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November 8,2002

Marlene **H.** Dortch, Secretary
Federal Communications Commission
Room CY-B-402
445 12th Street, **S.W.**
Washington, D.C. 20554

Re: Joint Application bv BellSouth Corporation. et al., for Provision of In-Region, InterLATA Services in Florida and Tennessee,
WC Docket No. 02-307, **Ex** Parte #5

Dear **Ms.** Dortch:

In response to requests by the Commission's Staff, I write on behalf of BellSouth to provide additional information relevant to the Florida PSC's consideration and rejection of AT&T's argument that BellSouth's cost studies impermissibly double-count inflation costs. These materials further establish that there is no legal basis for this Commission to second-guess the reasoned decision of the Florida PSC -- and, indeed, of this Commission itself in the *GA/LA Order* -- on this question.

First, Attachment A to this letter details the thorough and careful review that the Florida PSC gave to AT&T's argument on this point. This Attachment demonstrates that the Florida PSC developed a full record and carefully considered the conflicting arguments presented by BellSouth and AT&T. The record before the Florida PSC included live testimony, including cross-examination, as well as depositions and written pre-filed testimony. After considering that full record, both the Florida PSC and its Staff rejected AT&T's argument, and fully explained their conclusion in written orders. Additionally, this issue was raised again in the Florida PSC's section 271 proceeding, and the Florida PSC again rejected it. Attachment A further demonstrates that the Florida PSC's reasonable determination on this precise issue accords with the decisions of *every* other state commission in BellSouth's region to consider the issue, as well

as this Commission's own explicit judgment in **the** *GA/LA Order* **(¶¶ 62, 64, 76).** Finally, Attachment A shows that AT&T has recently noted this issue yet again before the Florida PSC.

Under established precedent, these points should be crucial to this Commission's inquiry. Precisely because state commissions can develop full records through live testimony, cross-examination, and other mechanisms, this Commission defers to their resolution of complex TELRIC issues: "During **the** course of their UNE pricing proceedings, the state commissions ***are*** able to cross examine witnesses, compel discovery, and direct the submission of additional record evidence on particular issues. This Commission lacks the time to employ such tools during the course of the 90-day statutory review period for section **271** applications." ***Five State Order*** ¶ *31*. The Commission thus does not undertake a ***de novo*** inquiry in the compressed section **271** timeframe, but rather places "great weight" on the careful review undertaken by state commissions such **as** the Florida PSC. ***New York Order*** ¶ 238. Just as the Commission relied heavily "on the New York Commission's active review and modification **of** Bell Atlantic's proposed unbundled network element prices, [and] its commitment to TELRIC-based rates," ***id.***, here too, the Commission should rely on the careful and active review and modification of BellSouth's UNE rates by **the** Florida PSC and its Staff (indeed, as a result of this review, **the** Florida PSC cut BellSouth's proposed cost of capital from 11.25% to **10.24%).**

In fact, by any measure, the Florida PSC's commitment of time and resources to establishing TELRIC-compliant rates has been extraordinary. The Florida PSC began setting forward-looking rates even before this Commission's **1996** ***Local Competition Order*** **(¶ 812),** and it devoted **600** pages to reviewing various parties' arguments and analyzing cost issues in its May 2001 order alone. In the end, as the Supreme Court has recognized, "battles of experts **are** bound to be part of any ratesetting scheme," ***Verizon Communications, Inc. v. FCC*****, 122 S.** Ct. **1646, 1678 (2002),** and the Florida PSC has devoted significant time and energy to resolving this particular battle **(as** well as countless others) in a reasonable way. In accord with its precedent, this Commission should defer to the Florida PSC's judgment on this issue. ***See also WorldCom, Inc. v. FCC,*** No. ***01-1*** 198,2002 WL **31360443,** at ***2** (D.C. Cir. Oct. 22,2002). (noting that the Commission "defers to **the** [pricing] determinations of the state agencies who possess a considerable degree of expertise and who typically perform a significant amount of background work.") (internal quotation marks omitted).

