

EXHIBIT B

**REPLY DECLARATION OF RON HILYER
IN SUPPORT OF AT&T INC.**

**Before the
Federal Communications Commission
Washington, D.C. 20554**

_____)	
In the Matter of)	
)	
Special Access Rates for Price)	
Cap Local Exchange Carriers)	WC Docket No. 05-25
)	
AT&T Corp. Petition for)	
Rulemaking to Reform Regulation)	
Of Incumbent Local Exchange)	RM-10593
Carrier Rates for Interstate)	
Special Access Services)	
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**REPLY DECLARATION OF
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I. BACKGROUND AND QUALIFICATIONS

1. My name is Ron Hilyer. I am the same Ron Hilyer who submitted a Joint Declaration with Thomas Makarewicz on behalf of AT&T Inc. (“AT&T”) in this proceeding on January 19, 2010.¹

II. PURPOSE AND SUMMARY

2. The purpose of this Reply Declaration is to respond to the “Defense of ARMIS” set forth in a paper prepared for Ad Hoc Telecommunications Committee by Economics and

¹ See Joint Declaration of Ron Hilyer and Thomas Makarewicz on Behalf of AT&T Inc., filed January 19, 2010, in WC Docket No. 05-25 and RM-10593 (“Joint Declaration” or “Joint Decl.”).

Technology, Inc (“ETI”),² which argues that the effects of the 2001 separations freeze did not significantly undermine the reliability of rates of return computed using data contained in the Automated Reporting Management Information System (“ARMIS”). As demonstrated below, this attempted defense of ARMIS-derived returns is meritless.

III. THE ARMIS DEFENSE PAPER DOES NOT ADDRESS MANY OF THE SIGNIFICANT FLAWS WITH ARMIS-DERIVED RETURNS.

3. It is important to recognize as a preliminary matter that the focus of the ARMIS Defense Paper is on the impact of the 2001 separations freeze, and it therefore does not address the fact that ARMIS-derived service-specific returns have always been of limited use and were otherwise outdated by the mid-1990’s. As Mr. Makarewicz and I explained in the Joint Declaration, service-specific ARMIS data reflect necessarily arbitrary allocations of the costs of multi-service and multi-jurisdiction firms among particular services and jurisdictions, and service-specific ARMIS data therefore have never been used to regulate prices of any specific service under price caps.³ In addition, the Commission specifically recognized in the late 1990’s that its cost allocation rules failed to capture significant technology shifts, explaining that it would be necessary to undertake a “comprehensive review” of its allocation rules, given that telephone networks had “changed substantially since the jurisdictional separations rules were first established in 1947” and that “[t]he introduction of new network control technologies changes the way services are delivered and thus call into question the validity of the service

²See S. Gateley, H. Golding, L. Selwyn, and C. Weir, “Longstanding Regulatory Tools Confirm BOC Market Power: A Defense of ARMIS,” January 2010 (“ARMIS Defense Paper” or “Paper”) (Attachment B to Comments of the Ad Hoc Telecommunications Users Committee).

³ See Joint Decl., ¶ 8; Order on Reconsideration, *Policy and Rules Concerning Rates for Dominant Carriers*, 6 FCC Rcd. 2637, ¶ 199 (1991).

distinctions specified in the separations rules.”⁴ In 2001, the Commission again explained that its ARMIS cost allocation rules were “outdated regulatory mechanisms that are out of step with today’s rapidly-evolving telecommunications marketplace.”⁵

4. ARMIS-derived service-specific returns were thus meaningless even before the 2001 separations freeze. Therefore, even if the ARMIS Defense Paper were correct (which it is not) that the 2001 separations freeze did not significantly increase the problems with using service-specific ARMIS-derived returns, it is still clear that ARMIS-derived returns by specific interstate service category would be economically meaningless.⁶

IV. THE ARMIS DATA DO NOT ALREADY ACCOUNT FOR THE DRAMATIC INCREASES IN RELATIVE SPECIAL ACCESS DEMAND THAT OCCURRED FROM 2001 THROUGH 2007.

5. Contrary to the allegations in the ARMIS Defense Paper, as explained in my initial Joint Declaration, the 2001 separations freeze *did* dramatically increase the problems with

⁴ Notice of Proposed Rulemaking, *Jurisdictional Separations and Referral to the Federal-State Joint Board*, 12 FCC Rcd. 22120, ¶¶ 12-13 (1997).

⁵ Report and Order, *Jurisdictional Separations and Referral to the Federal-State Joint Board*, 16 FCC Rcd. 11382, ¶ 1 (2001) (“*Separations Freeze Order*”).

