

ORIGINAL



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September 2, 1998

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

RE: Docket No. 980696-TP

Dear Mrs. Bayo:

Enclosed for filing in the above referenced dockets on behalf of AT&T of the Southern States, Inc.'s (AT&T) and MCI Telecommunications Corporation is the Rebuttal Testimony of Catherine Petzinger, John Hirshleifer, Michael Majoros, Art Lerma, and Don Wood/Brian Pitkin. Please note that the Rebuttal Exhibit CEP-1 attached to Catherine Petzinger's Rebuttal Testimony may contain proprietary confidential business information and is being filed separately in accordance with Rule 25-24.006(5), Florida Administrative Code.

Copies of the foregoing are being served on all parties or record in accordance with the attached Certificate of Service. Thank you for your assistance in this matter.

Sincerely,

*Tracy Hatch*  
Tracy Hatch

- ACK
- AFA
- APP
- CAF
- CMH
- CTR
- EAG
- LEG
- LIN
- OPG
- RCH
- SEC
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*Petzinger*  
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09599 SEP-2 98

RECORDS/REPORTING

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*Hirshleifer*  
DOCUMENT NUMBER - DATE  
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DOCUMENT NUMBER - DATE  
9603 SEP-2 98

DOCUMENT NUMBER - DATE  
9602 SEP-2 98

RECORDS/REPORTING

**CERTIFICATE OF SERVICE  
DOCKET 980696-TP**

I HEREBY CERTIFY that a true and correct copy of the foregoing was furnished via \*hand delivery/\*\*Federal Express and U.S. Mail to the following parties of record on this 2<sup>nd</sup> day of September, 1998:

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*W. C. [unclear]*

**ORIGINAL**

**BEFORE THE  
FLORIDA PUBLIC SERVICE COMMISSION**

**REBUTTAL TESTIMONY OF**

**ART LERMA**

**ON BEHALF OF**

**AT&T COMMUNICATIONS OF THE SOUTHERN STATES,  
INC.**

**Docket No. 980696-TP**

**September 2, 1998**

DOCUMENT NUMBER-DATE

~~9602~~ SEP-2 8

FPSC-RECORDS/REPORTING





1 Regulatory Support with responsibility for AT&T financial regulatory matters in  
2 Texas. Since 1983, I have been responsible for AT&T financial regulatory  
3 matters and have been involved in the review of LEC cost information filed  
4 before public utility regulatory agencies in the southern or southwestern portions  
5 of the country.

6

7 **Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND.**

8 **A.** I have a Bachelor of Arts degree in Mathematics from Trinity University in San  
9 Antonio, Texas and Master of Business Administration from St. Edwards  
10 University in Austin, Texas. I have also completed a Telecommunications  
11 Management Program from the Graduate School of Management at the University  
12 of Dallas and an Advanced Management Program in Telecommunications from  
13 the Marshall School of Business at the University of Southern California.

14

15 **Q. HAVE YOU TESTIFIED PREVIOUSLY BEFORE ANY REGULATORY**  
16 **COMMISSION ?**

17 **A.** Yes. I have testified previously before the Florida Public Service Commission  
18 ("FLPSC") and in numerous proceedings involving cost issues before public  
19 regulatory commissions in Alabama, Arkansas, Georgia, Kentucky, Louisiana,  
20 Mississippi, North Carolina, South Carolina, Tennessee, and Texas.

21

22 **Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY IN THIS**  
23 **PROCEEDING?**

24 **A.** The purpose of my testimony is to evaluate the calculation of BellSouth  
25 Telecommunications Inc.'s ("BST"), GTE Florida Inc.'s ("GTE"), and Sprint-

1 Florida Inc.'s ("Sprint") operating expense inputs to the Benchmark Cost Proxy  
2 Model 3.1 ("BCPM3.1") Operating expenses result from activities such as  
3 marketing, operator services, general administrative, and network operations.  
4 Attached to my testimony as Exhibit ALR-1 is a table that itemizes the total  
5 universal service cost per line proposed by BST, GTE, and Sprint. In this table, I  
6 have highlighted in bold print the operating expenses that are the focus of my  
7 analysis. The cost model adopted by the FLPSC should reflect the total forward-  
8 looking costs that an efficient provider of telecommunications services incurs in a  
9 competitive environment. Based on my analysis, the BCPM3.1 operating expense  
10 inputs submitted by BST, GTE and Sprint do not meet this criteria  
11

