REBUTTAL TESTIMONY OF
ART LERMA
ON BEHALF OF AT&T COMMUNICATIONS OF
THE SOUTHERN STATES, INC.
BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

Docket No. 960833-TP

Filed: August 30, 1996

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Art Lerma and my business address is Promenade I, Room 5082, 1200 Peachtree Street, Atlanta, GA. 30309.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by AT&T as Area Controller-Regional Controller Organization.

Q. DID YOU FILE TESTIMONY PREVIOUSLY IN THIS DOCKET?

A. Yes. I have previously filed both direct and supplemental testimony in conjunction with docket no. 960833-TP.

Q. WHAT IS THE PURPOSE OF THIS TESTIMONY?

A. The purpose of this testimony is to respond to the direct and supplemental testimonies filed by BellSouth witness Walter S. Reid. Specifically I will address both BellSouth's avoided cost study attached to Mr. Reid's direct testimony as Exhibit WSR-1 (the "original" BellSouth study) and BellSouth's avoided cost study attached to his supplemental testimony. Mr. Reid characterizes the latter as being based upon the FCC's First Report and Order No. 96-325 released August 8,1996 ("Order"). My analysis will show that neither study complies with the FCC-provided criteria for determining a permanent percentage reduction to BellSouth's retail rates in the resale environment.

Q. **HAS BELLSOUTH REPLACED ITS ORIGINAL AVOIDED COST STUDY WITH ONE PREPARED IN ACCORDANCE WITH THE FCC RULES?**

A. No. Mr. Reid in his supplemental study states that the Company does not agree with the FCC's criteria regarding the determination of avoided costs, and BellSouth believes that its original avoided cost study complies with the Telecommunications Act of 1996 (the "Act"). Mr. Reid further states he has prepared Exhibit WSR-3 which is attached to his supplemental testimony, only to demonstrate the impact of the methodology stemming from the FCC's Order.

Q. **WHAT IS YOUR ASSESSMENT OF BELLSOUTH'S ORIGINAL AVOIDED COST STUDY?**

A. BellSouth's original study appended to Mr. Reid's direct testimony improperly omits direct categories of costs that will be avoided or that reasonably can be avoided in a wholesale environment, fails to recognize avoided indirect costs, lacks sufficient detail to permit necessary adjustments to cost categories that are included, and fails to explain why it has included less than 100% of those accounts the Act says always are avoided or that the FCC Order says are presumed avoided. The following is a more detailed assessment of this study:

1. Attached as Exhibit ALR-1 is a comparison of AT&T's simplified avoided cost study ("ASAC"), which is attached to my supplemental testimony as Exhibit ALS-1, and the original BellSouth study. It is apparent from this comparison that BellSouth is not acknowledging all appropriate retail costs that it will avoid or that can reasonably be avoided when it provides those services for resale. There are numerous categories of costs that show no avoided costs at all, although clearly some costs are avoided. Also, BellSouth's study contains no data that allows for the calculation of other costs related to BellSouth's retail services that will be avoided or that reasonably can be avoided.

2. In Exhibit ALR-2, I calculate avoided cost in BellSouth's original and FCC-based studies as a percentage of BellSouth's total 1995 regulated costs by account. BellSouth shows no avoided costs for product management (account 6611), call completion (account 6621), and number services (account 6622-directory assistance). These are cost categories that the FCC presumes are avoided. BellSouth, however, provides no convincing rationale or evidence that these costs will remain the same when wholesale service is being provided.

Further, BellSouth concludes in its original cost study that approximately 66.72% of regulated sales expenses (account 6612) and 62.69% of regulated customer service expenses (account 6623) will be avoided. See Exhibit ALR-2. Thus, BellSouth concludes that more than 33% of regulated sales expense and more than 37% of regulated customer service expense is *not* avoided. Mr. Reid states on page 12 of his testimony that "the Company identified all regulated residential and business sales expenses in account 6612," Reid Test. at 12, but no rationale is offered to support the conclusion that over 33% of this expense must continue in a wholesale market. Similarly, there is no support for the continuation of over 37% of regulated customer service expenses, particularly where AT&T will provide all retail customer service functions via the real time electronic interfaces it is seeking with several BellSouth databases, e.g., directory listing and line information, service trouble reporting, pre-service ordering, service order processing and provisioning, and daily local usage data. For both sales and customer service costs, (accounts 6612 and 6623) there is insufficient evidence to support that anything less than 100% of retail costs will be avoided.

5. There are other categories of retail costs reflected on Exhibit ALR-1 that BellSouth will directly avoid but which BellSouth shows little or no avoided costs. The following is a list of these and the rationale supporting why they are costs that will be avoided:

a. Product management (account 6611)- Resellers will manage their own products and services. Current product management costs are incurred in support of retail sales and thus will be or reasonably can be avoided when services are provided on a wholesale basis. BellSouth reflects zero avoided costs for this category. This

BellSouth will avoid all operator related expenses. BellSouth reflects zero avoided costs for these categories.

6. BellSouth has included little or no costs that are directly related to the retailing of end user services but are commingled with other corporate operations costs or general support service costs. These are the costs that are referred to as indirectly avoided when BellSouth's residence and business services are made available for resale. Exhibit ALR-1 shows these categories of indirectly avoided retail costs included in AT&T's study. Because there is a direct correlation between the total costs of a company and the level of its general and administrative expenses, the largest component of the indirect retail costs, BellSouth has inappropriately excluded the bulk of this category of avoided costs. In addition, a portion of these indirect costs are also presumed avoided in the FCC's regulations. See 47 C.F.R. Section 51.609 (c)(2).