Indeed, the Commission has previously deferred to the Louisiana PSC's exact same resolution of the exact same **issue.** ***See GA/LA Order*** ¶¶ 62, 64. Moreover, in the ***GA/LA Order,*** the Commission expressly concluded, just as the Florida PSC did here, that ***"it is not double countingfor a commission to accountfor inflationary pressures on both the price of material goods and on the price of money itself." Id.*** ¶ **76** (emphasis added). Simply put, it is impossible to conclude that the Florida PSC has committed **an** error -- much **less the** kind of "basic" TELRIC error necessary to find a checklist issue here, ***see Five State Order*** ¶ ***30 -- in reaching the exact same conclusion as this Commission,*** the Louisiana PSC, and every other state commission in BellSouth's region on this precise issue. How can the Florida PSC have made a basic error in adopting the exact **same** analysis that this Commission has found persuasive in a **prior** section **271** order?

Second. Attac nen **B** is a **tter** from Dr. *R* andall Billingsley tha esponds **issu** that have been raised by the Commission Staff and that demonstrates that **the** Flohda PSC's conclusion is a reasonable -- indeed, a correct -- one. Dr. Billingsley shows in detail that **the** "TELRIC cost of the loop increases each year with inflation. Therefore the price **for** the **loop. . .** has to increase each year either by having a new UNE cost proceeding each year and a single-year interconnection agreement, by inflating the UNE price of the loop each year, or by accounting for the increase in the initial price, **as** BellSouth has done. By the **same** token, the investor is entitled to his money back and to eam a return on that money invested." Accordingly, if BellSouth did not recover for both of those effects, it would under-recover its costs when a state commission sets rates, as the Florida PSC has done, for a multiple year period. Dr. Billingsley's analysis confirms that there is no reason for this Commission to second-guess the judgment reached by the Florida PSC after careful analysis based on a full record.

Respectfully submitted,

Sean A. Lev

Attachment

cc: Christine Newcomb
Jeff Dygert
Jay Atkinson
Richard Kwiatkowski
Richard Lerner
Tamara Preiss
Scott **Bergmann**
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Janice Myles
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Attachment A

Chronology of Inflation Issue in Florida

The consideration of inflation in UNE cost development has been an issue throughout the recent Florida generic cost proceedings. BellSouth and intervening parties filed opposing views on this topic. In fact, it was in Florida in 2000 where AT&T first contended that BellSouth had double counted the impact of inflation; i.e., the allegation that inflation was inappropriately considered in both the investment and in the cost of capital. In addition to written testimony, witnesses were crossed on the subject during the hearings and in depositions, the Florida Staff analyzed the testimony on inflation, and the Florida Public Service Commission ("FPSC") ruled based on the record of evidence. Thus, inflation has been thoroughly reviewed.

In fact, AT&T presented the same allegation, based on the same premise, in the Florida generic cost docket, as it is arguing before this Commission. The FPSC's Order (App. D – FL, Tab 46), dated May 25, 2001 ("May 25th Order") confirms this fact:

> AT&T and WorldCom's witness Pitkin states that the cost of capital input is a nominal cost of capital and, as such, compensates investors for the effects of inflation. He alleges that BellSouth is double counting the effects of inflation by applying an inflation factor to material investment in the loop model and by updating unit costs from what was previously determined by the Commission. If the investment has been increased by an inflation factor, then applying the nominal cost of capital to that investment results in the double counting of inflation, according to witness Pitkin. To avoid this double counting, unit prices for material and labor must be locked in at the levels initially established by this Commission. Witness Pitkin recommends that we adopt the material and unit prices we adopted in the USF proceeding, Docket No. 980696-TP. to avoid double counting. (Page 299)

In order to support his position in the Florida UNE proceeding, Mr. Pitkin filed the same example based on a $1,000,000 investment, a 10% nominal cost of capital, a 10-year economic life, and a 4% inflation rate. See Pitkin/Donovan testimony filed July 31, 2000 in Docket No. 990649-TP. In fact, Figures 2 & 3 of the Klick/Pitkin Declaration, filed in this proceeding, correspond to Exhibits JCD/BFP-5 and JCD/BFP-4, filed in the Florida UNE docket. Thus, this is not new evidence and the FPSC has reviewed and rejected Mr. Pitkin's "example."