12 **Q. ARE YOU FAMILIAR WITH THE OPERATING EXPENSE INPUTS**  
13 **ASSOCIATED WITH THE BCPM COST MODEL?**

14 **A.** Yes. In addition to evaluating inputs to the BCPM3.1 model filed here in Florida,  
15 I have also evaluated inputs to the BCPM models filed by BST in Alabama,  
16 Louisiana, Kentucky, Mississippi, North Carolina, South Carolina, and  
17 Tennessee. BST has routinely populated the operating expense modules of the  
18 BCPM model with cost data that was developed in the shared and common cost  
19 module of BST's Unbundled Network Element ("UNE") Total Element Long Run  
20 Incremental Cost ("TELRIC") cost model. I have previously filed testimony  
21 addressing BST's shared and common cost development in the UNE cost  
22 proceeding here in Florida in conjunction with Docket Nos. 960833-TP/960846-  
23 TP/971140-TP/960757-TP/960916-TP. I have also reviewed GTE's and Sprint's  
24 operating expense inputs to the BCPM model in various other states including  
25 Alabama, Kentucky, North Carolina, South Carolina, and Tennessee.



1 Q. SHOULD THE FLPSC ACCEPT THE METHOD IN WHICH  
2 OPERATING EXPENSES, RESULTING FROM THE PROVISION OF  
3 BASIC LOCAL SERVICE, HAVE BEEN CALCULATED BY BST, GTE,  
4 AND SPRINT AS INPUTS TO THE BCPM3.1 MODEL? IF NOT, WHY  
5 NOT?

6  
7 A. No. The FLPSC cannot rely on the method in which BST, GTE, and Sprint have  
8 calculated universal service operating expenses because:

- 9 1. the accuracy of the BST, GTE, and Sprint operating expense inputs  
10 and calculations cannot be confirmed; and
- 11 2. the operating expense inputs for BST, GTE, and Sprint are based  
12 largely on historical costs and include other inappropriate costs that are  
13 not reflective of forward-looking, competitive costs.

14  
15 Q. WHAT ARE BST'S, GTE'S, AND SPRINT'S RECOMMENDED  
16 OPERATING EXPENSES PER LINE RESULTING FROM THE  
17 PROVISION OF BASIC UNIVERSAL SERVICE IN FLORIDA?

18 A. Exhibit ALR-1, line 4, provides a summary of the total operating expenses  
19 proposed by BST, GTE, and Sprint for use in this proceeding as inputs to the  
20 BCPM3.1 model. Exhibit ALR-2 provides an account summary for certain BST  
21 operating expenses that are identified as basic local service costs. Neither GTE  
22 nor Sprint provided sufficient operating expense detail in its filings for the  
23 development of a comparable exhibit.

24

1 Q. HAVE BELLSOUTH, GTE, OR SPRINT PROVIDED THIS  
2 COMMISSION ADEQUATE SUPPORTING DOCUMENTATION WITH  
3 WHICH TO VERIFY THE ACCURACY OF THE OPERATING EXPENSE  
4 INPUTS TO THE BCPM3.1 MODEL? PLEASE EXPLAIN.

5 A. No. On page 16, lines 6-7, of the testimony of BellSouth witness Daonne  
6 Caldwell, she states that operating expense inputs to the BCPM3.1 model were  
7 based on "BellSouth-specific expenses using 1998-2000 period total regulated  
8 expenses." These are the expenses reflected in column B of Exhibit ALR-2 to my  
9 testimony. Nowhere in the testimony or the BCPM study data that was filed, has  
10 BellSouth provided any calculations or supporting documentation that affords this  
11 Commission, or any party to this case, the means with which to verify the  
12 appropriateness of these operating expenses.