⁶ The ARMIS Defense Paper concedes that the ARMIS separations allocations “produce[] results that are “not necessarily precise.” ARMIS Defense Paper at 5. The Paper’s only response concerning changes in telecommunications technology is that the “public telephone network has always migrated to new technologies” and that there “is nothing about the use of ‘digital’ technology or ‘fiber optic’ facilities that creates any fundamental or conceptual difference” between the current RBOC networks “and the multi-service, multi-jurisdictional network infrastructure that has been in place for more than a century.” ARMIS Defense Paper at 10. But the fact that networks may have previously migrated to new technologies does not mean that the decades-old allocations rules captured the specific technology changes that occurred in the 1980’s and 1990’s. Furthermore, the notion that the shift away from analog copper facilities to digital fiber facilities is irrelevant is incorrect. For example, this shift resulted in switched and special access traffic sharing even more facilities, which the prior allocation rules did not anticipate. In any event, as noted, the Commission instituted the separations freeze in 2001 precisely because the ARMIS cost allocation rules were “outdated regulatory mechanisms that are out of step with today’s rapidly-evolving telecommunications marketplace.” *See id. at 12*; Joint Decl., ¶ 12 (quoting *Separations Freeze Order*, ¶ 1).

the service-specific returns derived from ARMIS data. The cost allocation rules depended in large part on complex studies conducted by telecommunications carriers to determine how their shared and common facilities were being used and to allocate the costs of those facilities among jurisdictions and services in a manner consistent with the Commission's allocation rules. The effect of the freeze was that no carrier has conducted such studies since 2000, and that carriers instead have been required to use the allocations they developed in 2000 to allocate costs in subsequent years. But the use of networks has changed dramatically since 2000. For AT&T, special access lines have increased by 135.2 percent and special access revenues have increased by 65.8 percent, while at the same time switched access lines have decreased by 30.5 percent and interstate switched access revenues have decreased by 28.4 percent. It is therefore clear that a far larger share of investment and expenses would have been allocated to special access from 2001 through 2007, if not for the 2001 separations freeze. Because the ARMIS data correctly recognized the increased special access revenues but failed to recognize the corresponding increases in special access investments and expenses, ARMIS-derived special access returns are significantly inflated.

6. The ARMIS Defense Paper responds by stating that "even if the individual allocators have been frozen, the allocations themselves generally reflect and capture changing demand," and that the ARMIS data therefore *do* reflect the increases in special access investment and expenses associated with the significant increase in special access demand.⁷ In support of this argument, the ARMIS Defense Paper asserts that the relative amount of investment and expenses allocated to special access from 2001 to 2007 increased by 1 or 2 percentage points.⁸

⁷ ARMIS Defense Paper at 13.

⁸ *Id.* at 13-15.

But this small increase in relative special access investment and expenses clearly does not account for the 135.2 percent increase in special access lines and the 30.5 percent decrease in switched access lines.

7. In arguing that ARMIS data do fully reflect the increases in special access lines and revenues, the ARMIS Defense Paper appears to confuse the changes in the relative special access investment reflected in ARMIS by application of the frozen 2000 allocations with the relative increases in special access investment that *should* have been reflected in ARMIS given the dramatic increases in special access lines and revenues. An example illustrates this point. Assume that historical total plant in service was \$100 in 2000 and included \$50 in Switching Equipment (allocated entirely to switched access services) and \$50 in Circuit Equipment (allocated half to switched access services and half to special access services). The 2000 special access plant would be \$25, or 25 percent of total plant in service. Next, assume that due to large increases in demand for special access, from 2001 through 2007, the company makes an additional investment in Circuit Equipment of \$100, all of which is being used for special access, but, due to the frozen allocators, only \$50 (rather than the full \$100) is allocated to special access. The result would be a total of \$200 of total plant in service with only \$75 (rather than the full \$125) being allocated to special access. Even with frozen allocations, the portion of allocated special access plant to total plant would increase from 25 percent ($\$25/\100) in 2000 to 37.5 percent ($\$75/\200) in 2007.

8. This example illustrates that the frozen allocators prevented the additional \$100 investment in special access from properly being assigned entirely to special access. If the correct assignment of the plant in service had been accurately reflected, it would have included the \$25 original special access investment, plus the additional \$100 special access investment for

a total of \$125 in special access investment, which would be 62.5 percent of total investment (rather than 37.5 percent).

