BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Determination of Prices,	)	
Terms, and Conditions of Certain Unbundled	)	Case No. TO-2005-0037
Network Elements: Consideration Upon Remand	)	
From the United States District Court.	)	

SBC MISSOURI'S BRIEF

SBC Missouri[1] respectfully submits this Brief in support of its request that the Missouri Public Service Commission ("Commission"): (1) adopt the 86% equity and 14% debt capital structure advocated by Dr. William Avera, SBC Missouri's cost of capital expert witness, and use this factor to recalculate the rates set in Case No. TO-2001-438 in accordance with the US District Court's mandate; and (2) direct the parties to use these recalculated rates to correct the prior true-up (for the period December 27, 2002 to June 26, 2003) that was based on rates that have been found to be unlawful, and to true-up charges for subsequently provided services based on the recalculated rates.

EXECUTIVE SUMMARY

Capital Structure. As confirmed by the U.S. District Court, the Commission in this case must adopt a forward-looking capital structure prescribed by the FCC's TELRIC methodology that "is calculated within the context of a competitive market."[2] The market value approach yields a capital structure that is consistent with both the U.S. District Court's Remand Order and the FCC's TELRIC methodology. Any attempt to artificially "adjust" the market value capital structure as, for example, by averaging market value capital structure with book value capital structure, would

[1] Southwestern Bell Telephone, L.P., d/b/a SBC Missouri, will be referred to in this pleading as "SBC Missouri."

[2] Southwestern Bell Telephone, L.P., d/b/a SBC Missouri v. Missouri Public Service Commission, et al., No. 03-04148-CV-C-NKL, slip op. at 5 (D. Mo. June 17, 2004).

directly violate the U.S. District Court's Order and would be flatly inconsistent with the FCC's TELRIC rules.

In Case No. TO-2001-438, SBC Missouri's and the CLECs'[3] cost of capital witnesses provided evidence that complied with this standard. Both witnesses presented evidence of the market-value capital structure for SBC Missouri based on a comparable group of large LEC holding companies. And that evidence was strikingly consistent. SBC Missouri witness Dr. William Avera testified that the appropriate market-value capital structure was 86% equity and 14% debt. The CLECs' witness Mr. John Hirshleifer testified that the market-value capital structure was 80% equity and 20% debt. Mr. Hirshleifer's proposed factor was lower only because he included much smaller LECs (Alltel and CenturyTel) in his comparable group.

But in an attempt to drive the cost of capital factor lower, Mr. Hirshleifer improperly attempted to downwardly adjust his market-based capital structure factor by averaging it with the book-value capital structure he calculated, arguing that market value capital structure does not reflect the relevant risk of providing UNEs. The FCC, however, specifically rejected this argument (along with nearly the exact same evidence) when AT&T and other CLECs presented it in the Verizon-Virginia arbitration. There, the FCC gave <u>no weight to the portion of the CLECs' proposal that was based on incumbent LECs' book value capital structure</u>. Moreover, the U.S District Court also rejected this approach ruling that TELRIC "requires the consideration of market risk instead of the risk reported in an incumbent LEC's books."[4] And even aside from his improper consideration of historical book value data, Mr. Hirshleifer's underlying risk assumption is <u>backwards</u>. As Dr. Avera testified, small, less diversified business have <u>higher</u> capital costs due to the higher risk investors perceive. In his conservative view, investors would certainly perceive the provision of

[3] The CLECs participating in this phase of the proceeding refer to themselves as the "CLECs." Although they called themselves the "Joint Sponsors" in Case No. TO-2001-438 below, SBC Missouri will follow their preferred designation in this case.

[4] <u>Southwestern Bell Telephone v. MoPSC</u>, slip op. at p. 8.

UNEs as at least as risky, and probably more risky, than they would view the business of a diversified telephone holding company.[5] The Commission here should similarly give no weight to Mr. Hirshleifer's "adjustment."

The Commission should adopt Dr. Avera's 86% equity and 14% debt capital structure as his estimate fully complies with the FCC's TELRIC standards, is most representative for SBC Missouri and is consistent with the portion of the CLECs witness' testimony that may be considered in this proceeding.

<u>The True-Up</u>. The CLECs should not be permitted to limit the practical application of the U.S. District Court's Order by claiming that any rate changes resulting from this Remand proceeding would neither apply to their individual entry agreements nor result in any monetary true-ups from the rate corrections the Commission must necessarily make in this case.

A refusal to modify the existing M2A-based interconnection agreements would constitute a flagrant and unlawful refusal to comply with the U.S. District Court's Remand Order. Such a refusal would place the Commission in direct violation of the Remand Order and should not be considered.

With regard to true-up, the claims advanced by the CLECs would turn the language in the M2A on its head. The entire premise underlying the need to replace the interim rates in the M2A was that they were to be replaced by permanent rates that were <u>lawful</u>. Having convinced the Commission to adopt an unlawful approach, the CLECs now seek to retain the benefits of successfully advocating an unlawful pricing method. This should not be countenanced.