Further, Mr. Pitkin acknowledged that he had based his argument on a regulatory requirement foundation, a factor specifically excluded by this Commission from consideration in a TELRIC analysis:

> Witness Pitkin argues that there is a distinction between forecasted revenues and the revenues determined by the cost model. He contends that forecasted revenues may include an inflation factor **but** revenues from the cost model are **like a regulatory revenue requirement** in that it is revenue required to provide a return on investment. That return includes an allowance for inflation. Any additional adjustment for inflation would be double-counting, according to the witness. (Emphasis added. Page 253)

The FPSC Staff, based upon examination of the evidence presented, did not agree with AT&T's position. In its April 6, 2001 recommendation ("Staff Rec")(App. D – FL, Tab 43), the Staff stated:

> Staff believes witness Caldwell makes an important distinction between the types of inflation. (TR 1230) One type is general inflation for which investors demand compensation through the cost of capital. The other type is specific inflation related to an investment or asset. Investors would need to be compensated for that as well. Therefore, **staff does not believe that BellSouth double counts inflation in its cost model.** (Emphasis added. Page 338)

The FPSC Staff reiterated its position on pages 342-343:

> Regarding inflation, staff believes that in a proceeding that is setting rates for a certain study period, it makes sense to forecast the investment to that period. This is no different than using a projected test year in a rate proceeding. BellSouth has attempted to do this by taking a simple average of the effects of inflation projected over the 2000-2002 period. Applying an inflation factor is simply recognizing a forecasted increase or decrease in material prices for a given period of time.
>
> As discussed earlier, staff does not believe that BellSouth is double counting inflation since the specific type of inflation is related to material prices. Investors need to be compensated for this inflation in addition to the general inflation compensated through the cost of capital.

The FPSC concurred with the FPSC Staff and soundly rejected Mr. Pitkin's position:

> We note that in Docket No. 980696-TP, we considered the cost of basic local service. In that docket, we did not allow inflationary (or deflationary) factors for the cost proxy model because the model was for a certain point in time. We left open the possibility of applying inflation factors when a specified time or planning period, as with a contract, was involved. **See** Order No. PSC-99-0068-FOF-TP. BellSouth used a three-year planning period for calculating its investment inputs in this proceeding. We emphasize that while we believe witness Caldwell makes an important distinction between the types of inflation, we are, however, concerned about BellSouth's use of inflation factors in its cost model, as explained later in this Order. (Emphasis added. May 25th Order, page 300)

As noted above, the FPSC had "concerns" with BellSouth's reflection of inflation in its cost studies. Indeed. initially, the FPSC ruled that inflation should be eliminated. However, the FPSC was not concerned about including inflation in both the cost of capital and in the investment. A review of the testimony, the staff recommendation, dated April 6, 2001, the agenda transcript (April 18, 2001)(App. D – FL, Tab 44), and the FPSC's May 25th Order makes it apparent that there was a significant level of confusion on the use of inflation factors as it relates to productivity, expenses, and demand.

It is important to emphasize that the FPSC did not base its elimination of inflation on AT&T's allegation that BellSouth had double-counted inflation. In fact, the FPSC's decision to eliminate inflation arose directly from the testimony filed by Sprint witness Kent Dickerson. Mr. Dickerson, however, misunderstood BellSouth's use of inflation factors. He used BellSouth's explanation of the development of the Plant Specific expense factor and inappropriately stated that the same methodology was used in the application of inflation to every investment. This is wrong. The development of the Plant Specific Factor and the application of inflation to investments are two entirely different exercises.