9. An examination of AT&T's ARMIS reports confirms that the ARMIS Defense Paper's conclusion that the frozen cost allocations account for the increasing special access demand is incorrect and that the growth in special access plant is in fact based entirely on the growth in total plant investments recorded in specific Part 32 accounts and the application of the various frozen separation factors to each of those investments. From 2001 through 2007, approximately 95 percent of the increase in AT&T's regulated Total Plant In Service was in COE - Transmission and Cable and Wire Facilities. These two types of investments represented more than 90 percent of all Total Plant In Service allocated to special access for AT&T in 2007. As a result, as illustrated in the example above, the relative increase in Part 32 total investment used in the provision of Special Access services caused the special access investment as a percent of Total Plant in Service to increase slightly from 2000 to 2007. However, the ARMIS Defense Paper's suggestion that this slight increase in the portion of ILEC special access investment relative to total investment is evidence that the ARMIS allocations capture the dramatic increases in demand for special access services is obviously incorrect.⁹

⁹ Notably, examination of the two predominant types of plant investment used in the provisioning of special access services, COE - Transmission and Cable and Wire Facilities, confirms that the portion of these investments allocated to special access under the freeze did not materially change from 2000 to 2007. The amount of AT&T's COE - Transmission investment allocated to special access as a percentage of total regulated COE - Transmission was 19.2 percent in 2000 and 19.3 percent in 2007. Likewise, the amount of AT&T's Cable and Wire Facilities investment allocated to special access as a percentage of total regulated Cable and Wire Facilities was the same (3.9 percent) in 2007 as it was in 2000. If the portion of these investments allocated to special access had substantially increased to reflect actual higher demand for special access services, those percentages would have increased substantially, and the portion of special access investment relative to overall total investment would have increased by much more than the 1-2 percentage points relied on by the ARMIS Defense Paper.

10. The ARMIS Defense Paper tries to address the discord between its argument that the 1-2 percentage point increase in the portion of total plant allocated to special access and the fact that special access lines increased by 135.2 percent while switched access lines decreased by 30.5 percent, by arguing that due to economies of scale, the special access percentage of investment and expenses will not necessarily increase in precise proportion to the very large increases in special access lines that occurred.¹⁰ But the ARMIS Defense Paper acknowledges that actual special access costs should have increased by some amount (even if not in strict proportion) with increases in lines, and the Paper's assertion that a 135.2 percent increase in lines (as occurred here) could result in only a 1 or 2 percentage point increase in relative costs has no support and defies logic.¹¹ In addition, the Paper states that switched access costs *do* change in proportion to changes in lines (*see* ARMIS Defense Paper at 14), and the Paper does not dispute that AT&T's switched access lines decreased by 30.5 percent from 2000 to 2007. Based on the Paper's logic, therefore, AT&T's actual switched access costs should have fallen by approximately 30.5 percent. That, by itself, means that the portion of overall investment and expenses attributed to special access should have increased by substantially more than the one or two percentage points reflected in ARMIS.

11. The ARMIS Defense Paper's argument that a 1-2 percentage point increase in special access costs that results from the separations freeze is consistent with the 65.8 percent increase in special access revenues and the 28.4 percent decrease in interstate switched access revenues is likewise unsound.¹² The Paper here challenges the 2009 NRRI Report's conclusion

¹⁰ ARMIS Defense Paper at 14-15.

¹¹ *See, e.g.*, ARMIS Defense Paper at 15, Table 2.2 (showing the RBOC special access percent of total RBOC plant in service increased from 9 percent in 2000 to 10 percent in 2007).

¹² ARMIS Defense Paper at 14-15.

that ARMIS derived returns are overstated by orders of magnitude based on adjustments made to ARMIS investments and expenses that reflect changes in revenues for special access services relative to other services.¹³ The Paper disputes that such an analysis is meaningful because “all of the investments were [not] made in the year being analyzed.”¹⁴ But the ARMIS-derived rates of return on which the Paper relies are based on the total investment (which was placed in service over a number of years), and revenues and expenses for each given year. To argue that there is a mismatch in investment, expenses *and* revenues in any given year is to argue that those ARMIS-derived return calculations are also invalid.

12. This argument is logically unsound for a second reason as well. The ARMIS Defense Paper challenges NRRI’s analysis because it is inconsistent with the purported “facts” that there have been “escalating rates and profit levels” for special access and that it is “not” the case that special access “competition is operating to continually push prices down to cost-based levels.”¹⁵ However, this is precisely the *question* that the ARMIS Defense Paper is trying to answer. Thus, in making this argument, the Paper has assumed its conclusion.

