage their own depreciation. Nevertheless, in 1994, the last time the FCC set AT&T's depreciation rates, the authorized lives for exactly the same plant accounts as BellSouth's were equivalent to or shorter than the lives BellSouth uses in its cost studies. (Tr. p. 851).

C. BellSouth's Proposed Nonrecurring Rates Are Appropriate.

In the cost studies, BellSouth identified the one-time work activities that are typically associated with installing or disconnecting a UNE. (Tr. p. 338). For these work activities, BellSouth defined work functions, established work flows, and determined work times. (Tr. p. 339). Thereafter, BellSouth developed directly assigned labor costs and accumulated work function costs to determine the total nonrecurring costs for each UNE, with proper recognition of shared and common cost and tax factors. (Tr. p. 339).

In identifying the work functions associated with the provision of UNEs, BellSouth considered (1) the basic work activities that are required to deliver an unbundled element, such as a loop, including cross-connects in the field or in the central office; (2) the specific functions, such as testing, that ALECs have requested BellSouth to perform in interconnection agreements; and (3) any additional manual processing that BellSouth must perform when electronic orders "fall out" of the system. (Tr. p. 478-79).

In contrast to BellSouth's thorough analysis of nonrecurring costs, AT&T and MCI, sponsor their Nonrecurring Cost Model, which attempts to eliminate virtually all nonrecurring charges. Their justification for so doing is a repeated characterization of such charges as "barriers to entry." (E.g., Tr. p. 1245). All business ventures carry with them the necessity for assuming some degree of risk and investment. Thus, not every dollar a business must spend to enter a new market can fairly be called an "entry barrier." AT&T/MCI attempt to eliminate all but the odd dollar's worth of nonrecurring charges. Nothing in the Act requires BellSouth to subsidize its competitors' entry into the market. Nonrecurring charges are standard in the industry. This is because of the well-recognized principle that the causer of cost should be the one to bear the cost. Costs of ordering and installing lines are

caused directly by the party that orders those lines, whether that party is an end user or a CLEC. Thus, such costs are appropriately recovered through nonrecurring charges.

The AT&T/MCI model is based on default percentages for factors such as the amount of copper facilities, the number of central offices that are staffed rather than unmanned, and the amount of set-up time needed. (Tr. pp. 1254-56). The values assumed for these items affect the costs that are derived. Yet, AT&T and MCI have not used Florida-specific data, opting instead to rely on national default values for these items. (Tr. pp. 1254-56).

One of the key assumptions underlying the AT&T/MCI Nonrecurring Cost Model is that UNE orders (including orders for new and additional lines) will automatically flow through the ordering and provisioning process using currently available OSS, processes and procedures with little or no manual intervention. Although the AT&T/MCI Nonrecurring Cost Model refers to Bellcore's Telecommunications Management Network ("TMN") architecture in which 100% electronic flow-through of orders may become possible, ATT/MCI concede that the architecture is still evolving. (Tr. p. 1265).

The AT&T/MCI model does not assume a fully TMN-compliant network. (Tr. p. 1263). However, in an unexplained leap of faith, their study does assume that current OSS will lead to the almost identical flow through that is the goal of the evolving TMN network. There is simply no basis for this assumption. AT&T/MCI witnesses made no independent analysis of BellSouth's OSS, processes or procedures or indeed those of any other ILEC.

To support the assumption of 98% automatic flow through of UNE orders over forward looking currently available OSS, Mr. Lynott refers to statements made by Southwestern Bell Telephone Company ("SBC") concerning its EASE system at a recent pre-hearing conference. (Tr. p. 1215). The EASE system on which the 2% fall-out assumption is

based, however, supports only resale ordering and provisioning, and not the ordering and provisioning of UNEs. (Tr. p. 1215). Mr. Lynott also cites a U.S. West cost study filed in Minnesota that referenced a 97% flow through of PIC changes. The latter reference offers no support to the AT&T/MCI proposal. The activity involved in changing a customer's preferred interexchange carrier has utterly nothing to do with the provision of UNEs. In sum, there is no basis in this record or in the real world of telecommunications for AT&T's assumption that human hands will be needed only 2% of the time for the provisioning of unbundled network elements.¹⁰

Another faulty underpinning for the contention that UNE ordering and provisioning will have a 98% mechanized flow through is the assumption regarding dedicated facilities. AT&T/MCI would have this Commission believe that there is no need for technicians to work in the field to provision UNEs because BellSouth has in the past "dedicated" facilities in every neighborhood in Florida sufficient to meet all conceivable demand for the foreseeable future. (Tr. at 1258). The fact that BellSouth has hundreds of technicians in the field every day working to install lines in and of itself disproves that assumption. BellSouth's studies reflect the reasonable amount of time it expects its technicians to spend installing plant on a forward looking basis, taking into account the dedicated plant that BellSouth will have in place.