[5] Ex. 2, Avera Surrebuttal, pp. 23-24; T. 121, 143, 147-148, 151-153.

BACKGROUND

A. The FCC's TELRIC Costing Standard.

Under the Telecommunications Act of 1996, incumbent LECs like SBC Missouri may charge any requesting telecommunications carrier a "just and reasonable rate" for access to its unbundled network elements ("UNEs").[6] To determine what rates are just and reasonable, the FCC adopted as its standard, the Total Element Long Run Incremental Cost ("TELRIC") methodology. Under that standard, UNE prices are to be "based on the use of the most efficient telecommunications technology currently available and the lowest cost network configuration, given the existing location of the incumbent LEC's wire centers."[7] The FCC has explained that TELRIC must be calculated within the context of a competitive market:

> TELRIC is based on the assumption that competition would constrain the value of an incumbent LEC network and the price that could be charged for use of that network. In other words, the "cost" of the element . . . for purposes of section 252(d)(1) equals the price than an incumbent LEC would be able to charge for an element in a competitive market.[8]

B. Procedural Background.

The Commission opened Case No. TO-2001-438 in an order issued February 15, 2001, and indicated that it established the case:

> . . . to determine the recurring and non-recurring rates for the unbundled network elements (UNEs), including dedicated local transport, identified by the Staff of the Missouri Public Service Commission (Staff) in TO-99-227 that have not been reviewed by the Commission for conformance with the FCC's pricing standards. In addition, this case will address the recurring and non-recurring rates found in the Commission's December 23, 1997 Report and Order in TO-98-115 that had been set as interim in TO-99-227.[9]

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[6] 47 U.S.C. Section 252(d)(1).

[7] 47 CFR Section 51.505(b)(1).

[8] In re Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers, 18 F.C.C.R. 18,945 para. 16 (September 15, 2003) ("TELRIC NPRM").

[9] Order Establishing Case and Directing Notice, Case No. TO-2001-438, issued February 15, 2001, p. 1.

The CLECs that participated in Case No. TO-2001-438 (which called themselves the "Joint Sponsors") proposed and the Commission accepted a list of 356 issues regarding the various TELRIC cost studies SBC Missouri prepared to support the prices it proposed to charge CLECs for the use of the UNEs at issue in the proceeding (some of the same issues arose regarding more than one cost study and, as a result, those issued appeared more than once on the list of issues).

Following the pre-filing of extensive direct, rebuttal, and surrebuttal testimony, the Commission held evidentiary hearings from December 3 through December 6, 2001. The parties filed initial briefs on January 25, 2002, and reply briefs and proposed findings of fact and conclusions of law on February 19, 2002. The Commission issued its Report and Order on August 6, 2002, making specific findings about the factors SBC Missouri used to prepare its cost studies and directed SBC Missouri to rerun its cost studies, incorporating the changes the Commission ordered, and to prepare revised prices for the Commission's consideration.

SBC Missouri on August 15, 2002, filed an application for reconsideration and/or rehearing of determinations the Commission made in it August 6, 2002 Report and Order concerning the cost of capital and other factors the Commission ordered it to use in its TELRIC cost studies. The Commission denied SBC Missouri's application on September 10, 2002.

SBC Missouri submitted its revised cost information and prices on September 20, 2002, and again applied for reconsideration and/or rehearing concerning the revised UNE costs and rates, again raising concerns with the cost of capital and other factors the Commission adopted. The Commission denied SBC Missouri's second application for reconsideration and/or rehearing on November 14, 2002.

Following SBC Missouri's September 20, 2002 submission of revised costs and prices, the Commission's Staff and the Joint Sponsors respectively filed comments on November 1 and 4, 2002, concerning SBC Missouri's revised costs and prices. SBC Missouri replied to the Joint Sponsors' and Staff's comments concerning the revised cost studies and prices on November 22,

2002. Following discussions concerning various compliance issues,[10] SBC Missouri submitted revised rates on April 7, 2003.[11] SBC Missouri subsequently revised two of those rates in a May 30, 2003 filing.

At the same time SBC Missouri filed its revised rate schedule on May 30, 2003, SBC Missouri also filed an application for reconsideration and/or rehearing and an alternative motion to hold in abeyance. SBC Missouri indicated that during the phase of this case in which SBC Missouri's revised rates were being reviewed for compliance with the Commission's August 6, 2002 Report and Order, the FCC announced in a February 20, 2003 News release[12] that it had concluded its Triennial Review proceeding and was, among other issues, providing clarification on the cost of capital and depreciation components of the TELRIC pricing rules to ensure that UNE prices send appropriate economic signals to incumbent LECs and competitive LECs. Specifically, the FCC clarified that:

- The risk-adjusted cost of capital used in calculating UNE prices should reflect the risks associated with a competitive market (emphasis added).

