

1 *combined synergy gains fall below the amounts forecast by Salomon and upon which*
2 *Salomon's fairness opinion has been based.*

3
4 Q. Are all merger synergies considered when determining the amount to flow to Illinois
5 ratepayers under Section 204(c)?

6
7 A. No. In calculating the gains to be flowed to Illinois ratepayers, the Commission need only
8 concern itself with the portion of the merger synergies that are attributed to Ameritech
9 shareholders, because these synergies represent the increase in value of the Ameritech
10 network that has been financed largely at the captive ratepayers' expense. The proper
11 assessment of the amount to flow to Illinois ratepayers would be to first determine the
12 amount of the merger synergies attributed to Ameritech shareholders, and then to determine
13 the appropriate portion to allocate to Illinois regulated intrastate telco operations.

14
15 **The Applicants' estimation of synergy benefits is unrealistically small.**

16
17 Q. Have the Applicants attempted to quantify the anticipated synergy benefits resulting from the
18 proposed merger?

19
20 A. Yes. According to SBC, total synergy benefits to SBC and Ameritech resulting from the
21 merger are estimated to be \$2.5-billion by 2003, of which \$1.4-billion are associated with
22 cost savings, \$778-million are associated with increased revenues, and \$300-million (of both

1 cost savings and increased revenues) are associated with the provision of long distance
2 service.¹¹⁰

3
4 In calculating the Illinois-specific portion of the benefits, Mr. Kahan relies only upon the
5 benefits attributed to expense saving in Ameritech's serving area, or \$646-million of the
6 \$1.431-billion estimate.¹¹¹ SBC disaggregated the \$646-million value into four groups
7 (Administrative, Support, Telco and Procurement), and then applied several factors.¹¹² The
8 resulting portion of the total synergies attributed by SBC to Illinois Bell was calculated at
9 \$90-million.¹¹³ Mr. Kahan calculates the net present value of the synergy savings in Illinois,
10 after taxes, interest, depreciation and amortization, net of implementation costs, to be \$31-
11 million.¹¹⁴

12
13 Q. Do you agree with this estimate and with the manner in which it was constructed?

14
15 A. No, in fact, I have several serious concerns about the unrealistically small "cost savings"
16 figure that Mr. Kahan has presented.

110. Kaplan (SBC), FCC Affidavit, at ¶¶ 2, 4, 17 and 26.

111. Kahan (SBC), at 71.

112. Factors derived by Ameritech witness Gebhardt included a "Telco" factor (portion of Ameritech Corporation attributed to AOCs), an "Illinois" factor (portion of AOC's attributed to Illinois), a "Regulated Services" factor (portion of Ameritech-Illinois attributed to regulated services), and an "Intrastate" separations factor were applied to the Ameritech synergy savings, separately by group. Gebhardt (Ameritech); at Schedule 1.

113. Kahan (SBC), at 73-74.

114. *Id.*, at 74.

1 First, Mr. Kahan's calculation includes only the initial three years following the closing date
2 of the transaction; any cost savings beyond that period have been excluded, apparently on the
3 theory that after three years, all of Illinois Bell's services will be deregulated.¹¹⁵ As
4 discussed briefly earlier in my testimony, such an aggressive assertion should be viewed
5 with a high amount of skepticism by the Commission for several reasons:

- 6
- 7 • As discussed in the Direct Testimony of Charlotte TerKeurst, there is sufficiently little
8 actual competition in Illinois as to belie the three-year deregulation expectation.
 - 9
 - 10 • Nearly three years have passed since enactment of the Telecommunications Act of 1996,
11 yet local competition is minimal in almost every jurisdiction in the country.¹¹⁶
 - 12
 - 13 • Even SBC concedes that its own penetration of out-of-region local markets under the
14 National-Local Strategy will be limited to 4% for residential and small business
15 segments. As the most powerful local entrant in such markets, that 4% is likely to
16 represent the dominant portion of the non-ILEC market share; but even if it were half of
17 the non-ILEC share, that would still leave the ILECs with 92%, hardly enough
18 competitive presence to justify "deregulation."
 - 19

20 Merger synergies realized by the combined SBC/Ameritech will undoubtedly extend beyond
21 the 2003 horizon set by the Applicants, and limiting the amount of savings to be flowed to

115. *Id.* This assumes acceptance of the proposed merger by year-end 1999.

116. Common Carrier Bureau Survey of Local Competition, FCC CC Public Notice regarding responses to the Common Carrier Bureau Survey on the State of Local Competition, March 27, 1998, www.fcc.gov/ccb/local_competition/survey/responses.

1 Illinois customers based on the unrealistic expectation that all services will be competitive
2 by that time presents a serious flaw in SBC's calculation.

3
4 Second, Mr. Kahan's number is limited entirely to expense savings, and gives no weight
5 whatsoever to other synergy benefits, such as the increased productivity of Illinois Bell's
6 network due to the various revenue enhancement marketing initiatives that SBC plans to
7 pursue, or to the allocation of certain Illinois Bell costs to nonregulated SBC affiliates as a
8 consequence of the transfer of certain of Illinois Bell's assets and other resources (including
9 its best practices, brand identification, experienced and highly trained managers and other
10 employees, cash flow, customer base, and other valuable resources) to affiliates, as is
11 specifically required by Section 7-204(b)(3).

12
13 Third, Mr. Kahan has offset the first three years' worth of savings with *the entirety* of the
14 merger implementation costs (all of which would be incurred by SBC within the first three
15 years), thereby ignoring entirely the fact that the synergies made possible by these
16 implementation measures will continue to generate cost savings to SBC for many years to
17 come — *even if all of Illinois Bell's noncompetitive services were to be deregulated after*
18 *three years*, which of course won't be the case.

19
20 Q. How did Mr. Kahan allocate merger implementation costs to Illinois in calculating the value
21 of net merger savings attributable to Illinois intrastate regulated services?
22

1 A. At this point, it is unclear what the total implementation costs associated with the merger
2 are¹¹⁷ and how these costs were apportioned to Illinois regulated intrastate telco operations,
3 as the Applicants have failed to provide any specific derivations on how these costs should
4 be spread across SBC, other (future) lines of business, non-telco Ameritech operations, other
5 AOCs, unregulated services, and interstate services.¹¹⁸ As such, it is difficult to ensure that
6 the implementation costs accounted for by SBC in its synergy estimate workpapers
7 accurately make these apportionments.

8

9 **The Section 7-204(c) allocation of merger savings to Illinois ratepayers should be based**
10 **upon the allocation of aggregate merger benefits as determined through arm's length**
11 **negotiations between SBC and Ameritech.**

12

13 Q. Dr. Selwyn, you have expressed several serious concerns with the Applicants' calculation of
14 the amount of synergy benefits that should flow to Illinois ratepayers. Have you developed
15 an alternative method as to how the merger-driven benefits allocated to Illinois Bell
16 customers pursuant to Sections 7-204(b)(3) and 7-204(c) should be calculated?

17

18 A. Yes. I touched on this methodology earlier in my testimony, and I will now discuss it in
19 greater detail. The appropriate manner in which to derive "the allocation of any savings
20 resulting from the proposed reorganization" should be based upon the ratio of:

117. See SBC response to GCI-SBC-4-3(a).

118. See SBC response to GCI-SBC-4-3(b). The idea that implementation costs have not been apportioned in this manner is particularly curious given the fact that some disaggregation of implementation costs must have been necessary in order to provide the values appearing in proprietary Illinois-specific workpapers provided by SBC (Bates pages 004-04985 through 004-04992) that were used to derive the \$31-million net present value of the Illinois-specific merger benefits.