¹⁰ Ultimately, the disparity between BellSouth's and the Petitioners' estimates of work activities associated with provisioning UNEs can be traced to the fundamental difference of opinion between the parties on the issue of recombination. To support their minimal work activity estimates, Petitioners have necessarily assumed that BellSouth will provide ALECs with a combined loop and port, which BellSouth has no duty to do. *See Iowa Utilities Board, et al. v. Federal Communications Commission*, 120 F.3d 753 (8th Cir. 1997). BellSouth will reserve further comment on this issue, however, in light of the Commission's pending docket on this issue.

The Commission should reject the AT&T/MCI Nonrecurring Cost Model. BellSouth's studies provide accurate, Florida-specific data for establishing nonrecurring costs in this proceeding.

D. BellSouth's Proposed Collocation Rates Are Reasonable.

Physical collocation is not an unbundled network element, nor is it interconnection under the Act. It is simply the process by which an ALEC uses space belonging to the ILEC to place "equipment necessary for interconnection or access to unbundled network elements." 47 U.S.C. § 251(c)(6). Virtual collocation is the process by which the ALEC obtains this access when space limitations prohibit actual use of ILEC property for the placing of ALEC equipment. Subsection 251(c)(6) imposes upon the ILEC the following duty:

(6) COLLOCATION.-- The duty to provide, on rates, terms, and conditions that are just, reasonable, and nondiscriminatory, for physical collocation of equipment necessary for interconnection or access to unbundled network elements at the premises of the local exchange carrier, except that the carrier may provide for virtual collocation if the local exchange carrier demonstrates to the State commission that physical collocation is not practical for technical reasons or because of space limitations.

The duty to provide unbundled access to network elements and interconnection appear in separate sections of the Act. *Compare* 47 U.S.C. § 251(c)(6) *with* 47 U.S.C. § 251(c)(1) and 251(c)(3). Moreover, the pricing standard contained in section 252(d) (calling for prices based on cost without reference to a rate of return proceeding) on its face does not apply to collocation, but only to interconnection and unbundled network elements.

The FCC's Order No. 96-355 contains certain, non-pricing rules that are binding for purposes of collocation. They make it clear that the ILEC's duty to provide physical collocation arises only where current space constraints allow; where they do not, the ILEC may provide virtual collocation (which does not involve using space in the ILEC central

office). The ILEC's obligation is to make space available at or on its premises on a first-come, first-served basis; provided, however, that an ILEC is not required to lease or construct additional space to provide for physical collocation when existing space has been exhausted. See FCC Order 96-355, § 51.323(f)(1). Only when planning renovations of existing facilities or constructing or leasing new facilities does the ILEC have the obligation to take into account projected demand for collocation of equipment. *Id.* at § 51.323(f)(3).

Although the ILEC clearly has no legal duty to construct additional space to provide for physical collocation that takes into account demand for collocation, that is precisely the premise of AT&T/MCI's collocation model. AT&T and MCI have hired consultants who have been charged with the task of designing and building from the basement up fictitious central offices specifically designed to accommodate ALEC needs for collocation. The resulting "model" central office that does not reflect the specific space, design or layout of BellSouth's central offices in Florida. (Tr. p. 1082).

Significantly, the Collocation Model has designed space that may not be acceptable to ALECs, including one of its sponsors -- MCI. As Mr. Bissell explained at the hearing, the model assumes that ALECs will share cable racks. (Tr. p. 1093). And, in the model, the ALECs' point of termination (POTS) bays are lined up in the same common area. (Tr. p. 1094). In a proceeding in North Carolina, a representative of MCI testified that it would require vice presidential level approval for MCI to accept collocation space in which other ALECs had access to MCI's POTS bay. (Tr. p. 1099; Exh. 38). Although Messrs. Klick and Bissell attempted to synthesize Mr. Martinez's testimony with their own, the larger point made by that cross-examination is that the Collocation Model is little more than an attempt

by AT&T and MCI to keep collocation rates as low as possible, even at the expense of security within the central office.

Moreover, there is absolutely no support offered for the primary assumption in the Collocation Model that BellSouth would operate more efficiently by replacing all of its central offices with this new “model” central office. When asked whether an analysis was done to determine if it would be more efficient to use the “model” central office in preference to existing central offices, Mr. Bissell replied glibly that “it’s just common sense” that his “model” building would be more efficient than BellSouth’s existing buildings. (Tr. p. 1084-85).

The AT&T/MCI model also assumes a 75% occupancy rate, even though the model assumes that 4 cages (550 sq. feet) are built out after the first request is received. If 75% occupation is not achieved, Mr. Klick admitted that collocators would be paying too little. (Tr. p. 1092).¹¹

Inside of this fictitious central office planned specifically to meet the needs of ALECs, AT&T and MCI have also assumed costs for collocation enclosures that are based on how they would like to see such enclosures constructed, rather than on BellSouth’s specifications for construction of such enclosures. BellSouth’s specifications are reasonable and based on legitimate security considerations. *See* FCC Order, 96-325 § 51.323(i) (“An incumbent LEC may require reasonable security arrangements to separate a collocating telecommunications carrier’s space from the incumbent LEC’s facilities”). AT&T and MCI do not contend that BellSouth’s construction requirements are unreasonable, they just prefer other, cheaper methods of construction.