On June 26, 2001, BellSouth filed for reconsideration on the FPSC's decision to eliminate inflation. CLECs also filed in response to BellSouth's motion. They did not, however, offer any new evidence and "contend[ed] that BellSouth merely reargues matters." (Decision on Reconsideration, dated October 18, 2001 ("Recon Order"), page 4)(App. D – FL. Tab 54). The FPSC ruled:

> Upon consideration, we find that BellSouth has identified a mistake of fact or law in our decision on this point. Based on further scrutiny of the existing record, we have determined that what previously appeared to be a mismatch is not. Our staff erred in its analysis of the testimony and as such, its statements to us at Agenda and in their recommendation that a mismatch exists were incorrect. In fact, the record reflects that the total demand for loops that was used to size the overall network is identical to the demand which is used as the denominator to yield the loop unit cost; thus, there is no mismatch. As such, we hereby reconsider our decision to reject BellSouth's proposed inflation factor, because it was based upon a misinterpretation and misrepresentation of the facts presented. (Recon Order, pages 6-7)

120-Dav Proceeding

As part of the May25th Order, the FPSC initiated a follow-up proceeding that in part would again address the issue of inflation. The FPSC's intent, however, was to limit the arguments on this topic to the following issue: "In BellSouth's 120-day filing, has BellSouth accounted for the impact of inflation consistent with Order No. PSC-01-2051-FOF-TP?" AT&T argued that the vintage of the inflation rates and the fact that they reflect a meld of material and labor inflation trends made BellSouth's inflation input incorrect. AT&T did not, however, re-argue their double-counting position. In fact, in this phase of the docket, which reflected a previously established 10.24% nominal cost of capital, Mr. Pitkin proposed material inflation factors. (The FPSC Order in the 120-Day proceeding, dated September 27, 2002, ("120-Day Order")(Ex Parte Letter from Sean Lev to Secretary Dortch, Oct 18, 2002) stated: " witness Pitkin proposes revised inflation factors developed using actual 2000 and 2001 inflation data, and linear trending for 2002." (Page 107))

The FPSC issued the following ruling on inflation:

> Engineering factors shall also should [sic] be adjusted to reflect projected inflationary impacts. Likewise, a labor-only inflation factor should apply to the labor cost. A blended inflation rate that includes inflation for both material and labor should not be applied to material-only investment. The result is an overstatement in material investments
>
> Regarding whether BellSouth's inflation rates should be updated to reflect the most current actual data, certainly when 1998-2000 actual inflation is now known, there is some sense to recognizing the actual data. BellSouth even agrees with this. However, as BellSouth notes, material prices and other factors in the cost study are based on 1998 data. For consistency, BellSouth continued its use of inflation rates based on 1998 projections. We also note that

> the UNE prices reflected in Order 1181 and the Reconsideration Order are based on 1998 data and inflation projections. Only loop rates are being considered for revision in this case as a result of the "bottoms-up" cost approach. For consistency between all UNE rates, we believe 1998 projected inflation rates should continue to be used. (120-Day Order, pages 112-113)

AT&T has protested the FPSC's decision claiming that consistency was not sufficient grounds to justify using 1998 inflation factors and on October 14, 2002 filed for reconsideration. Furthermore, in that request for reconsideration, AT&T made a veiled attempt to again reargue its double-counting allegation claiming that the FPSC had made an incorrect finding.

> The actual inflation information shows without any possible doubt that BellSouth's projected inflation rates filed with its cost study have overstated the rates of inflation that have been used to establish UNE prices in this proceeding. This overstatement causes UNE loop rates to be higher than they should be based on the more accurate actual inflation rates experienced by BellSouth for the years 2000 and 2001. The incorrect excessive inflation rate comes **on** top of the Commission's decision in Order No. 01-2051 to allow BellSouth to double recover for inflation through inflation of material prices and again through the application of a cost of capital that includes inflation. (Emphasis added. AT&T Motion for Reconsideration, ¶ 5)

BellSouth's response to these contentions is attached to Daonne Caldwell's reply affidavit (Reply App., Tab C) – Reply Exhibit DDC-1. Currently, the FPSC Staff will issue its recommendation on November 20,2002 and the FPSC is scheduled to address AT&T's motion at its December 2,2002 agenda session.