13 With respect to the determination of GTE operating expenses, witness Michael R.  
14 Norris states on page 4, lines 19-22, that "the starting point for assigning expense  
15 and investment to cost pools is state-specific, 1997 USOA ARMIS data. The  
16 ARMIS account data, at a budget center level of detail, is then assigned to work  
17 centers, which are, in turn, assigned to cost pools." GTE relies upon this cost pool  
18 data to develop its local service costs. However, nowhere in their filing has GTE  
19 provided calculations, mappings of costs between centers and cost pools, and the  
20 necessary supporting documentation that would allow this Commission to verify  
21 the appropriateness of the resulting operating expense inputs. In addition, a  
22 footnote to Exhibit MRN-3 page 1 of 2 of the testimony of witness Michael R.  
23 Norris states "adjusted expenses were developed based on the ICM 3.0 model".  
24 Nowhere in their filing has GTE provided supporting documentation for this

1 model nor does it indicate whether other inputs to the BCPM3.1 were also  
2 developed using data from the ICM model.

3 With respect to Sprint's operating expenses, witness Kent W. Dickerson states on  
4 page 16, lines 10-17, of his testimony that " estimates were derived from the  
5 actual operating expenses Sprint experienced in Florida during 1997." Here too,  
6 Sprint has provided no calculations or supporting documentation to allow for the  
7 verification of operating expenses.

8  
9 **Q. DOES THE METHOD IN WHICH BST, GTE, AND SPRINT DETERMINE**  
10 **OPERATING EXPENSE INPUTS FOR THE BCPM3.1 MODEL**  
11 **PRODUCE APPROPRIATE FORWARD-LOOKING RESULTS? PLEASE**  
12 **EXPLAIN.**

13 **A.** No. For BST, I concluded this when I evaluated the same operating expense data  
14 derived from the shared and common cost component of the UNE TELRIC cost  
15 model filed by BST here in Florida in conjunction with Docket Nos. 960833-  
16 TP/960846-TP/971140-TP/960757-TP/960916-TP. I determined that the  
17 projected operating expense levels are based largely on historical costs instead of  
18 the forward-looking costs that an efficient company can achieve today in a  
19 competitive environment. BellSouth did not fully consider the role that  
20 competition, technology, and productivity play in reducing operating expenses  
21 below historical costs.

22 Based on the insufficient and or lack of calculations and information filed by GTE  
23 and Sprint in support of their operating expense inputs, it is abundantly clear that  
24 this Commission does not have the means to determine whether these expense

1 inputs are reflective of the forward-looking costs that an efficient provider of  
2 telecommunications services incur in a competitive environment.

3  
4 **Q. HOW DO COMPETITION, TECHNOLOGY, AND PRODUCTIVITY**  
5 **PLAY A ROLE IN PRODUCING LOWER OPERATING EXPENSE UNIT**  
6 **COSTS THAN THE HISTORICAL COSTS OF A REGULATED**  
7 **MONOPOLY?**

8 **A.** Competition, technology, and improved productivity produce lower operating unit  
9 costs for a number of reasons. First, competition provides a powerful incentive  
10 for a regulated monopoly to reduce its overhead expenses and to increase its  
11 productivity. Otherwise, it would find itself unable to compete against its "leaner  
12 and meaner" competition. Although the onset of competition has impacts on  
13 operating expenses across-the-board, it has a particularly significant impact on  
14 General and Administrative ("G&A") costs. These are overhead or common costs  
15 like executive salaries or accounting and finance costs. In a competitive  
16 environment, G&A expenses per line are considerably less than those reflected by  
17 BST, GTE, and Sprint in their BCPM3.1 inputs.

18 Second, the increased use of more modern, least cost technology produces lower  
19 network operating expenses in a competitive environment. In a least-cost,  
20 forward-looking environment, an efficient carrier starting in business today would  
21 utilize the most modern network equipment available. Because current trends  
22 show network operations expenses per line declining, they can be expected to be  
23 less than the historical levels reflected in BST's, GTE's, and Sprint's operating  
24 expense inputs and by necessity, be more in line with those of a least cost, most  
25 efficient carrier.