13. In addition, the ARMIS Defense Paper purports to show that “between 2000 and 2007, 16% of the total new plant put in service was allocated to the special access category – substantially more than the historic special access portion of total plant in service (8.5%), and quite close to the special access revenue ratio of 18% referenced above.”¹⁶ This statement is misleading in numerous respects. First, the fact that 16 percent of total new plant in service was allocated to special access in ARMIS is meaningless by itself without knowing what the increase

¹³ *Id.* at 14 n.23.

¹⁴ *Id.* at 15.

¹⁵ *Id.* at 14 n.23.

¹⁶ ARMIS Defense Paper at 16.

should have been. As noted, the fact that special access lines increased by 135.2 percent and special access revenues increased by 65.8 percent, while switched access lines and revenues plummeted, strongly suggests that far more than 16 percent of total new plant in service should have been allocated to special access services. Second, the Paper makes an apples-to-oranges comparison when it compares the portion of the *change* in total plant in service attributed to special access (16 percent) to the *total embedded* portion of total plant in service attributed to special access (8.5 percent). Third, the Paper misleadingly suggests that the 16 percent special access investment ratio is comparable to the 18 percent special access revenue ratio. In reality, the 18 percent special access revenue ratio is the ratio of special access investment to *total* plant investment that would have been reflected in ARMIS if special access investment was adjusted to track the changes in special access revenues.¹⁷ The comparable figure in the Paper’s Table 2.2 is the 10 percent of total special access plant in service to total plant in service for 2007 using ARMIS reported plant in service based on frozen separations factors, which is far below 18 percent.¹⁸

V. THE ARMIS DEFENSE PAPER’S ANALYSIS OF “DISINVESTMENT” IS FUNDAMENTALLY FLAWED.

14. The ARMIS Defense Paper argues that RBOCs have been “disinvesting”¹⁹ in special access investments at a lower rate than their “disinvestment” related to other regulated

¹⁷ *Id.* at 14 n.23.

¹⁸ *Id.* at 15.

¹⁹ The term “disinvestment” is a misnomer, because – as used in the Paper – it does not refer to taking plant out of service or otherwise retiring existing plant. Instead, the Paper appears to be using the term to refer to a situation where the amount of depreciation for a given category of plant exceeds the amount of new investment for that category in a given year. *See* ARMIS Defense Paper at 16 n.24 (“Network disinvestment occurs when the depreciation charge in any given year is greater than the amount of new capital invested in the network”).

services, such that RBOC special access net investment has effectively increased as a percentage of total investment.²⁰ This argument is premised on a flawed analysis. First, the Paper erroneously represents Average Net Investment (“ANI”) in ARMIS as “Net Plant.” They are not the same thing. Net Plant is Total Plant in Service less Accumulated Depreciation and Amortization, whereas ANI includes many additional items, such as Customer Deposits, Other Long-Term Liabilities and Deferred Credits, Other Jurisdictional Liabilities and Deferred Credits, Cash Working Capital, FCC Investment Adjustment, and Deferred Operating Income Taxes. Many of these additional items have nothing to do with Net Plant. Moreover, several of the items in ANI were not populated in both the subject to separations and special access columns of the ARMIS reports, as is required by the ARMIS instructions and procedures. As a result, the Paper’s inclusion of these additional items in its analysis of ANI creates significant inconsistencies and renders its results and conclusions invalid.

15. In Attachment 1 hereto, I have recalculated the AT&T “disinvestment” from 2000 to 2007 in two ways that more accurately and consistently compare the ANI and Net Plant changes. First, I removed from ANI all of the additional items (such as those described above) that are not consistently populated in the special access and subject to separations columns of the ARMIS reports. Second, I calculated Net Plant simply by subtracting Accumulated Depreciation and Amortization from Total Plant in Service, consistent with the commonly accepted definition of Net Plant.

16. Both of these approaches demonstrate that, contrary to the assertion in the ARMIS Defense Paper, the rate of decline in AT&T’s net investment for special access was very similar to the rate of decline in net investment for other regulated services. Under the first

²⁰ See ARMIS Defense Paper at 16.

method, AT&T's special access ANI declined by 54.7 percent between 2000 and 2007, compared to a 50.4 percent decrease in ANI for all other regulated services.. Using the second method, special access Net Plant (Total Plant In Service minus Accumulated Depreciation and Amortization) declined by 32.5 percent during the same time period, versus 30.3 percent in Net Plant for all other regulated services.