<u>271 Docket No. 960786-TL</u>

WorldCom submitted the testimony of Grea Darnell in the Florida 271 case on October 5, 2001, again restating AT&T's allegation that inflation is accounted for twice in BellSouth's cost studies. In its September 25, 2002 Opinion, however, the FPSC recognized that "this issue, which has been addressed in Docket No. 990649-TP, has been resolved by the Commission, and witness Darnell provides no evidence or testimony not previously considered." (Emphasis added. Page 97)

<u>Other State Proceedinas</u>

The inflation issue is not unique to Florida. In fact, in the most recent round of generic cost dockets, CLECs have argued that inflation was considered twice. As this

Commission is aware, no state commission has agreed with the CLEC position. For example:

Louisiana

This argument was presented in Louisiana in Docket No. U-24714-A bv the Southeastern Competitive Carriers Association ("SECCA"), it was promptly rejected by the LPSC. In rejecting this "inflation" argument, the Louisiana Public Service Commission ("LPSC") agreed with the Administrative Law Judge's ("ALJ's") finding that: "there are two distinct types of inflation which impact BellSouth's costs: an inflation which compensates investors for the use of their funds and an inflation amount associated with the increased price of the plant over the years." ***LPSC Order*** Number ***U-24717-A,*** at 10; (App. F – LA, Tab 40); ***see also*** LPSC ALJ Proposed Brief, Docket No. U-24714-A, at 31.

Kentucky

SECCA also argued that BellSouth's application of inflation factors renders a "double counting" of the impact of inflation. The Kentucky Public Service Commission did not agree with SECCA.

Mississippi

WorldCom also argued that BellSouth's application of inflation factors renders a "double counting" of the impact of inflation. This faulty proposition is based upon the premise that inflation is already reflected in the nominal cost of capital. The Mississippi Public Service Commission ("MPSC") did not agree with WorldCom stating that: "BellSouth must pay both for its facilities and to reimburse its investors." MPSC Order at 21 (App. D – MS, Tab **9).** Additionally, the MPSC recognized that: "the Commission has previously endorsed the use of investment inflation factors in establishing rates for UNEs. BellSouth used this same approach in earlier dockets establishing UNE rates, and the Mississippi Commission adopted it. WorldCom has not offered any legitimate reason for this Commission to reach a contrary conclusion in this case." MSPC Order at 21.

Commission's GA/LA Order

AT&T made this same allegation before this Commission in response to BellSouth's Georgia/Louisiana 271 Application. In reply to AT&T's contention, this Commission stated: "it is not double counting for a commission to account for inflationary pressures on both the price of material goods and on the price of money itself." *GA/LA Order* ¶ 76.

New North Carolina Proceeding

BellSouth is currently preparing testimony in conjunction with the latest North Carolina UNE cost proceeding. AT&T witness, Mr. Pitkin is a participant in this case. It is interesting to note that he has not devoted any of his testimony, which he claims covers "cost issues that have the greatest impact on UNE rates," to the issue of inflation, only giving it a bullet point as a potential "error". Further, he does not support that allegation, nor does he recommend any changes to BellSouth's proposed inflation factors.

Attachment B

November 8,2002

Marlene H. Dortch, Secretary
Federal Communications Commission
Room CY-B-402
445 12th Street, S.W.
Washington, D.C. 20554

Re: Joint Application by BellSouth Corporation. et al.. for Provision of In-Region, InterLATA Services in Florida and Tennessee
WC Docket No. 02-307

Dear Ms. Dortch:

At the request of the Wireline Competition Bureau Staff, I am providing additional information regarding AT&T's allegation that BellSouth's supposed double-counting of inflation. My purpose is to clarify and extend the analysis provided in my reply affidavit filed before the Commission on November 1,2002. Thus, I clarify and extend my evaluation of Mr. John C. Klick and Mr. Brian F. Pitkin's declaration, which was filed on behalf of AT&T Corporation (AT&T) in this proceeding. Specifically, I extend my evaluation of their incorrect argument that BellSouth double-counts inflation and thereby allegedly overstates the costs used to establish unbundled network element (UNE) rates.