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Merger gains specifically associated with
Illinois Bell intrastate noncompetitive services

Total merger gains inuring to Ameritech

In order to calculate this ratio, I relied primarily upon the factors presented by Ameritech witness Gebhardt.¹¹⁹ By multiplying all of the factors together, I arrived at a “composite” allocation factor that can be used to accurately capture the Illinois intrastate regulated portion of the total merger benefits resulting from the proposed combination. These factors are:

	Percentage of Ameritech represented by telco operations	72.8%
x	Percentage of Ameritech telco operations represented by Illinois Bell	25.3%
x	Percentage of Ameritech telco operations that is jurisdictionally intrastate	77.3%
x	Percentage of Ameritech intrastate telco operations that are associated with regulated services	83.5%
x	Percentage of Ameritech intrastate telco operations that is associated with noncompetitive services ¹²⁰	73.8%

119. See footnote 112, *infra*.

120. To Mr. Gebhardt’s factors, I added a factor that captures the portion of Ameritech associated with noncompetitive services (i.e., Telecommunications and Directory services), which is based on the segmented public market analysis valuation of Ameritech Corporation prepared by Salomon Smith Barney, as reported in the Amended Joint Proxy Statement, September 21, 1998, at 30-32. It is important to note, however, that we assume this factor includes all noncompetitive services independent of the price cap plan. If that is not the case, this factor should be corrected.

1 = Share of aggregate merger savings allocable to Illinois Bell
2 noncompetitive services 8.77%

3
4 Q. To what figure should this 8.77% allocation factor be applied?

5
6 A. As I have previously noted, Salomon Smith Barney has estimated the present value of total
7 merger synergies at approximately \$19-billion. As I discuss in detail below, under the
8 specific terms of the Applicants' Merger Agreement, the bulk — in fact, as much as \$15.4-
9 billion — of those synergy gains will go to Ameritech shareholders. The 8.77% allocation
10 factor should be applied to Ameritech's share of the merger synergies; however, there are
11 two different ways in which that figure can be computed.

12
13 I will refer to the first method of calculating Ameritech's share of the merger synergies as
14 the *pre-announcement share price basis*. Immediately prior to the May 10, 1998
15 announcement date, Ameritech shares closed at \$43-7/8 and SBC shares closed at \$42-3/8.
16 Applying the 1.316 Exchange Ratio to the pre-announcement price of SBC produces a post-
17 merger share value for Ameritech of \$55.77 (i.e., 1.316 times 42-3/8), representing an
18 increment of \$11.89 over the pre-announcement value of Ameritech. Multiplying this
19 difference by the 1.109-billion Ameritech shares outstanding results in \$13.2-billion, the
20 premium value that SBC is prepared to pay in order to acquire Ameritech.

21
22 Q. What is the significance of this "premium value" in the present discussion?

23
24 A. The premium value represents a *portion* of the share of the aggregate merger synergies that
25 the parties have agreed to allocate to Ameritech shareholders. Further, inasmuch as

1 Salomon Smith Barney has issued a fairness opinion to SBC shareholders and Directors, one
2 may infer that, in Salomon Smith Barney's opinion, the aggregate synergy gain from the
3 merger will be *at least* the \$13.2-billion premium that SBC is prepared to pay for Ameritech.
4 Since both parties agreed to this price, one must assume that each is not only happy with the
5 outcome, but expects to gain more from the transaction than is merely reflected in the price
6 paid. Therefore, the \$13.2-billion premium would have to be considered the *minimum* share
7 of the merger synergies anticipated to be received by Ameritech shareholders.

8
9 Q. Recent share prices for the two companies that Ameritech shares are trading at something
10 less than 1.316 times the value of SBC shares. For example, on October 12, 1998,
11 Ameritech closed at \$49 5/16, or only 1.176 times the \$41 15/16 closing price of SBC on
12 that same day. Doesn't this suggest that the actual "premium" will be less than the \$13.2-
13 billion that you have calculated?

14
15 A. No. Ameritech shares are trading at a discount relative to their imputed value of 1.316 times
16 the SBC share price as established in the Merger Agreement. However, the reason for this
17 discount is the lack of certainty on the part of investors that the merger will actually take
18 place. If the merger does take place in accordance with the terms of the Merger Agreement,
19 then the value of one share of Ameritech will equal 1.316 shares of SBC, and the full \$13.2-
20 billion in premium will then be paid.

21
22 Q. What is the second method of calculating Ameritech's share of the synergy benefits resulting
23 from the merger?

24

1 A. The second such method is the *present value basis*: Salomon Smith Barney has calculated
2 the present value of synergy gains over and above the immediate premium that is to be
3 conferred on Ameritech shareholders.¹²¹ According to Salomon Smith Barney, on a fully-
4 diluted (i.e., post-merger) basis, the total increase in the value of the post-merger SBC is
5 expected to be approximately \$5.51 per share,¹²² which would apply to a total of
6 3,323,444,000 shares of SBC stock.¹²³ This results in a total anticipated synergy benefit of
7 \$18.3-billion.¹²⁴

8
9 Since Ameritech shares will have already absorbed \$13.2-billion of this amount, the
10 additional gain reflected in the diluted SBC share value will be roughly \$5.1-billion.
11 However, this residual gain will be shared by *both* SBC and Ameritech shareholders. Using
12 an allocation factor of 44% (the ratio of former Ameritech shares to the total post-merger

121. These estimates were calculated using the correct principle that synergy gains are *permanent*. This was the principle upon which the Applicants based their Merger Agreement, upon which their respective investment advisors based their fairness opinions, and upon which the Applicants apportioned the aggregate synergy gains between their respective groups of shareholders.

122. Amended Proxy Statement/Prospectus, September 21, 1998, at 35. Though Salomon Smith Barney also provided a "low" value for the increase in SBC's stock price of \$4.64, it is reasonable and conservative to use the high-end estimate. By Mr. Kahan's own admission, the National-Local Strategy will not even turn a profit until 2008. Hence, extending the merger synergies/benefits analysis into the profitable stage of the National-Local Strategy initiative would produce an aggregate synergy benefit well in excess of \$5.51 per share.

123. Of the total post-merger shares of SBC stock, 1,459,444,000 would be held by former Ameritech shareholders (1,109,000,000 current Ameritech shares multiplied by the 1.316 Exchange Ratio), and 1,864,000,000 would be held current SBC shareholders.

124. This value differs from the \$19-billion referenced in the Amended Joint Proxy Statement, possibly due to rounding.

1 number of SBC shares),¹²⁵ one can see that an *additional* \$2.3-billion will be flowed to
2 Ameritech shareholders, which results in \$15.4-billion in initial and additional gains
3 combined.

4
5 Q. What does that leave for SBC shareholders?

6
7 A. SBC shareholders will capture only \$2.9-billion out of the aggregate \$19-billion in
8 combined synergies.

9
10 Q. Which of these two methods do you propose to the Commission?

11
12 A. I recommend that the Commission use the “present value basis” in calculating the amount of
13 synergy benefits that will ultimately inure to Ameritech shareholders, as it more accurately
14 captures the *total* amount of synergy benefits to which Illinois ratepayers have a certifiable
15 claim.

16
17 Q. It would appear that the merger synergies anticipated from the proposed combination are
18 unfairly biased toward Ameritech shareholders. Is this true?

19
20 A. The manner in which merger synergies have been allocated — and in particular the relatively
21 small gain that would flow to those who held SBC shares prior to the announcement — begs
22 the question as to why SBC is even bothering with this transaction at all. In fact, Salomon
23 Smith Barney’s net present value estimates appear to have accepted without modification the

125. $1,459,444,000 \div 3,323,444,000 = 0.44$

1 savings and cash flow analysis that was provided to it by SBC; even a modest reduction in
2 merger savings or additional revenues from those estimated by SBC could result in
3 aggregate merger synergies of less than \$13.2-billion, i.e., creating a net *loss* for the pre-
4 merger SBC shareholders. However, inasmuch as Salomon Smith Barney was willing to
5 render a fairness opinion based upon the data and analysis that it had, one must conclude that
6 neither Salomon nor SBC expected merger synergies to be any *less* than the figures
7 presented in the Joint Proxy Statement, and indeed that SBC must believe that they will be
8 considerably greater!