17. Additionally, based on my first method, special access ANI as a percent of total subject to separations ANI declined from 7.1 percent in 2000 to 6.5 percent in 2007. Based on the second method, special access Net Plant as a percentage of total subject to separations Net Plant declined from 7.0 percent in 2000 to 6.8 percent in 2007. These modest decreases show that the "disinvestment" rate for special access was not materially different from that of other regulated services and that the "disinvestment" rate for special access services was actually greater than that of other regulated services (not less, as claimed by the ARMIS Defense Paper). Thus, even if the relative "disinvestment" rate could be used to "validate" ARMIS special access returns – and they cannot – the ARMIS Defense Paper simply has the facts wrong.

VI. THE ARMIS DEFENSE PAPER'S SUGGESTION THAT AT&T'S SPECIAL ACCESS ARMIS-DERIVED RETURNS ARE SIGNIFICANTLY UNDERSTATED DUE TO THE INCLUSION OF INVESTMENT AND EXPENSES RELATED TO U-VERSE IS INCORRECT.

18. The ARMIS Defense Paper asserts that essentially all of the investment and expense that AT&T has incurred related to the deployment of U-verse have been assigned to regulated operations, and that ARMIS therefore "almost certainly understates" the rates of return for special access.²¹ This assertion is not correct. AT&T has treated U-verse as a *non-regulated* service in its Cost Allocation Manuals ("CAMs") filed with the Commission ever since it began

²¹ ARMIS Defense Paper at 20-26.

its build out of the U-verse network during 2005.²² As such, the costs incurred by AT&T's traditional regulated local carriers (such as Illinois Bell Telephone Company) for U-verse were attributed to non-regulated activities – not to regulated activities, such as special access services.²³

19. The Paper attempts to support its false allegation that U-verse costs are reflected in AT&T's ARMIS special access data by asserting that AT&T's "investment dollars assigned to the special access category grew by 35% – more than twice the rate of all other service categories combined" from 2000 to 2007.²⁴ These comparisons are highly misleading because they are being used as evidence that U-verse costs are being assigned to special access. In reality, as explained in paragraphs 8 and 9 above, the higher percentage increase in special access is largely attributable to the relative change in the Part 32 investment categories used in the provisioning of special access services compared to the change in other investment categories and the application of the various frozen separation factors to each of those categories of investments.²⁵

²² AT&T's compliance with the Commission's requirements for CAMs has been audited and confirmed by an independent auditor, in accordance with the Commission's Rules and Regulations (47 C.F.R. § 64.104).

²³ Furthermore, the ARMIS Defense Paper bases its assertions on AT&T's annual 10-K report filed with the Securities and Exchange Commission. *See* ARMIS Defense Paper at 20-21 & nn. 33, 35; *id.* at 24 & n. 45. A significant portion of the U-verse capital expenditures described in those reports, however, were incurred by other wireline affiliates of AT&T that provide unregulated services and are not subject to ARMIS reporting requirements. None of the investment incurred by these affiliates is reported in ARMIS.

²⁴ ARMIS Defense Paper at 24.

²⁵ Again, examination of the two predominant types of plant investment used in the provisioning of special access services, COE - Transmission and Cable and Wire Facilities, confirms that the calculations in the ARMIS Defense Paper are highly misleading. I have computed the percent change in special access and all other services combined relative to both COE - Transmission and Cable and Wire Facilities. For COE - Transmission, the rate of growth for special access

VII. THE LACK OF ALTERNATIVE METHODS FOR COMPUTING SERVICE-SPECIFIC RETURNS IS MEANINGLESS.

20. The ARMIS Defense Paper argues that ARMIS-derived special access returns must be accurate because otherwise, ILECs would have submitted their own cost and revenue data demonstrating that their special access returns are lower.²⁶ But, for the reasons explained above, any attempt to allocate the many shared and common investments and expenses to special access would be arbitrary. Prior to 2001, AT&T had to devote enormous resources to the task of trying to allocate joint and common costs among its services, but the 2001 separations freeze put an end to that exercise, and the Commission eliminated cost assignment reporting requirements in 2008. Accordingly, it is not at all surprising that AT&T and other LECs have not attempted to devise internal methods of replicating functions that the Commission itself has not required for many years.

VIII. CONCLUSION

21. For the foregoing reasons, the FCC should not use ARMIS-based returns to evaluate price cap LEC prices.

was 36.9 percent between 2000 and 2007, as compared with 33.5 percent for the other services combined; for Cable and Wire facilities, the growth rate of special access was 27.6 percent, as compared with 25.8 percent for the other services combined, for the same time period.

²⁶ ARMIS Defense Paper at 9-10.

VERIFICATION PAGE

I declare under penalty of perjury that, based on the information available to me, the foregoing is true and correct to the best of my knowledge.

/s/ Ron Hilyer

Dated: February 24, 2010