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January 25, 2002

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**BY HAND DELIVERY**

Ms. Blanca Bayó, Director  
Division of Records and Reporting  
Room 110, Easley Building  
Florida Public Service Commission  
2540 Shumard Oak Blvd.  
Tallahassee, Florida 32399-0850

Re: FPSC Docket No. 990649A-TP

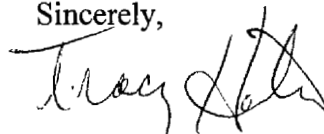
Dear Ms. Bayó:

AT&T Communications of the Southern States, Inc. and MCI WorldCom, Inc. pursuant to Section 364.183(1), Florida Statutes, hereby claims that certain information provided to Staff in the Brian Pitkin Late Filed Deposition Exhibit No. 2 and the Darnell Late-Filed Deposition Exhibit No. 3 contain confidential and proprietary business information that should be held exempt from public disclosure. Pursuant to Rule 25-22.0006(5), Florida Administrative Code, in the attached envelope is one copy of Brian Pitkin Late Filed Deposition Exhibit No. 2 and the Darnell Late-Filed Deposition Exhibit No. 3 with the confidential information highlighted. A redacted copy has been served on the Staff.

Please acknowledge receipt of this letter by stamping the extra copy of this letter filed" and returning the same to me.

Thank you for your assistance with this filing.

Sincerely,

  
Tracy W. Hatch

TWH/amb  
Enclosures

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**Brian Pitkin Late Filed Exhibit #2**  
**“Explanation of Inflation Factors”**

**CONTAINS BELLSOUTH PROPRIETARY INFORMATION**

Ms. Caldwell’s direct testimony states that “the Commission found that the application of inflation factors to both the investment and to labor rates is appropriate. The cost study filed on October 8, 2001 reflects the impact of inflation based on factors originally filed in this docket.” (Caldwell Direct at 30).

The BellSouth model originally filed in this proceeding developed material investments, which were then multiplied by linear loading factors (referred to by BellSouth as “in-plant” factors) to develop total installed investment amounts. These total installed investment amounts were then multiplied by an inflation factor in the BellSouth Cost Calculator to develop forecasted investment amounts. Because BellSouth’s original cost model required inflation of both the material and labor components, the inflation factor was a “blended” factor that was a weighted average of material price inflation and labor price inflation.

In this 120 day proceeding, BellSouth continues to use this blended inflation rate. This is not appropriate, however, because BellSouth is applying the rate only to the material portion of costs. To be consistent, BellSouth should apply only a material inflation rate to these material costs. Because inflation in materials has been almost non-existent since 1997, while inflation in labor costs has been significant, BellSouth’s application of a blended inflation rate overstates the inflation applicable to material costs and, therefore, overstates material investments.

On December 31, 2001, AT&T and WorldCom received BellSouth’s responses to their 1<sup>st</sup> Set of Interrogatories. In response to Item No. 9, BellSouth provided “the supporting documentation for each of BellSouth’s Forecast Telephone Plant Indexes from 1995 - 2002 used in the calculation of BellSouth’s Average Levelized Inflation Loadings.” In

this data response, BellSouth states that:



Pursuant to this Commission's order, which concluded that use of linear loading factors to estimate the labor component served to distort costs, BellSouth developed a bottoms-up estimate of the labor component of total installed costs, using labor rates based on current contracts. Because these contracts already reflect the inflation that has occurred over the past several years, BellSouth's calculations in this proceeding do not apply any inflation factors to these labor investments. On this much, we agree. However, BellSouth should have modified the inflation factors to remove the labor component of inflation before applying them to the materials-only investment. The following examples illustrate the potential for cost overstatement.

BellSouth's original use of inflation factors in this proceeding:

This is mathematically equivalent to the

**Illustration 1**

	<u>Original Investment</u>	<u>Inflation Factor</u>	<u>Inflated Investment</u>
Material	\$ 100		
In-Plant Factor	1.00		
Labor	<u>\$ 100</u>		
following: <b>Total</b>	<b>\$ 200</b>	<b>6.00%</b>	<b>\$ 212</b>

As the first illustration shows, BellSouth's original methodology multiplies a composite material and labor

### Illustration 2

	<u>Original Investment</u>	<u>Inflation Factor</u>	<u>Inflated Investment</u>
Material	\$ 100	0.00%	\$ 100
In-Plant Factor	1.00		
Labor	<u>\$ 100</u>	12.00%	<u>\$ 112</u>
investment <b>Total</b>	<b>\$ 200</b>	<b>6.00%</b>	<b>\$ 212</b> by

a composite material and labor inflation factor. As the second illustration shows, this is conceptually the same as multiplying material investment by a material-only inflation rate, and multiplying labor investment by a labor-inflation rate.

In this proceeding, however, BellSouth uses a bottoms-up estimate of current labor costs and applies a melded (material and labor) inflation rate to only the material portion of investment. Following is an illustration of the methodology BellSouth is using in this proceeding:

### Illustration 3

	<u>Original Investment</u>	<u>Inflation Factor</u>	<u>Inflated Investment</u>	
Material	\$ 100	6.00%	\$ 106	
In-Plant Factor	N/A			
Labor	\$ 112	0.00%	\$ 112	
<b>Total</b>	<b>\$ 212</b>	<b>6.00%</b>	<b>\$ 218</b>	The above


illustration shows that, because BellSouth is directly developing labor investment, no inflation factor is applied and results in the same inflated labor investment as shown in Illustration 2. However, BellSouth inappropriately applies a melded inflation factor (which includes a labor component) to the material-only investment. If labor inflation is higher than material inflation, this approach overstates the amount of investment. In illustration 3, this overstatement is 3% (\$218 / \$212).

In fact BellSouth's response to AT&T and WorldCom's 1<sup>st</sup> Set of Interrogatories makes clear that material costs have not increased nearly as much as labor costs over the past several years:

[REDACTED]

[REDACTED]

[REDACTED]



From these statements, it is obvious that the material prices certainly have not increased as fast as BellSouth's labor costs. A blended inflation rate overstates inflation in the material component of investment and BellSouth's continued use of a blended material/labor inflation factor overstates total investment. Thus, it is essential for this Commission to insist on the development of a material only inflation factor for use in this proceeding.

There are three options for correcting BellSouth's error. First, the Commission could require BellSouth to provide the components to its calculation of the blended inflation rate and use that data to develop a material-only inflation rate. Second, the Commission could use the inflation factors I use in my restatement of BellSouth's model filed in this proceeding. However, the source I use for these factors still includes labor and therefore likely overstates the true amount of inflation that BellSouth has experienced (which may actually be a decline in material prices). Third, the Commission could simply reject BellSouth's inclusion of inflation in both the development of investments and in the cost of capital as I recommended in my testimony in the prior proceeding.