9
10 The portion of the aggregate merger synergies that the parties have allocated to Ameritech
11 shareholders is the result of an arm's length negotiation by informed and sophisticated
12 parties, backed up by opinions issued by qualified investment bankers that the specific
13 allocation is fair to both firms. This Commission can and should accept the portion of total
14 synergies allocated to Ameritech as constituting a composite of all of the sources of such
15 gains — cost savings through elimination of duplication, scale, lower input procurement
16 costs, and adoption of each firm's best practices; increased revenues through improved
17 utilization of existing plant; and substantial opportunities for expansion into new markets
18 through exploitation of each firm's customer base, managerial talent, network resources,
19 brand identification, patents, and other assets; all net of implementation costs.

20
21 Q. What is the dollar amount of Ameritech's share of the total synergy gains that should be
22 allocated to Illinois ratepayers as required by Section 7-204(b)(3) and 7-204(c)?
23

1 A. My recommendation of applying a “composite” allocation factor of 8.77% to the total
2 estimated Ameritech synergy benefits of \$15.4-billion (using the “present value basis”)
3 results in a total allocation to Illinois Bell intrastate noncompetitive services of \$1.4-billion.

4

5 Q. Earlier you raised some concern over SBC’s proposed recovery of implementation costs. Are
6 implementation costs properly apportioned in your calculation of synergy gains?

7

8 A. Yes. My calculation of synergy benefits attributable to Illinois Bell customers that I have
9 described above relies on publicly disclosed total synergy estimates *net of implementation*
10 *costs*, which should provide the Commission with some comfort that merger-related
11 implementation costs are apportioned without bias throughout the new SBC’s operations.¹²⁶

12

13 Q. How should this \$1.4-billion be flowed through to Illinois Bell ratepayers?

14

15 A. Even though most (i.e., \$13.2-billion ¹²⁷) of the total Ameritech share of combined synergy
16 gains will be realized by Ameritech shareholders on the date of the closing, I believe that it
17 would be appropriate for the \$1.4-billion Illinois ratepayer allocation to be flowed through
18 ratably over a ten-year period, amortized at a 9.5% discount rate. Moreover, because the

126. Unfortunately, the National-Local Strategy (and other new competitive ventures) were not considered by Salomon when its total synergies of \$19-billion were estimated; consequently, my “arm’s length” calculation of the Illinois-specific merger synergies will not reflect the National-Local Strategy’s portion of implementation costs of the merger, upon which the National-Local Strategy indisputably relies. As such, my recommendation is further established as a conservative amount.

127. \$1.2-billion of which can be attributed to Illinois ratepayers, using my composite allocation factor of 8.77%

1 flow-through would constitute a reduction of Illinois Bell earnings, the annual flow-through
2 will need to be adjusted from an after-tax to a pre-tax basis.

3

4 Q. Have you made this calculation?

5

6 A. Yes. Applying the 9.5% discount rate to the \$1.4-billion present value of the Illinois Bell
7 ratepayer allocation results in an annual after-tax figure of \$216-million. The rate decrease,
8 on a pre-tax basis, would then be \$343-million. This amount should be applied to all
9 noncompetitive IBT services, including wholesale, access, UNEs, transport and termination,
10 in a manner that fairly apportions the merger synergies across all noncompetitive services
11 and avoids the creation of a price squeeze between IBT retail services and services furnished
12 to competitive carriers.

13

14 Q. Are accounting adjustments required to reflect these merger synergies that would be flowed
15 through to consumers in lower rates?

16

17 A. Yes. The appropriate adjustment to Illinois Bell's rate base and operating expenses will be
18 needed in order to recognize the reduction in plant acquisition and operating costs, and the
19 allocation of certain costs to other components of the merged entity that result from the
20 merger. The effect of these accounting adjustments should be such that, together with the
21 rate reductions that I am recommending, there is no net change in Illinois Bell's intrastate
22 return on investment associated with noncompetitive services.

23

1 Q. Does the Commission need to reach a conclusion as to the date for ultimate deregulation of
2 all services in order to determine the amount of Section 7-204(b)(3) and 7-204(c) synergy
3 gains?
4

5 A. No, it does not. The manner in which I am proposing that synergy gains be allocated to
6 Illinois Bell ratepayers through a ten-year amortization will overcome the Company's
7 concerns about eventual deregulation. If significant, price-constraining competition in the
8 local market arrives and full deregulation occurs by the end of 2002 as Ameritech and SBC
9 suggest, then the regulatory-imposed flow-through will be replaced by market-driven
10 pricing. On the other hand if, as I expect, these services will remain noncompetitive and
11 fully regulated for some time to come, the flow-through of merger synergies will continue
12 without interruption.
13

14 **Conclusion**
15

16 Q. Does this conclude your testimony at this time?
17

18 A. Yes, it does.

Appendix 1
Statement of Qualifications

Statement of Qualifications**DR. LEE L. SELWYN**

Dr. Lee L. Selwyn has been actively involved in the telecommunications field for more than twenty-five years, and is an internationally recognized authority on telecommunications regulation, economics and public policy. Dr. Selwyn founded the firm of Economics and Technology, Inc. in 1972, and has served as its President since that date. He received his Ph.D. degree from the Alfred P. Sloan School of Management at the Massachusetts Institute of Technology. He also holds a Master of Science degree in Industrial Management from MIT and a Bachelor of Arts degree with honors in Economics from Queens College of the City University of New York.

Dr. Selwyn has testified as an expert on rate design, service cost analysis, form of regulation, and other telecommunications policy issues in telecommunications regulatory proceedings before some forty state commissions, the Federal Communications Commission and the Canadian Radio-television and Telecommunications Commission, among others. He has appeared as a witness on behalf of commercial organizations, non-profit institutions, as well as local, state and federal government authorities responsible for telecommunications regulation and consumer advocacy.

He has served or is now serving as a consultant to numerous state utilities commissions including those in Arizona, Minnesota, Kansas, Kentucky, the District of Columbia, Connecticut, California, Delaware, Maine, Massachusetts, New Hampshire, Vermont, New Mexico, Wisconsin and Washington State, the Office of Telecommunications Policy (Executive Office of the President), the National Telecommunications and Information Administration, the Federal Communications Commission, the Canadian Radio-television and Telecommunications Commission, the United Kingdom Office of Telecommunications, and the Secretaria de Comunicaciones y Transportes of the Republic of Mexico. He has also served as an advisor on telecommunications regulatory matters to the International Communications Association and the Ad Hoc Telecommunications Users Committee, as well as to a number of major corporate telecommunications users, information services providers, paging and cellular carriers, and specialized access services carriers.

Dr. Selwyn has presented testimony as an invited witness before the U.S. House of Representatives Subcommittee on Telecommunications, Consumer Protection and Finance and before the U.S. Senate Judiciary Committee, on subjects dealing with restructuring and deregulation of portions of the telecommunications industry.

In 1970, he was awarded a Post-Doctoral Research Grant in Public Utility Economics under a program sponsored by the American Telephone and Telegraph Company, to conduct research on the economic effects of telephone rate structures upon the computer time sharing industry. This work was conducted at Harvard University's Program on Technology and Society, where he was appointed as a Research Associate. Dr. Selwyn was also a member of the faculty at the College of Business Administration at Boston University from 1968 until 1973, where he taught courses in economics, finance and management information systems.

Dr. Selwyn has published numerous papers and articles in professional and trade journals on the subject of telecommunications service regulation, cost methodology, rate design and pricing policy. These have included:

"Taxes, Corporate Financial Policy and Return to Investors"
National Tax Journal, Vol. XX, No.4, December 1967.