1 Q. HAVE BST AND GTE INCLUDED NON-RECURRING COSTS IN ITS  
2 CALCULATION OF THE OPERATING EXPENSE PORTION OF BASIC  
3 UNIVERSAL SERVICE COSTS? IF SO, PLEASE EXPLAIN WHY THIS  
4 IS INAPPROPRIATE.

5 A. Yes. Based on an analysis of the calculation of operating expenses in the UNE  
6 model filed here in Florida in conjunction with Docket Nos. 960833-TP/960846-  
7 TP/971140-TP/960757-TP/960916-TP, BST has included non-recurring operating  
8 expenses such as those resulting from service order related activities, in its  
9 calculation of basic universal service costs. This is inappropriate because service  
10 order related activities are one-time cost based activities that only benefit the  
11 customers requesting the service. Non-recurring costs of this nature should be  
12 separately identified and considered in non-recurring cost studies.

13 BST's treatment of non-recurring costs is also contrary to the action taken by GTE  
14 to remove non-recurring costs from its calculation of basic local service costs. On  
15 page 3, lines 14-16, of the testimony of witness Michael R. Norris, he states  
16 "these costs are recovered through non-recurring charges associated with service  
17 order activity and as such must be removed so as not to recover the same expense  
18 twice".

19 I cannot determine what Sprint has done with non-recurring costs. In other states  
20 where sufficient supporting data was provided, Sprint included non-recurring  
21 costs in its determination of the costs of recurring local service.

22  
23 Q. HAVE YOU CALCULATED AN ADJUSTMENT TO REMOVE THE  
24 NON-RECURRING COSTS THAT BST AND SPRINT HAVE INCLUDED  
25 AS INPUTS TO THE BCPM MODEL?



1 A. No. I did not have the required information with which to make this adjustment  
2 at this time. Neither BST nor Sprint filed any supporting documentation that  
3 allows any party to this proceeding to calculate such an adjustment. This  
4 Commission must make certain that both BST and Sprint identify their non-  
5 recurring costs and exclude them from their calculation of basic local service  
6 operating expenses.

7  
8 **Q. IN CALCULATING BST'S, GTE'S, AND SPRINT'S BASIC SERVICE**  
9 **OPERATING EXPENSES, IS IT APPROPRIATE TO INCLUDE ALL**  
10 **MARKETING EXPENSES AS A NECESSARY COST OF RESIDENTIAL**  
11 **BASIC SERVICE COSTS? IF NOT, WHY NOT?**

12  
13 A. No. BST, GTE, and Sprint do not advertise basic local service. Consequently, it  
14 is inappropriate to include any advertising expense in the calculation of basic  
15 local universal service costs. On Exhibit ALR-3, I have reflected an adjustment  
16 that removes any advertising expenses included in the Marketing expense  
17 category for BST. Although I did not have sufficient detail by account with  
18 which to make a similar adjustment to GTE's and Sprint's calculations, advertising  
19 expense should be removed from their calculations as well.

20  
21 **Q. DO YOU AGREE WITH THE WAY THAT THE BST HAS**  
22 **CALCULATED THE PORTION OF REGULATED OPERATING**  
23 **EXPENSES ATTRIBUTABLE TO UNIVERSAL BASIC LOCAL**  
24 **SERVICE?**

1 A. No. As shown on Exhibit ALR-2, BST has utilized factors labeled "%  
2 Attributable to Basic Service" to derive the portion of total regulated expenses per  
3 line that BST presumes are attributable to basic service. In documentation  
4 supporting the BCPM3.0 and previous versions of BCPM that BST has filed in  
5 other states including, Kentucky, South Carolina and North Carolina, a uniform  
6 basic local factor was applied to all expense categories instead of the multiple  
7 factors now proposed. That factor represented basic local revenues as a percent of  
8 total revenues throughout the BST nine state region. BST has not explained why  
9 it has departed from their previous methodology nor provided evidence to support  
10 why either the single factor or the new/ multiple factors are appropriate cost  
11 drivers for determining the forward-looking operating expenses necessary for  
12 providing basic universal service. Without such a justification or verification, the  
13 Commission should not blindly rely on BST's data.