¹¹ Mr. Klick offered the reassuring possibility that collocators might be paying too much if the occupancy rate were too low. (Tr. p. 1092).

Lastly, AT&T and MCI have totaled the fictitious investment costs associated with their fictitious central office and collocation enclosure, and have modeled them in a manner designed to ensure that BellSouth subsidizes their competitive entry and bears the risk of the up-front investment associated with building a collocation enclosure. With the exception of a small amount of initial "planning," the entire cost of constructing a collocation cage is treated as a recurring cost to be recovered over the 50-year life of that cage in recurring rates. (Tr. p. 1090). This means that an ALEC can compel BellSouth to incur the cost of constructing the enclosure, quit the space anytime it wants, and leave BellSouth holding the proverbial bag and looking for another customer to take that space.

The Commission should reject the collocation model submitted by AT&T/MCI. It is inconsistent with BellSouth's obligations under the FCC's collocation rules and it contains unreasonable assumptions blatantly designed to simply wish away the legitimate costs that are incurred to fulfill a collocation request by an ALEC. The more reasonable approach has been presented in BellSouth's study. This study accurately estimates the cost that will be incurred to provide collocation, and should be adopted by the Commission.

E. The Commission Should Adopt BellSouth's Proposed Residual Recovery Requirement.

BellSouth has recognized that with respect to the 2-wire ADSL and the 2-wire and 4-wire HDSL compatible loops, and the 4-wire analog port, pricing that is completely forward looking will not provide BellSouth the reasonable opportunity to recover its investment in the plant and equipment currently in place and that will be used to provide service to customers. Accordingly, BellSouth seeks recovery of a Residual Recovery Requirement which is the difference between what BellSouth would recover under a pure TELRIC price of those loops and port and the amount necessary to allow BellSouth to recover all of its embedded

investment in the loops and port. Petitioners object to allowing BellSouth to recover the Residual Recovery Requirement because it is contrary to the forward-looking methodology that they contend is mandated by the Telecommunications Act and FCC Order 96-325. However, as was discussed above in greater detail, nothing in the 1996 Act prohibits the consideration or recovery of “embedded,” “sunk,” “stranded,” or “actual” costs.

Furthermore, if the Commission fails to provide BellSouth a reasonable opportunity to recover its investment in the loop and the port through the price of these elements, the result will be a confiscation of BellSouth’s property.

Utilities, like individuals and other businesses, enjoy constitutional protections against the taking of their property without due process and the payment of just compensation. The fifth and fourteenth amendments to the United States Constitution and Article I, Section 9 and Article 10, Section 6 of the Florida Constitution afford these constitutional protections. Compelling BellSouth to provide UNEs and interconnection to ALECs constitutes a taking of BellSouth’s property. Accordingly, BellSouth is *constitutionally guaranteed* the right to fair compensation for this taking. *See, e.g., FCC v. Florida Power Corp.*, 480 U.S. 245, 253, 107 S. Ct. 1107, 94 L. Ed. 2d 282 (1987). At the very least, justice requires that BellSouth be afforded the reasonable opportunity to recover its actual costs.¹²

¹² Under traditional regulation, the Commission sometimes priced certain utility services below cost. The Commission would offset this by allowing the utility to recover a higher margin or profit on other services. For example, in some areas, BellSouth was compelled to offer basic residential service below cost to ensure that it was available at affordable rates to everyone. On the other hand, BellSouth was allowed to price other services, such as basic business service, above cost to compensate for the under recovery on residential service. With the advent of competition, this option is no longer available to the Commission. Although the Commission will be able to use the Universal Service Fund to implement public policy purposes, such as below cost residential service, universal service support does not alleviate the constitutional concerns associated with requiring BellSouth to provide elements and services at rates that do not cover the cost of those elements and services.

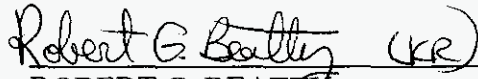
Numerous parties raised similar constitutional concerns in the appeal of the FCC's Interconnection Order. In its opinion on review of that Order, the United States Court of Appeals for the Eighth Circuit noted these concerns, but concluded that such claims were not yet ripe for review, particularly because the court overturned the FCC's pricing rules. *Iowa Utilities Board*, 120 F.3d at 818.

CONCLUSION

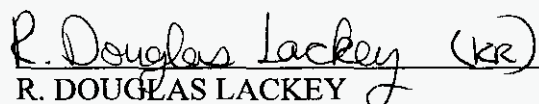
The Commission should adopt BellSouth's proposals in setting permanent rates for collocation and for the UNEs that are the subject of this proceeding. The evidence presented at the hearing demonstrated that BellSouth's rates are just, reasonable, and non-discriminatory as required by the Act.

Respectfully submitted this 3rd day of March, 1998.

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