I conclude that Mr. Klick and Mr. Pitkin's argument is neither relevant nor valid. I extend my prior analysis by explaining that their argument does not apply to the capital investment environment faced by BellSouth in particular or by the telecommunications industry in general. The context and assumptions of Mr. Klick and Mr. Pitkin's argument do not apply to BellSouth's cost methodology and the argument is consequently irrelevant in the current proceeding. Their argument is steeped in the traditional rate-of-return regulatory paradigm and is therefore irrelevant to UNE pricing in the current forward-looking TELRIC cost methodology environment.

A. BRIEF RESTATEMENT OF THE ARGUMENT

Mr. Klick and **Mr.** Pitkin incorrectly argue that "[b]oth inflating material prices into the future and including inflation in the cost of capital results in a double-count of inflation" (Declaration, p. **3).** Their fundamental argument is that the ***methodology*** of adjusting the cost of capital for anticipated inflation ***and*** of similarly adjusting the cash flows associated with an investment asset somehow allows investors to be doubly compensated for inflation. Further, Mr. Klick and **Mr.** Pitkin argue that BellSouth's inflation adjustment approach has a significant impact on the firm's UNE rates.

The essence of **Mr.** Klick and **Mr.** Pitkin's argument is summarized in their observations concerning a hypothetical example in which a firm invests $1 million in a capital investment with an expected useful life of ten years. Consider their final interpretation of the outcome:

> Under the assumptions of my hypothetical, the above table [Figure 3] shows that under BellSouth's approach, it would over-recover its initial investment by more than **21** percent if it were allowed to **use** the nominal cost of capital **and** adjust the per line asset values each of the 10 years for the effects of inflation (Declaration, p. **8,** paragraph **12).**

It is important to carefully examine this example. It considers a $1 million investment made at a single point in time that is used for ten years under assumed inflation of **4** percent (Declaration, p. **5**, paragraph 8). Importantly, the example assumes that the rate set to reflect the cost of the asset is fixed at the beginning of the period and therefore does not change during the ten-year cycle that is considered. This is the fundamental flaw in their analysis. If this is supposed **to** represent TELRIC pricing, the forward-looking cost of the asset could be reviewed every year. Even if the same asset is being evaluated, its current TELRIC cost would have to reflect the forward-looking cost of the asset in the second year, the third year, and so on.

The conclusion reached from this incorrect argument by Mr. Klick and Mr. Pitkin is that BellSouth's cost estimation methodology should not jointly adjust the cost of capital ***and*** investment cash flows for inflation, which allegedly biases the resulting UNE rates.

B. CLARIFICATION AND EXTENSION OF PRIOR ANALYSIS

Mr. Klick and **Mr.** Pitkin's argument incorrectly assumes a capital investment environment that is not comparable to that faced by BellSouth. They assume a world in which BellSouth can make a single network investment at a certain one-time price that will remain fixed for long useful lives. In addition, they assume that there will be no further application of the TELRIC pricing principles during the remainder of the useful life of the asset. That approach is traditional rate-of-return, rate base rate-setting, and is completely inconsistent with TELRIC pricing. To the contrary, neither BellSouth nor AT&T, nor the state commissions want to conduct new TELRIC pricing proceedings every year. BellSouth's methodology simply approximates the result that would be obtained if **sequential UNE** cost cases were conducted during each of **the** three years that the parties want to set rates for under an interconnection agreement.