"Pricing Telephone Terminal Equipment Under Competition"
Public Utilities Fortnightly, December 8, 1977.

"Deregulation, Competition, and Regulatory Responsibility in the
Telecommunications Industry"
*Presented at the 1979 Rate Symposium on Problems of Regulated Industries -
Sponsored by: The American University, Foster Associates, Inc., Missouri
Public Service Commission, University of Missouri-Columbia, Kansas City,
MO, February 11 - 14, 1979.*

"Sifting Out the Economic Costs of Terminal Equipment Services"
Telephone Engineer and Management, October 15, 1979.

"Usage-Sensitive Pricing" (with G. F. Borton)
(a three part series)
Telephony, January 7, 28, February 11, 1980.

"Perspectives on Usage-Sensitive Pricing"
Public Utilities Fortnightly, May 7, 1981.

"Diversification, Deregulation, and Increased Uncertainty in the Public Utility
Industries"
*Comments Presented at the Thirteenth Annual Conference of the Institute of
Public Utilities, Williamsburg, VA - December 14 - 16, 1981.*

"Local Telephone Pricing: Is There a Better Way?; The Costs of LMS Exceed
its Benefits: a Report on Recent U.S. Experience."
*Proceedings of a conference held at Montreal, Quebec - Sponsored by
Canadian Radio-Television and Telecommunications Commission and The
Centre for the Study of Regulated Industries, McGill University, May 2 - 4,
1984.*

"Long-Run Regulation of AT&T: A Key Element of A Competitive
Telecommunications Policy"
Telematics, August 1984.

"Is Equal Access an Adequate Justification for Removing Restrictions on BOC Diversification?"

Presented at the Institute of Public Utilities Eighteenth Annual Conference, Williamsburg, VA - December 8 - 10, 1986.

"Market Power and Competition Under an Equal Access Environment"

Presented at the Sixteenth Annual Conference, "Impact of Deregulation and Market Forces on Public Utilities: The Future Role of Regulation" Institute of Public Utilities, Michigan State University, Williamsburg, VA - December 3 - 5, 1987.

"Contestable Markets: Theory vs. Fact"

Presented at the Conference on Current Issues in Telephone Regulations: Dominance and Cost Allocation in Interexchange Markets - Center for Legal and Regulatory Studies Department of Management Science and Information Systems - Graduate School of Business, University of Texas at Austin, October 5, 1987.

"The Sources and Exercise of Market Power in the Market for Interexchange Telecommunications Services"

Presented at the Nineteenth Annual Conference - "Alternatives to Traditional Regulation: Options for Reform" - Institute of Public Utilities, Michigan State University, Williamsburg, VA, December, 1987.

"Assessing Market Power and Competition in The Telecommunications Industry: Toward an Empirical Foundation for Regulatory Reform"

Federal Communications Law Journal, Vol. 40 Num. 2, April 1988.

"A Perspective on Price Caps as a Substitute for Traditional Revenue Requirements Regulation"

Presented at the Twentieth Annual Conference - "New Regulatory Concepts, Issues and Controversies" - Institute of Public Utilities, Michigan State University, Williamsburg, VA, December, 1988.

"The Sustainability of Competition in Light of New Technologies" (with D. N. Townsend and P. D. Kravtin)

Presented at the Twentieth Annual Conference - Institute of Public Utilities Michigan State University, Williamsburg, VA, December, 1988.

"Adapting Telecom Regulation to Industry Change: Promoting Development Without Compromising Ratepayer Protection" (with S. C. Lundquist)

IEEE Communications Magazine, January, 1989.

"The Role of Cost Based Pricing of Telecommunications Services in the Age of Technology and Competition"

Presented at National Regulatory Research Institute Conference, Seattle, July 20, 1990.

"A Public Good/Private Good Framework for Identifying POTS Objectives for the Public Switched Network" (with Patricia D. Kravtin and Paul S. Keller)
Columbus, Ohio: *National Regulatory Research Institute*, September 1991.

"Telecommunications Regulation and Infrastructure Development: Alternative Models for the Public/Private Partnership"

Prepared for the Economic Symposium of the International Telecommunications Union Europe Telecom '92 Conference, Budapest, Hungary, October 15, 1992.

"Efficient Infrastructure Development and the Local Telephone Company's Role in Competitive Industry Environment" *Presented at the Twenty-Fourth Annual Conference, Institute of Public Utilities, Graduate School of Business, Michigan State University, "Shifting Boundaries between Regulation and Competition in Telecommunications and Energy", Williamsburg, VA, December 1992.*

"Measurement of Telecommunications Productivity: Methods, Applications and Limitations" (with Françoise M. Clottes)

Presented at Organisation for Economic Cooperation and Development, Working Party on Telecommunication and Information Services Policies, '93 Conference "Defining Performance Indicators for Competitive Telecommunications Markets", Paris, France, February 8-9, 1993.

"Telecommunications Investment and Economic Development: Achieving efficiency and balance among competing public policy and stakeholder interests"

Presented at the 105th Annual Convention and Regulatory Symposium, National Association of Regulatory Utility Commissioners, New York, November 18, 1993.

"The Potential for Competition in the Market for Local Telephone Services" (with David N. Townsend and Paul S. Keller)

Presented at the Organization for Economic Cooperation and Development Workshop on Telecommunication Infrastructure Competition, December 6-7, 1993.

"Market Failure in Open Telecommunications Networks: Defining the new natural monopoly," *Utilities Policy*, Vol. 4, No. 1, January 1994.

"The Enduring Local Bottleneck: Monopoly Power and the Local Exchange Carriers," (with Susan M. Gately, et al) a report prepared by ETI and Hatfield UAssociates, Inc. for AT&T, MCI and CompTel, February 1994.

"Commercially Feasible Resale of Local Telecommunications Services: An Essential Step in the Transition to Effective Local Competition," (Susan M. Gately, et al) a report prepared by ETI for AT&T, July 1995.

"Efficient Public Investment in Telecommunications Infrastructure"
Land Economics, Vol 71, No.3, August 1995.

"Market Failure in Open Telecommunications Networks: Defining the new natural monopoly," in *Networks, Infrastructure, and the New Task for Regulation*, by Werner Sichel and Donal L. Alexander, eds., University of Michigan Press, 1996.

Dr. Selwyn has been an invited speaker at numerous seminars and conferences on telecommunications regulation and policy, including meetings and workshops sponsored by the National Telecommunications and Information Administration, the National Association of Regulatory Utility Commissioners, the U.S. General Services Administration, the Institute of Public Utilities at Michigan State University, the National Regulatory Research Institute at Ohio State University, the Harvard University Program on Information Resources Policy, the Columbia University Institute for Tele-Information, the International Communications Association, the Telecommunications Association, the Western Conference of Public Service Commissioners, at the New England, Mid-America, Southern and Western regional PUC/PSC conferences, as well as at numerous conferences and workshops sponsored by individual regulatory agencies.

Appendix 2

**Derivation of Premium Over Market Value
Paid by SBC for Ameritech Corporation**

**Derivation of Premium Over Book Value
Paid by SBC for Ameritech Corporation**

**Derivation of Synergy Benefits Allocable to Illinois Bell Customers
Under Section 7-204(c) Using "Present Value" Basis**

**Derivation of Increase in Revenue Base Assigned to Illinois Bell
Based on the Premium Over Book Value
Paid by SBC for Ameritech Corporation**

Derivation of Premium Over Market Value Paid by SBC for Ameritech Corporation		
Ameritech pre-merger stock price	\$	43.88
SBC pre-merger stock price	\$	42.38
Exchange Ratio		1.316
Ameritech post-merger stock price	\$	55.77
Ameritech shares outstanding (pre-merger)		1,109,000,000
Pre-merger market value of Ameritech	\$	48,657,375,000
Post-merger market value of Ameritech	\$	61,843,939,500
Premium over market value paid by SBC for Ameritech	\$	13,186,564,500
Sources: Amended Joint Proxy Statement, September 21, 1998.		