14  
15 **Q. DO THE BASIC SERVICE FACTORS APPEARING ON EXHIBIT ALR-2**  
16 **REPRESENT REASONABLE PERCENTAGES FOR DERIVING COSTS**  
17 **THAT MAY BE ATTRIBUTABLE TO BASIC LOCAL SERVICE?**

18 A. No. This is illustrated by the factor being used to determine the portion of  
19 marketing expenses that are attributed to basic local service. As shown on Exhibit  
20 AL-2, BST assumes that 86.25% of all marketing expense per line is attributable  
21 to basic local service. If one keeps in mind that marketing expense includes sub-  
22 categories of expense such as product advertising, which is approximately 24% of  
23 marketing expense, this factor is particularly unreasonable because BST does not  
24 advertise its basic local service. Consumers should not have to pay for marketing  
25 expenses that BST does not incur.

1 Q. IN SUMMARY, WHAT IS THE IMPACT OF YOUR RECOMMENDED  
2 ADJUSTMENTS TO THE OPERATING EXPENSE INPUTS PROPOSED  
3 BY BST, GTE, AND SPRINT?

4 A. If this Commission adopts the BCPM3.1 model and the proposed inputs, Exhibit  
5 ALR-3 includes adjustments that must at minimum be made to reduce BST's  
6 overhead expenses by 15% and to reduce network operating expenses by 30%.  
7 These are the same adjustments recommended by the FLPSC Staff and adopted  
8 by this Commission in the Final Order for the UNE proceeding in conjunction  
9 with Docket Nos. 960833-TP/960845-TP/971140-TP/960757-TP/960916 ( See  
10 Order No. PSC-98-0604-FOF-TP). In addition, Exhibit ALR-3 also includes  
11 adjustments to remove advertising expenses from the Marketing expense line. I  
12 have also substituted the proposed BST basic service factors shown in Exhibit  
13 ALR-2 with a single factor of 40.85% as discussed previously. If applied to the  
14 data that BST has used to populate the BCPM3.1 model, the impact of those  
15 adjustments is to reduce the operating expenses per line related to plant non-  
16 specific expenses proposed by BST from \$9.14 to \$5.40. (see Exhibits ALR-2 and  
17 ALR-3)

18 Because GTE and Sprint have provided insufficient support for this Commission  
19 to verify the appropriateness of the operating expense inputs, the 15% reduction  
20 to overheads and 30% reduction to network operating expenses are reasonable  
21 adjustments that should be made. In addition, this Commission should obtain the  
22 necessary data to remove advertising expenses from the calculation of Marketing  
23 Expenses for GTE and Sprint and apply a single basic local service factor that  
24 represents basic local service revenues as a percent of total revenues.  
25

1 Q. DOES THIS CONCLUDE YOUR TESTIMONY?

2 A. Yes it does.

3

4

5

6

7



**STATE OF FLORIDA**  
**BST, GTE & SPRINT PROPOSED USF COST PER LINE**

		<b>Total State Summary (Uncapped)</b>		
	<u>Cost Component</u>	<u>BST (1)</u>	<u>GTE(2)</u>	<u>SPRINT (3)</u>
1	Capital Cost per line	20.00	20.09	20.85
	<u>Operating Expenses</u>			
2	Based on percent of investment	2.42	4.38	4.55
3	Expressed as expense per line	9.09	7.61	7.74
4	(Lns. 2&3) Total Operating Expenses per line	11.51	11.99	12.29
5	(Lns. 1-3) Total Basic Service Cost Per Line	31.51	32.08	33.14

**Sources:**

- (1) BellSouth filed BCPM 3.1; Total State Summary; Uncapped
- (2) GTE filed BCPM 3.1; Total State Summary; Uncapped
- (3) Sprint filed BCPM 3.1; Total State Summary; Uncapped