7. Based on available information, BellSouth's original cost study treats revenues related to categories labeled as Carrier Services, Public Services, and Operator Services as not available for resale. I would agree that all carrier (access) revenues are not subject to resale, but there is no basis for excluding Operator and Public services based on the FCC regulations. Further, the original BellSouth study removes several other categories of revenues for services that BellSouth has indicated it would not make available for resale such as non-recurring, grandfathered services, and revenues from Contract Service Arrangements(CSAs).

Q. HAVE YOU ANALYZED THE REVISED COST STUDY ATTACHED TO

MR. REID'S SUPPLEMENTAL TESTIMONY?

A. Yes. Attached as Exhibit ALR-3 is a comparison of BellSouth's revised cost study (the "FCC-based cost study") with AT&T's ASAC study. As is evident from Mr. Reid's supplemental testimony, BellSouth provides inadequate support for the low percentages of avoided costs it assigns to several accounts the FCC presumes are totally avoided. In fact BellSouth assigns no avoided costs at all to some of the accounts, e.g., call completion costs (account 6621) and number services (account 6622). Next, BellSouth makes no allowance for avoided profit or contribution, although the FCC Order indicates it is appropriate to do so. Lastly, BellSouth underestimates the portion of indirect costs that is avoided by employing an improper ratio calculation. The proper formula should be directly avoided costs divided by direct costs. This is the basis used in the ASAC study and is detailed in the workpapers of my supplemental testimony. The following is a more detailed analysis:

1. Costs in account 6611 (product management) are presumed avoided in the FCC's regulations. <u>See</u> 47 C.F.R. Section 51.609 (c)(1). In BellSouth's FCC-based study, only 19.93% of these costs are reflected as avoided with no convincing arguments that the remainder is necessary to carry on the wholesale business. This account should be shown as 100% avoided.

2. Costs in accounts 6612 (sales) and 6613 (product advertising) are also presumed avoided in the FCC's regulations. <u>See</u> 47 C.F.R. Section 51.609 (c)(1). In BellSouth's FCC-based study, 86.06% of sales and 95.63% of product advertising expense are reflected as avoided. Mr. Reid states that the portions reflected as not

avoided pertain to carrier services, public services, and operator services. It is not appropriate to exclude avoided costs pertaining to public services and operator services because the wholesale discount is applicable to these retail rates as well.

3. Costs in accounts 6621 (call completion) and 6622 (number services) are also presumed avoided in the FCC's regulations. See 47 C.F.R. Section 51.609 (c)(1). In BellSouth's FCC-based study, none of these costs are reflected as avoided. It is my understanding, based on the testimony of AT&T witness Jim Tamplin, that direct routing of operator services is technically feasible and therefore these costs should be 100% avoided. The FCC Order states at paragraph 917 that these costs are presumed avoidable "because resellers have stated they will either provide these services themselves or contract for them separately from the LEC or from third parties." FCC Order, Paragraph 917. Either way, these costs will be avoided.

4. Costs in account 6623 (customer services) are presumed avoided in the FCC regulations. See 47 C.F.R. Section 51.609 (c)(1). In BellSouth's FCC-based study, 65.56% of these costs are reflected as avoided. Mr. Reid states that he utilized the data from the BellSouth original cost study for this account but added as avoidable certain indirect and other expenses. The data from the original cost study is deficient because there are assumptions that many customer functions will continue to be performed by BellSouth while AT&T plans to perform all customer functions facilitated by the electronic interfaces. In addition, there are vague references to additional indirect and other expenses that have been added and to the fact that expenses for public services and operator services are again not treated as avoided. For these reasons, customer service expense should be 100% avoided.

5. Further, the FCC-based BellSouth study understates the indirect costs avoided. First, although account 5301 (uncollectibles) is referred to as an indirect expense in the FCC regulations, the entire amount is avoided by a wholesaler. The cost of uncollectibles transfers from the wholesaler to the reseller when BellSouth provides wholesale service. BellSouth included 100% of uncollectibles in avoided cost in their original cost. However, for reasons that are unexplained, it reflects only 10.91% of uncollectibles as avoided in its FCC-based study.

For all other indirect cost categories shown on Exhibit ALR-2 and ALR-3, BellSouth avoids 10.91%. This is based on a ratio of directly avoided costs to total costs. The FCC's criteria for cost studies provides that indirect costs "are presumed to be avoided in proportion to the avoided direct expenses." FCC Order, Paragraph 918. The ratio should instead be based on directly avoided costs divided by direct costs (total costs less indirect costs). This is appropriate because it is not reasonable to include in the denominator the same expenses to which the ratio should be applied. In the ASAC study this correct calculation produced a ratio of 28%.

6. Lastly, there are several other categories of costs designated as avoided in the ASAC study that are not reflected in the BellSouth FCC-related study. See Exhibit ALR-3. Specifically, the ASAC study includes a calculation for avoided return on in investment attributable to assets used in avoided retail activities. This is an approach that the FCC found consistent with the Act. FCC Order, Paragraph 913. The ASAC study also identifies other avoided costs which BellSouth does not include. The rationale for including these other costs in the avoided cost category is found in my

supplemental testimony.

Q. DOES YOUR ANALYSIS SHOW THAT EITHER OF THE STUDIES PRODUCED BY BELLSOUTH ARE COMPLIANT WITH THE FCC CRITERIA FOR COST STUDIES?

A. No. Neither of these studies complies with the FCC's criteria for cost studies and should be rejected.

Q. WHAT IS THE PROPER WHOLESALE DISCOUNT FACTOR THAT SHOULD BE ADOPTED FOR BELLSOUTH IN FLORIDA?

A. The wholesale discount of 39.99%, as accurately produced in the ASAC study attached to my supplemental testimony, should be adopted because it is produced by a cost study that complies with the Act and the FCC regulations.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes it does.