Derivation of Premium Over Book Value Paid by SBC for Ameritech Corporation		
Ameritech pre-merger stock price	\$	43.88
SBC pre-merger stock price	\$	42.38
Exchange Ratio		1.316
Ameritech post-merger stock price	\$	55.77
Ameritech shares outstanding (pre-merger)		1,109,000,000
Post-merger market value of Ameritech	\$	61,843,939,500
Ameritech Long-term Debt	\$	4,610,000,000
Ameritech Common Equity	\$	6,490,000,000
Difference between 10K and ARMIS Net Asset Values	\$	3,821,000,000
Book Value of Ameritech	\$	14,921,000,000
Premium over book value paid by SBC for Ameritech	\$	46,922,939,500
Sources:		
Amended Joint Proxy Statement, September 21, 1998.		
Ameritech Corporation 1997 Annual Report.		
FCC Statistics of Communications Common Carriers, 1997 edition.		

Derivation of Synergy Benefits Allocable to Illinois Bell Customers Under Section 7-204(c) Using "Present Value" Basis	
Total shares for combined SBC/AIT (post-merger)	3,323,444,000
Forecasted post-merger increase in SBC stock	\$ 5.51
Total forecasted post-merger synergies	\$ 18,312,176,440
Premium over market value paid by SBC for Ameritech	\$ 13,186,564,500
Forecasted post-merger synergies net of premium paid for Ameritech	\$ 5,125,611,940
Percentage of Ameritech shares in post-merger SBC/AIT	44%
Additional post-merger synergies received by Ameritech shareholders	\$ 2,250,840,872
Total merger benefits reaped by Ameritech shareholders	\$ 15,437,405,372
Total merger benefits reaped by SBC shareholders	\$ 2,874,771,068
Illinois "Composite" allocation factor	8.77%
Synergy benefit attributed to Illinois Bell	\$ 1,354,404,975
Discount Rate	9.5%
No. of payment periods (years)	10
Annual synergy benefit to Illinois Bell customers	\$ (215,710,868)
Composite Tax Rate	37%
Pre-tax annual rate reduction	\$ (343,313,707)
Sources: Amended Joint Proxy Statement, September 21, 1998. Gebhardt (Ameritech), at Schedule 1.	

Derivation of Increase in Revenue Base Assigned to Illinois Bell Based on the Premium Over Book Value Paid by SBC for Ameritech Corporation	
Premium over book value paid by SBC for Ameritech	\$ 46,922,939,500
Net Telephone Plant in Service (TPIS) for Illinois Bell	\$ 5,515,900,000
Net TPIS for Illinois Bell less long term debt	\$ 4,504,200,000
Ameritech Corp. Book value	\$ 14,921,000,000
Allocation factor of premium over book to Illinois Bell	30%
Amount of premium over book allocated to Illinois Bell	\$ 14,164,620,608
Overall investment in Illinois Bell	\$ 19,680,520,608
Composite intrastate, regulated, noncompetitive factor for Illinois	48%
Illinois Bell intrastate portion of premium over book	\$ 6,747,257,394
Discount Rate	9.5%
No. of payment periods (years)	10
Additional annual revenue requirement for Illinois Bell intrastate service	\$ (1,074,609,719)
Composite Tax Rate	37%
Additional pre-tax earnings required by Illinois Bell to offset the premium over book value paid by SBC for Ameritech	\$ (1,710,290,488)
Sources:	
Amended Joint Proxy Statement, September 21, 1998.	
Ameritech Corporation 1997 Annual Report.	
Illinois Bell 1997 Annual Report.	
FCC Statistics of Communications Common Carriers, 1997 edition.	
Gebhardt (Ameritech), at Schedule 1.	



ECONOMICS AND
TECHNOLOGY, INC.

ONE WASHINGTON MALL
BOSTON, MASSACHUSETTS 02108-2617

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FCC MAIL ROOM

Before the

**STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION**

SBC COMMUNICATIONS INC.,
SBC DELAWARE INC.,
AMERITECH CORPORATION,
ILLINOIS BELL TELEPHONE COMPANY
d/b/a AMERITECH ILLINOIS, and
AMERITECH ILLINOIS METRO, INC.

Joint Application for approval of the reorganization of Illinois Bell Telephone Company d/b/a Ameritech Illinois, and the reorganization of Ameritech Illinois Metro, Inc. in accordance with Section 7-204 of The Public Utilities Act and for all other appropriate relief.

Docket 98-0555

Rebuttal Testimony

of

LEE L. SELWYN

on behalf of the

Government and Consumer Intervenors (GCI):

Citizens Utility Board
Cook County State's Attorney
Attorney General of the State of Illinois

December 18, 1998

Before the
**STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION**

SBC COMMUNICATIONS INC.,
SBC DELAWARE INC.,
AMERITECH CORPORATION,
ILLINOIS BELL TELEPHONE COMPANY
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1 REBUTTAL TESTIMONY

2

3 **Introduction**

4

5 Q. Please state your name, position, and business address.

6

7 A. My name is Lee L. Selwyn. I am President of Economics and Technology, Inc., One
8 Washington Mall, Boston, Massachusetts 02108.

9

10 Q. Dr. Selwyn, have you previously submitted testimony in this proceeding?

11

12 A. Yes. On October 28, 1998, I submitted direct testimony in this proceeding on behalf of
13 the Government and Consumer Intervenors (GCI), consisting of the Citizens Utility
14 Board, the Cook County State's Attorney, and the Attorney General of the State of
15 Illinois.

16

17 **Summary of testimony**

18

19 Q. Please summarize your rebuttal testimony.

20

21 A. In my direct testimony, I discussed at great length the numerous risks to Illinois
22 consumers and competing local exchange carriers seeking to enter the local exchange
23 market that are engendered by the proposed merger between SBC and Ameritech
24 (Applicants). This rebuttal testimony will address and refute the contentions raised by
25 SBC witness James S. Kahan, Ameritech witness David H. Gebhardt, SBC/Ameritech

1 witness Robert G. Harris, and certain aspects of the testimony of Staff witness Rasha
2 Yow, on the following issues:

- 3
- 4 • *Only minimal, primarily niche-market competition currently exists in the local service*
5 *market in Illinois:* There is currently no mass-scale competition in the Illinois local
6 service market, and the incumbent LEC, Illinois Bell, continues to maintain a market
7 share in the 99% range.

 - 8
 - 9 • *Approval of the merger will have a chilling effect upon the entry of new local*
10 *competitors into Illinois and other portions of Ameritech's serving area:* The
11 increased concentration and elimination of SBC as an important and highly qualified
12 actual potential competitor will work to strengthen the post-merger SBC/Ameritech's
13 dominance in the Illinois telecommunications market and have a significant adverse
14 impact upon the development of actual and effective competition.

 - 15
 - 16 • *SBC is an actual potential competitor in the Ameritech region, and particularly in*
17 *Illinois:* SBC had begun to pursue a large-scale local wireline service entry initiative
18 in the Chicago metropolitan area bootstrapped off of its extensive cellular operations,
19 but abruptly abandoned this plan when its out-of-region entry strategy changed from
20 competition to acquisition.