Alternatively stated, in the TELRIC cost methodology UNE prices are designed to capture the forward-looking costs of replicating an incumbent local exchange company's (ILEC's) network in place at a point in time, say the first day of the contract period. **If** the forward-looking cost of replicating the network is higher in a year due to inflation or any other reason, under the TELRIC approach an ILEC would justifiably re-price its UNEs accordingly. Rather than estimating the forward-looking cost of replicating its network annually, BellSouth estimates the forward-looking costs of replicating its network **over a three year period** so that companies like AT&T can rely on UNE rates that are contractually in effect for that period. **Thus,** BellSouth effectively averages the expected forward-looking costs of such network replication over a three-year future period and prices UNEs consistent with that cost structure.

The key to understanding BellSouth's network cost estimation approach is recognizing that current UNE prices are designed to cover the costs of replicating the network **over a three-year forward-looking period.** Thus, it is necessary to adjust such replication costs to capture expected inflation over that period. BellSouth's three-year averaging approach is comparable to the firm deciding to estimate costs over each of **the** next three years and re-pricing accordingly each year. **The** only difference is that a set of **uniform prices** for the three-year forward-costing period is established rather than changing prices yearly in light of revised annual network replication costs. If BellSouth **were** required to establish a set of **UNE** prices to apply on **the** first day of an interconnection agreement, based **solely** on the forward-looking costs **known** on that day, then inflation would ensure that BellSouth did not recover its TELRIC costs for UNEs provided in the second and third years of the agreement.

Consider a simple example that illustrates **the** bare elements of BellSouth's UNE pricing approach. Assume that we are pricing only one loop that already exists in BellSouth's network. If AT&T wants to purchase that loop as a UNE, the embedded cost BellSouth incurred to place that loop has been declared irrelevant. Instead, BellSouth must price that loop based on forward-looking TELRIC costs, Assume that everyone agrees that, taking into account all appropriate costs, including the cost of capital, this loop's TELRIC forward-looking cost is $1,000. Now assume that time passes, but that the only change in any cost **over** time is inflation. Let's **assume** that it costs $1,030 to replicate the loop in one year, which reflects the rate of inflation over the year, Similarly, it costs $1,061 at **the** end of the second year, and **$1,093** at the end of the third year. One way to deal with this is to have a new UNE cost proceeding each year to reset the **UNE** price to reflect the increased cost of that loop, on a TELRIC basis, each year. No one, however, wants to have three proceedings when one will do. Further, no one wants one-year interconnection agreements because it takes time and resources to reach such an agreement. However, BellSouth cannot be forced to charge TELRIC-based prices, yet be precluded from the benefit, however small, of receiving the increase in TELRIC costs for the loop in the above example. In other words, it does not make sense to prevent BellSouth from realizing the increase in TELRIC prices just because it uses a multi-year interconnection agreement. This would force BellSouth to accept prices that are not only lower than the actual cost of building the loop, but that are also lower than the TELRIC cost of building the loop. To combat this result BellSouth effectively looks at the forward-looking costs of replicating the network over three years. It prices UNEs in a way that averages the expected replication costs over a three-year period. In contrast to pricing UNEs in light of a current forward-looking cost over a single year of a $1,000 investment, BellSouth effectively **uses** an average investment of $1,061 [($1,030 + $1,061 + $1,093)/3] to capture the expected increase in network replication costs over the three-year period over which the UNE rates are expected to be locked-in contractually.

Mr. Klick and **Mr.** Pitkin **refer** to Figure 3 in their affidavit to argue that BellSouth's approach over-recovers capital (see Declaration, p. **7).** Yet their position is analogous to arguing in the above example that an investment of only $1,000 should be used to price UNEs when prices that are expected to hold for three years can reasonably be based on the average investment over that period, which is $1,061. Clearly other approaches are possible, but BellSouth's approach is reasonable and internally logically consistent.

One extreme response to this analysis is that if you ***are*** going to assume that BellSouth could have a UNE cost case each year, and that its methodology simply avoids that result, then the cost of capital has to be adjusted. Specifically, some might argue that the cost of capital should be revised to reflect the assumption that the TELRIC costs capture multiple cases during the three-year period. Some might look at this type of analysis and expect the cost of capital to be lower. Indeed, it could be argued that an implication of this analysis is that inflation should be removed; if not from the price of the asset then from the cost of capital. This would suggest that AT&T's view is correct.