**BELLSOUTH  
EXPENSES PER LINE  
USF FILING  
PER BCPM 3.1 (DOCUMENTATION)**

<u>Account</u>	<u>Description</u>	<u>1998-2000 Expenses</u>	<u>Total Physical Lines</u>	<u>Annual Expenses Per Line</u>	<u>Monthly Expenses Per Line</u>	<u>% Attributable To Basic Service</u>	<u>Basic Local Svc Mo. Expenses Per Line</u>
	<u>a</u>	<u>b</u>	<u>c</u>	<u>d</u>	<u>e</u>	<u>f</u>	<u>g</u>
611X	Network Support	\$ 10,755,204	25,212,407	\$0.43	\$0.04	73.54%	\$0.026
6121 - 6124	General Support	\$ 568,701,312	25,212,407	\$22.56	\$1.88	76.85%	\$1.445
6311, 6362	IOT	\$ 129,608,934	25,212,407	\$5.14	\$0.43	85.74%	\$0.367
6512	Other Property Plant	\$ 9,580,707	25,212,407	\$0.38	\$0.03	79.83%	\$0.025
653x	Network Operations	\$ 851,910,306	25,212,407	\$33.79	\$2.82	79.86%	\$2.249
6610	Marketing	\$ 598,586,851	25,212,407	\$23.74	\$1.98	86.25%	\$1.706
6620	Services	\$ 1,078,993,063	25,212,407	\$42.80	\$3.57	12.94%	\$0.461
671X	Executive & Planning	\$ 45,153,642	25,212,407	\$1.79	\$0.15	65.56%	\$0.098
672X	General & Admin Uncollectibles	\$ 1,123,983,531	25,212,407	\$44.58	\$3.72	65.54%	\$2.435
		\$ 159,801,000	25,212,407	\$6.34	\$0.53	61.34%	\$0.324
	<b>Total Expenses</b>	<b>\$ 4,577,074,580</b>	<b>25,212,407</b>	<b>\$161.54</b>	<b>\$15.13</b>		<b>\$9.136</b>

**BELLSOUTH  
ADJUSTED EXPENSES PER LINE  
AT&T PROJECTED EXPENSES**

<u>Account</u>	<u>Description</u>	<u>1998-2000</u> <u>Expenses</u>	<u>Total</u> <u>Physical</u> <u>Lines</u>	<u>Annual</u> <u>Expenses</u> <u>Per Line</u>	<u>Monthly</u> <u>Expenses</u> <u>Per Line</u>	<u>Ratio: Basic</u>	
						<u>Local Svc</u> <u>Rev to Total</u> <u>Oper Rev</u>	<u>Adjusted</u> <u>Expenses</u> <u>Per Line</u>
		(1)	(2)	(3)	(4)	(5)	(6)
611X	Network Support	\$ 10,755,204	25,212,407	\$0.43	\$0.04	40.85%	\$0.015
6121 - 6124	General Support	\$ 568,701,312	25,212,407	\$22.56	\$1.88	40.85%	\$0.768
6311, 6362	IOT	\$ 129,608,964	25,212,407	\$5.14	\$0.43	40.85%	\$0.175
6512	Other Property Plant	\$ 8,706,495	25,212,407	\$0.27	\$0.02	40.85%	\$0.009
653x	Network Operations	\$ 596,337,214	25,212,407	\$23.65	\$1.97	40.85%	\$0.805
6610	Marketing	\$ 454,926,007	25,212,407	\$18.04	\$1.50	40.85%	\$0.614
6620	Services	\$ 1,078,993,063	25,212,407	\$42.80	\$3.57	40.85%	\$1.457
671X	Executive & Planning	\$ 38,380,596	25,212,407	\$1.52	\$0.13	40.85%	\$0.052
672X	General & Admin	\$ 955,386,001	25,212,407	\$37.89	\$3.16	40.85%	\$1.290
	Uncollectibles	\$ 159,601,000	25,212,407	\$6.34	\$0.53	40.85%	\$0.216
	<b>Total Expenses</b>	<b>3,999,595,856</b>	<b>25,212,407</b>	<b>\$ 158.64</b>	<b>\$ 13.22</b>		<b>\$5.400</b>