 - 21
 - 22 • *The Applicants' National-Local Strategy will have an adverse impact upon Illinois*
23 *Bell and customers of its noncompetitive services:* SBC's plans to staff and finance
24 its new out-of-region entry program will divert resources from Illinois Bell and other

1 SBC ILECs and will be cross-subsidized by captive customers of the Company's
2 noncompetitive services.

- 3
- 4 • *Section 7-204(c) of the Illinois Public Utilities Act applies to all Illinois utilities,*
5 *including those currently operating under an alternative form of regulation: There is*
6 *no factual basis for the Applicants' contention that Section 7-204(c) does not apply*
7 *to "price cap" regulated companies such as Illinois Bell.*

 - 8
 - 9 • *The amount of merger-related synergy benefits that should be shared with Illinois*
10 *Bell ratepayers is correctly based upon the size of the premium that SBC is to pay to*
11 *acquire Ameritech in this arm's length transaction between two highly sophisticated*
12 *and knowledgeable entities.*

13

14 **The local service market in Illinois is not effectively competitive at the present time.**

15

16 Q. Dr. Selwyn, Mr. Kahan claims that your testimony should be disregarded because, he
17 contends, it mischaracterizes the state of local competition in Illinois by failing to
18 acknowledge the existence of AT&T and MCI as competitors.¹ Do AT&T and MCI
19 represent broad-based competition for Illinois Bell's local telephone services?

20

21 A. No, they do not. In his rebuttal testimony, Mr. Kahan discusses at length the emergence
22 of competitors, particularly large "integrated" interexchange carriers such as AT&T, MCI
23 and Sprint, into the Illinois local market, yet appears to rely simply upon their existence

24 1. Kahan (SBC), Rebuttal at 4-7, 66.

1 in the marketplace as some sort of proof of the "success" achieved by these companies in
2 presenting a serious challenge to Illinois Bell's incumbency, monopoly and dominance.²

3 In fact, Mr. Kahan relies heavily upon the presumption that the extensive advertising and
4 marketing of integrated services by these three IXCs is somehow linked to the current
5 level of market share possessed by each.³

6
7 Mr. Kahan's characterization of the current condition of the local service market is in
8 stark contrast to SBC's view that true mass-scale local entry can only take place if it is
9 permitted to acquire Ameritech and thereby to launch its so-called "National-Local
10 Strategy." Indeed, Mr. Kahan has repeatedly emphasized the importance of the proposed
11 merger to the success of the National-Local Strategy.⁴ Among other things, Mr. Kahan
12 testified that local entry could not succeed unless pursued on a mass scale,⁵ and that
13 some 8,000 employees and experienced management personnel, drawn from both SBC
14 and Ameritech local telephone operating companies, would be essential if the effort was
15 going to be successful.⁶

16
17 By Mr. Kahan's own standard, then, neither AT&T nor MCI can expect to be successful
18 in competing with ILECs *on a mass scale*. Neither AT&T nor MCI possess a large pool

19 2. *Id.*, at 6.

20 3. *Id.*, at 20, 52-56, 66, 73-74, 81-84 and 91.

21 4. Kahan (SBC), Direct at 6-7; Rebuttal at 56-59; FCC Affidavit at ¶ 11.

22 5. Kahan (SBC), FCC Affidavit at ¶ 11.

23 6. Kahan (SBC), Rebuttal at 57, 59.

1 of management or craft talent experienced in the provision of local services; AT&T lost
2 those people at the time of the break-up of the former Bell System, and MCI never had
3 them to begin with. If SBC could not, by its own admission, amass the needed local
4 service management resources without acquiring another RBOC, how can anyone expect
5 entities such as AT&T and MCI, without these resources, to represent a serious
6 competitive threat in the local service market?
7

8 In fact, and as I discussed at pages 39-43 of my direct testimony, the level of actual
9 competition in the serving areas of both Ameritech and SBC is minimal at this time and
10 is anything but broad-based. In Table 1 of his rebuttal testimony, Mr. Kahan provides
11 statistics that purport to prove the existence of substantial market entry on behalf of
12 CLECs,⁷ yet his data is extremely misleading and grossly exaggerates the actual extent
13 of competitive presence in SBC's serving areas. Based upon the data in Table 1, SBC
14 has lost no more than 3.6% of the 33.4-million access lines in its 7-state region, and
15 2.1% out of that 3.6% are in fact still being provided by SBC on a resold basis.⁸ Thus,
16 while there may be limited competition at the *retail* end of the local service market, SBC
17 remains solidly in control of over 98% of the underlying local service facilities.⁹ As I

18 7. Table 1, on page 90 of Mr. Kahan's rebuttal testimony, apparently is an updated version
19 of Table 3 from Mr. Kahan's direct testimony.

20 8. According to Table 1, 1,194,322 of a possible 33,440,000 lines in SBC's 7-state region
21 have been lost to CLECs. Kahan (SBC), Rebuttal at 90; Statistics of Communications
22 Common Carriers, Table 1.1, 1997 edition.

23 9. In Table 2 at page 91 of his rebuttal testimony, Mr. Kahan attempts to estimate the
24 number of lines provided by CLECs through interconnection trunks, yet he provides no
25 support whatsoever for his estimate of 2.75 lines per trunk, and also fails to acknowledge why
26 at least some, perhaps even the majority, of these lines would not be included in the E-911
27

(continued...)

1 noted in my direct testimony at page 39, only a monopolist would characterize the retail
2 sale of its own products and services by non-affiliated resellers as "competitive losses."

3
4 Mr. Kahan cites the amount of CLEC advertising as "compelling evidence" that CLECs
5 are competing with SBC in the 7-state region.¹⁰ His conception of the extent of IXC
6 local service competition thus appears to come from watching their commercials on TV
7 or reading their ads in local newspapers, but the level of CLEC advertising teaches
8 nothing about the actual level of CLEC penetration or local service market share. What
9 is at issue in this case is not the level of CLEC advertising, but rather the level of actual
10 CLEC competition for ILEC local services. The fact that *all* competitors, from the giant
11 IXCs down to the smallest niche-market players, are only capable of capturing just 1.5%
12 of the total market for lines served in SBC's 7-state region,¹¹ despite the substantial
13 CLEC marketing efforts described by Mr. Kahan, is compelling evidence indeed that the
14 market for local service is far from exhibiting the characteristics of effective competition,
15 regardless of the presence of large national companies like AT&T and MCI.

16

17 9. (...continued)
18 listings; therefore, this analysis should be disregarded. However, even if we consider Mr.
19 Kahan's estimates in Table 2 to be correct and non-duplicative of Table 1, this still leaves
20 SBC with control of 96.7% of the local service market. This value is calculated by dividing
21 the number of "bypass lines" by the total number of lines in SBC's territory (SBC lines plus
22 the total number of CLEC bypass lines).

23 10. Kahan (SBC), Rebuttal at 91.

24 11. Even if we assume Mr. Kahan's estimation of "bypass" lines is correct, CLECs still
25 control just 3.3% of the local service market.

1 Q. Do the Applicants and other ILECs have an incentive to overstate the extent of
2 competition they actually confront for their core local services?

3

4 A. Indeed, they do. Besides the obvious benefit of convincing regulators, in the present
5 context, that robust competition is sufficiently established that it cannot be harmed by the
6 proposed merger, Illinois Bell can realize significant financial benefits if it can convince
7 regulators that noncompetitive services are "competitive."

8

9 Q. Please explain.

10

11 A. Under the price cap form of regulation adopted by this Commission in Docket
12 92-0448/93-0239 (consol.), prices for "noncompetitive" services are subject to strict limits
13 as determined by the annual change in the Gross Domestic Product Price Index (GDP-PI)
14 offset by a productivity or "X" factor of 4.3%¹² (plus or minus certain so-called
15 "exogenous" cost changes). Because the annual change in GDP-PI has generally been
16 lower than 4.3% in each of the years since the implementation of price caps in Illinois,
17 the Company has actually been required to *reduce prices* for its monopoly basic services
18 since the onset of price caps in 1994.¹³ However, the Illinois price cap system provides

19 12. ICC Docket No. 92-0448; 93-0239 Consol., *Illinois Bell Telephone Company: Petition*
20 *to Regulate Rates and Charges of Noncompetitive Services Under An Alternative Form of*
21 *Regulation. Citizens Utility Board -vs- Illinois Bell Telephone Company: Complaint for an*
22 *investigation and reduction of Illinois Bell Telephone Company's rates under Article IX of the*
23 *Public Utilities Act*, Order, at 40.