Such a conclusion is demonstrably wrong. Importantly, UNE prices are set assuming a three-year horizon in this case. No one has suggested that the cost of capital should be calculated as if the investor were to get all of his money back at the end of the three-year period. ***So*** why would assuming that the period is shortened from three years to one year change that? The answer is that this would not affect the cost of capital. The cost of capital is independent of whether a three- or a one-year horizon is used. The investor, under either scenario, gets the return of his investment over the useful life of the investment, which is not based on the artificial horizon placed on the effectiveness of the UNE rates.

It is conceivable that someone may still want to argue that using a one-year horizon somehow reduces the risk to the investor, which should reduce the cost of capital. However, then you are **left** with the logical conclusion that the only way this could happen is if the investor is going to get his investment back at the end of the period – only one year. However, if that is the conclusion one wants to reach, then the depreciation rate for the asset has to be adjusted to recover the cost of the asset in the first year, which would obviously greatly increase the TELRIC loop rate. Yet no one is requesting this extreme action.

Some might still argue that there is no reason to compensate both BellSouth and its investors for the inflation component of the forward-looking TELRIC costs of BellSouth's network over the indicated three-year time horizon. Yet it is critically important to understand that BellSouth must be compensated appropriately for inflation, which is a forward-looking **cost** it must bear, or it will not be able to meet the return requirements of its investors. BellSouth's network is an earning asset that must recover its costs and a reasonable, risk-adjusted return if it is to be able to turn around and distribute that return among its investors. Compensating both BellSouth and its investors for inflation is not "double-counting,'' it is a necessity in a T E W C environment disciplined by competitive capital markets.

The logical implication of the above argument is that how inflation is a necessary part of the cost of capital and how it is used in the pricing of the assets necessary to build a loop are separate and distinct items. BellSouth is entitled to the TELRIC cost of the loop. The TELRIC cost of the loop increases each year with inflation. Therefore the price for the loop in the example has to increase each year either by having a new UNE cost proceeding each year and a single-year interconnection agreement, by inflating the UNE price of the loop each year, or by accounting for the increase in the initial price, as BellSouth has done. By the same token, the investor is entitled to his money back and to earn a return on that money invested. Since, even under a TELRIC study, the investor will get his money back over the life of the asset, the investor is entitled to his required cost of capital, which is going to be inflation-adjusted, since the investor may be looking at a number of years before he gets the money back.

As discussed in my previously filed reply affidavit, it is telling that Mr. Klick and Mr. Pitkin rely on two academic studies that allegedly support their position (see Declaration, p. 3, referring to studies as Attachments 1 and 2). Both papers are by Stewart C. Myers, A. Lawrence Kolbe, and William B. Tye and both deal with the treatment of inflation under traditional rate-of-return regulation. It is critical to note that the context of these two studies is **not** that of the forward-looking TELRIC approach. Importantly, BellSouth's cost estimation framework is not derived using traditional rate-of-return regulatory cost principles. In contrast, BellSouth relies on the forward-looking TELRIC methodology that estimates costs in light of the de-regulated, competitive telecommunications environment. Thus, the academic papers offered as support for Mr. Klick and Mr. Pitkin's argument are misguided in the current proceeding because those studies are couched exclusively in a traditional rate-of-return environment, which is not present in the current proceeding.

It is also important to note that the academic studies cited by Mr. Klick and Mr. Pitkin assume that the considered investments are singular outlays at a certain one-time price that will remain fixed for long useful lives. As such, the cited studies do not consider the issue of TELRIC pricing, which did not even exist when the papers were written. Thus, the cited studies do not capture the effective increase in the cost of the investment that must be captured if BellSouth is entitled to costs based on a TELRIC analysis. The studies relied on by Mr. Klick and Mr. Pitkin are not applicable to the analysis of BellSouth's UNE cost methodology.

Sincerely,

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