24 13. ICC Docket No. 95-0182 Order, June 21, 1995; Docket No. 96-0172 Order, June 26,
25 1996; ICC Docket No. 97-0157 Order, June, 1997; and ICC Docket No. 98-0259 Order, June
26 30, 1998.

1 a mechanism for "reclassification" of individual services to "competitive" status if certain
2 conditions are satisfied. Specifically, Section 13-502(b) of the PUA states that:

3
4 A service shall be classified as competitive only if, and only to the extent that, for
5 some identifiable class or group of customers in an exchange, group of exchanges, or
6 some other clearly defined geographical area, such service, or its functional
7 equivalent, or a substitute service, is reasonably available from more than one
8 provider, whether or not any such provider is a telecommunications carrier subject to
9 regulation under this Act. (220 ILCS 5/13-502(b)).
10

11 In its Order in Dockets 95-0135/95-0197, Consolidated, the Commission stated that in
12 making a decision in a reclassification proceeding under Section 13-502(b), the
13 Commission would consider three basic issues:

- 14
15 (1) The functional equivalence of alternative services; or
16 (2) the substitutability of alternative services; and
17 (3) the reasonable availability of those functional equivalent or substitute services.
18

19 Once a service is reclassified into the "competitive" category, it is no longer subject to a
20 price cap and the Company is free to adjust (raise or lower) the prices of such services as
21 it wishes, with the sole constraint being the Long Run Service Incremental Cost (LRSIC)
22 as the "floor" price. In principle, if a service is subject to actual competition, consumers
23 would be protected against price hikes by competitive marketplace forces. However, this
24 has not occurred in actual practice.
25

26 Q. Please explain.
27

1 A. A report issued November 25, 1998 by the Commission's Telecommunications Division
2 Staff¹⁴ highlights the problem: "Between March of 1997 and November of 1998,
3 Ameritech Illinois filed twelve tariff filings in which it reclassified several of its business
4 and residential services as competitive."¹⁵ These were all in the form of tariff filings
5 made on one day's notice, and were permitted to go into effect. As the Staff Report
6 notes, "[a]fter declaring some of the services listed above as competitive, Ameritech
7 increased the retail and wholesale rates for those services."¹⁶ In some cases, *the prices*
8 *of services that were already set well in excess of cost*, such as local usage, were
9 increased.

10

11 Q. Can anything be inferred from these reclassifications and subsequent rate increases as to
12 the presence of competition for these services?

13

14 A. Indeed, yes. In its Order in Docket 95-0135/0179 in which the Commission rejected
15 Illinois Bell's reclassifications to "competitive" of Band B calls, Band C calls, credit card
16 calls, and operator assistance services, the Commission stated:

17

18 Competitive classification under Section 13-502 requires a convincing demonstration
19 that competition will in fact serve effectively as a market-regulator of the quality,
20 variety and price of telecommunications services. *Ameritech Illinois' ability to*
21 *increase its prices notwithstanding the presence of other providers is a strong*
22 *indication that those rates are not just and reasonable, and that the competitive*

23 14. Telecommunications Division, Illinois Commerce Commission, *Staff Report on*
24 *Competitive Reclassification*, issued November 25, 1998.

25 15. *Id.*, at 5.

26 16. *Id.*, at 10.

1 *classification here fails to satisfy this statutory policy.* The evidence indicates rather
2 that the declaration of competition in this case is being used as a device to raise rates
3 to customers which demonstrably have not found the alternative offerings by other
4 carriers to be the functional equivalents or reasonably available substitutes for
5 Ameritech Illinois' service.¹⁷
6

7 As the Staff Report goes on to observe, in affirmation of the Commission's rejection of
8 these reclassifications, the Illinois Appellate Court found that:

9
10 Allowing a provider to classify a service as competitive prior to the development of
11 a competitive market for the service would enable the provider to enjoy the benefits
12 of a monopoly without the concomitant regulation which the legislature has declared
13 is necessary to protect the interests of consumers. Accordingly, the Commission's
14 conclusion that it must examine actual market behavior in order to determine whether
15 a competing services is reasonably available was not clearly erroneous, and we defer
16 to this interpretation.¹⁸
17

18 A copy of the *Staff Report on Service Reclassification* is attached to my rebuttal
19 testimony as Appendix 1.

20
21 Q. Should the Commission accept Mr. Kahan's and Dr. Harris' assertions in this merger
22 proceeding as to the presence of competition in protecting consumers against the
23 anticompetitive effects of the increased concentration that this proposed merger would
24 create?

25
26 A. No, it should not. In fact, as the *Staff Report* also notes, for each of the various
27 competitive reclassification filings,

28 17. Quoted in *Staff Report*, at 3. Emphasis supplied.

29 18. *Id.*, at 5.

1 in the support material accompanying the reclassification of the services listed [in the
2 Staff Report], it is questionable whether Ameritech Illinois provided sufficient
3 evidence to demonstrate that these services are competitive. Specifically, Ameritech
4 provided a one or two page verified statement for each filing, listing possible
5 competitors for the services in its filings. However, *Ameritech did not provide any*
6 *information regarding its market share for each reclassified service; the trend of its*
7 *market share for the reclassified service; specific examples of services that compete*
8 *with Ameritech's service; whether there are any functional differences in the*
9 *Ameritech's service and that of a competitor, an explanation of the functional*
10 *differences between those services to the extent they exist; or an analysis of the*
11 *impact on demand of any price increase associated with the reclassification.*¹⁹
12

13 The various claims as to the presence of competition in the Illinois local service market
14 that have been offered by the Applicants in the present proceeding suffer from precisely
15 these same deficiencies. The Commission has no more basis to accept Mr. Kahan's and
16 Dr. Harris' contentions, based entirely upon sightings of would-be rivals, than it did with
17 respect to claims as to the conformance of the various services that Illinois Bell has
18 sought to reclassify as "competitive" with the statutory and regulatory standards.
19

20 Following the release of the Staff Report, the Commission on November 30, 1998 issued
21 Orders initiating two new dockets specifically for the purpose of examining these recent
22 Illinois Bell service reclassifications.²⁰ In Docket 98-0860, the Commission will
23 consider "whether the classification as competitive of the services provided by Illinois
24 Bell Telephone Company pursuant to the tariffs listed in the Appendix to this order is

25 19. *Id.*, at 10. Emphasis supplied.

26 20. ICC Docket No. 98-0860, *Illinois Commerce Commission On Its Own Motion vs.*
27 *Illinois Bell Telephone Company, Investigation into Specified Competitive Tariffs to*
28 *Determine Proper Classification of the Tariffs and to Determine Whether Refunds Are*
29 *Appropriate*, and ICC Docket No. 98-0861, *Illinois Commerce Commission On Its Own*
30 *Motion vs. Illinois Bell Telephone Company, Establishment of Filing Requirements for the*
31 *Reclassification of Noncompetitive Services as Competitive Services.*

1 proper and to determine refunds for any retail services found to be not properly classified
2 as competitive, as well as their wholesale counterpart."²¹ In Docket 98-0861, the
3 Commission will "establish filing requirements for the reclassification by Illinois Bell
4 Telephone Company of noncompetitive services as competitive services pursuant to
5 Section 13-502 of the Public Utilities Act."²²

6
7 In view of the initiation of these two investigations and the paucity of substantive
8 information supporting claims as to the competitive nature of its various services that
9 Illinois Bell has furnished to the Commission, and in view of the fact that the evidence
10 being offered by the Applicants herein contain essentially the same types of anecdotal
11 descriptions of would-be competitors as the Commission has in the past and has again
12 concluded are insufficient for a determination of the presence of actual competition, it is
13 difficult to see how the Commission can give any credence to the various claims being
14 advanced by the Applicants' witnesses here.

15
16 Q. In his rebuttal testimony, Mr. Gebhardt has data alleged to be proprietary regarding
17 Illinois Bell's share in the local service market,²³ although I understand that you
18 disagree with the basis for his calculation, which, like the analysis provided by Mr.
19 Kahan, treats resellers of Illinois Bell's services as "competitors" of the telephone
20 company. That notwithstanding, has this Commission previously made any findings as to

21 21. ICC Docket No. 98-0860 Order, at 2.

22 22. ICC Docket No. 98-0861 Order, at 2.

23 23. Gebhardt (Ameritech), Rebuttal at Schedule 2.

1 the relationship between Illinois Bell's market share and the determination that a "service,
2 or its functional equivalent, or a substitute service, is reasonably available from more
3 than one provider, whether or not any such provider is a telecommunications carrier
4 subject to regulation under this Act"²⁴?

5
6 A. Yes. The Staff Report notes that in its Order in Docket 95-0135/0179 dealing with
7 reclassification of Band B and C calls, "because Ameritech held 86.6% of the market
8 share, the Commission found that the IXCs' services were not reasonably available to
9 Ameritech's customers."²⁵ Significantly, the Commission concluded that an 86.6%
10 market share on the part of Illinois Bell was evidence of a *lack* of competition, and on
11 that basis specifically *rejected* the Company's reclassification of these services as
12 "competitive." Even if Mr. Gebhardt's computation of the Illinois Bell local service
13 market share were valid, which as I have explained it is not,²⁶ by his own reckoning the
14 Company has a share of the local service market *well in excess of the level of market*
15 *dominance that this Commission has previously found to evidence a lack of effective*
16 *competition.*

18 24. 220 ILCS 5/13-502(b).

19 25. *Staff Report*, at 4.

20 26. In addition to Mr. Gebhardt's treatment of resellers, he, like Mr. Kahan, attempts to
21 estimate the number of self-supplied CLEC lines without providing any supporting
22 documentation while, in his case alone, providing no explanation of the methodology used to
23 make these estimates. Therefore, Mr. Gebhardt's assessment of the extent of competition in
24 the Illinois local market should also be disregarded.

1 **Approval of the merger will in no way enhance, and will likely adversely affect, the level**
2 **of competition in Illinois and other portions of Ameritech's serving area**
3

4 Q. Dr. Selwyn, the Applicants contend that, in order to compete in the telecommunications
5 market, it is necessary to become an "integrated" provider of service with a national
6 presence, much like AT&T, MCI and Sprint.²⁷ Will the merger create an "integrated"
7 provider of service with a national presence, much like AT&T, MCI and Sprint?
8

9 A. The merger *per se* will not make SBC/Ameritech into an "integrated" local/long distance
10 provider; the two companies can, individually, achieve that status by complying fully
11 with Section 271 of the federal *Telecommunications Act*. The theory underlying Section
12 271 is that the BOCs would be unable to leverage their local monopoly to dominate the
13 long distance business if there were actual and effective competition in the local
14 exchange market, and the Section 271(c)(2)(B) "competitive checklist" was designed to
15 make local entry possible by requiring that the BOCs eliminate specific economic barriers
16 to such entry. That no BOC has as yet, nearly three years after enactment of the federal
17 statute, satisfied the Section 271 requirement confirms the utter lack of effective local
18 competition that presently exists here and throughout the country.
19

20 Significantly, SBC's National-Local Strategy contemplates precisely the kind of leverage
21 of the local monopoly into adjacent competitive markets that the federal *Act* was
22 attempting to eliminate. SBC candidly states that it plans to, and expects that it can,
23 readily capitalize upon its relationship with the various large corporate customers

24 27. Kahan (SBC), Rebuttal at 6-7, 48-49.

1 headquartered within the 13-state post-merger SBC region to encourage them to do
2 business with SBC in the 30 out-of-region local markets that it plans to enter and in the
3 long distance business, assuming that (at some point) SBC is able to gain Section 271
4 approval. For example, SBC could offer such customers volume purchase contracts that
5 include both the in-region monopoly local services as well as out-of-region local services
6 and long distance services. *No other telecommunications company, local or long*
7 *distance, would possess this capability.*

8
9 Q. Are you suggesting that it will be easier for Ameritech and SBC to vie for the long
10 distance business of in-region customers, once they obtain Section 271 authority, than for
11 IXCs to overcome the dominance of the ILECs in their respective in-region local
12 exchange markets, if (as the FCC has noted²⁸) compliance with the Telecommunications
13 Act of 1996 does not in and of itself ensure that barriers to CLEC entry are fully
14 removed and a competitive market effectively established?

15
16 A. Yes, precisely. SBC/Ameritech's entry into the long distance market could occur rapidly
17 after Section 271 approval. The mega-RBOC could purchase long distance services for
18 resale to its in-region local customers from any number of interexchange service
19 providers as well as by deploying its own (currently "official") interLATA transport

20 28. *In the Applications of NYNEX Corporation, Transferor, and Bell Atlantic Corporation,*
21 *Transferee, For Consent to Transfer Control of NYNEX Corporation and Its Subsidiaries*, File
22 No. NSD-L-96-10, Memorandum Opinion and Order, released August 14, 1997 (*BA/NYNEX*
23 *Merger Order*) at ¶ 42.

1 facilities²⁹ for use in furnishing retail long distance services. A customer could be
2 switched to SBC/Ameritech long distance through a simple data base entry. (IXCs are
3 typically charged about \$5 for each such "PIC change," but have contended that the
4 actual cost is considerably less.³⁰) By contrast, considerable cost, time and effort are
5 required for a CLEC to switch a BOC local service customer to its own facilities-based
6 or UNE-based service; In Illinois, for example, Illinois Bell imposes nonrecurring charges
7 amounting to some \$38.25 for a CLEC to convert an existing Illinois Bell residence
8 customer to a UNE-based service.³¹ Moreover, because such conversions frequently
9 result in various "fallout" conditions (due to errors in order processing, data bases, or
10 other problems), such conversions can often result in inconvenience to the customer
11 including, for example, a temporary loss of dial tone. It will take a number of years
12 before the changeover of a BOC customer to a CLEC can be accomplished as quickly,
13 inexpensively, and seamlessly as a change in long distance provider.

15 29. In an exception to the interLATA line-of-business restriction, the RBOCs were
16 permitted, at the time of the break-up of the former Bell System, to construct and to own
17 interLATA facilities whose use was limited solely to intracompany communications (so-called
18 "official" services). *U.S. v. AT&T*, Civil Action No. 82-0192; (D.D.C., 1983), July 8, 1983,
19 as amended July 28, 1983, and August 5, 1983, 569 F. Supp. 1057, 1097-1101.

20 30. See December 16, 1996 Complaint filed by MCI, *MCI Telecommunications Corp. v.*
21 *US West Communications, Inc.*, citing a BellSouth PIC change cost study dated April 2, 1990,
22 that identifies the cost of a PIC change at \$1.49, averaged across all BellSouth territories.
23 Further, BellSouth's current interstate access tariff levies a rate of \$1.49 per line for an
24 Interexchange Carrier Subscription Change. BellSouth Telecommunications, Inc., Tariff
25 F.C.C. No. 1, Section 13.3.3.E.3, 7th Revised Page 13-12, effective January 25, 1997.

26 31. Illinois Bell Telephone Company, ILL. C.C. No. 20, Part 19, Section 2, 1st Revised
27 Sheet No. 8, effective April 18, 1998.