In its May 30, 2003 application, SBC Missouri explained that the FCC's clarification on this key component of the TELRIC pricing rules confirmed the concerns SBC Missouri expressed in its August 15 and September 20, 2002 applications for rehearing that the Commission misapplied TELRIC principles, which resulted in the setting of rates substantially below what would be required by a proper application of the TELRIC methodology. As an alternative to rehearing or

[10] SBC Missouri and the Joint Sponsors resolved all of the compliance cost study issues (i.e., issues concerning whether the revised rates SBC Missouri filed complied with the revisions ordered by the MoPSC) raised by the Joint Sponsors as a settlement limited to this particular case, under which the parties reserved their right to appeal the MoPSC's determinations. See, e.g., the parties' jointly filed List of Remaining Issues, filed February 21, 2003 in Case No. TO-2001-438.

[11] After making this filing, SBC Missouri discovered that its revised rate sheet still contained a few references to "TO-97-40" and "T2A" rates (instead of showing the actual rates themselves) and corrected those references (by listing the actual rates) in an April 30, 2003 resubmission.

[12] A copy of the News Release was provided to the MoPSC with SBC's May 30, 2003 Application for Reconsideration and/or Rehearing and Alternative Motion to Hold in Abeyance.

reconsideration, SBC Missouri requested the Commission to temporarily hold its adoption of final rates in this proceeding in abeyance until the FCC's Triennial Review Order was released and sufficiently analyzed to ensure that that the final rates in this proceeding were consistent with the FCC's directives on TELRIC in these two areas.

The Commission denied SBC Missouri's May 30, 2003 application for reconsideration and/or rehearing and alternative motion to hold in abeyance on June 17, 2003. As a result, SBC Missouri implemented the new rates, effective June 27, 2003, the effective date of the Commission's order. In addition, SBC Missouri implemented the six-month retroactive rate true-up covering the period December 27, 2002 through June 26, 2003.

SBC Missouri appealed the Commission's determinations in Case No. TO-2001-438 by filing a complaint with the U.S. District Court for the Western District of Missouri on July 16, 2003. Following full briefing, the Court granted SBC Missouri's Motion for Summary Judgment on June 12, 2004, and vacated the Commission's capital structure determination. Accordingly, the Court remanded the case to the Commission for reconsideration of the appropriate capital structure and resulting rates.

The Commission opened Case No. TO-2005-0037 for the purpose of reconsidering this remanded issue. In its October 21, 2004 <u>Order Establishing Briefing Schedule</u>, the Commission directed the parties to file a single brief regarding (1) the appropriate capital structure to be ascribed to SBC Missouri for the purpose of determining the rates SBC Missouri may charge for unbundled network elements; and (2) whether a further true-up of rates should occur following the Commission's decision on remand.

ARGUMENT

I. THE COMMISSION SHOULD ADOPT DR. AVERA'S 86% EQUITY/14% DEBT CAPITAL STRUCTURE.

A. The Capital Structure Component of the Cost of Capital.

The overall cost of capital input to UNE cost studies is designed to ensure that the incumbent LEC's investors are adequately compensated for their investments given the relevant market and regulatory risks. The cost of capital factor is a critical input in nearly all UNE rates because, once the cost of capital is calculated, it is applied as a multiplying factor to all investments to ensure proper cost recovery.

The cost of capital is generally derived from estimating the market cost of each source of capital (i.e., equity and debt) and then weighting these costs by the relative importance of each source of funds in the capital structure. This "weighted average cost of capital" approach has been universally accepted in the regulatory arena and is used by companies in all industries for calculating the cost of capital for capital budgeting purposes.[13]

From a mathematical perspective, the cost of capital calculation consists of three major components: the cost of equity, the cost of debt, and the capital structure. Once the first two components are determined, they are weighted according to the capital structure to produce an overall cost of capital. In this case, SBC Missouri proposed a 13.0% cost of equity and a 7.18% cost of debt combined with a capital structure consisting of 86% equity and 14% debt, which would produce an overall weighted average cost of capital of 12.19%. The specific calculation is: (13.0 x .86) + (17.18 x .14) = 12.19.[14]

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[13] Ex. 1, Avera Direct, Sch. 2, p. 19.

[14] Exhibit 1, Avera Direct, pp. 4-5, Schedule 2, pp. 19, 39.

In this case, the Commission's adoption of a 13% cost of equity and a 7.18% cost of debt were not appealed. They are therefore final and not a subject of this proceeding. Only the capital structure component is at issue here.

B. The Legal Standard for Determining Cost of Capital.

The need to meet market standards of capital attraction and financial integrity was recognized by the FCC in its Local Competition Order, through which it implemented the Telecommunications Act of 1996:

> We note that our interpretation is consistent with existing Supreme Court precedent concerning what constitutes a reasonable rate of return for a regulated public utility. For example, in Blue Field Water Works, the Supreme Court stated:
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> > A public utility is entitled to such rates as will permit it to return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the general part of the country on investment in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profit such as are realized or anticipated in highly profitable enterprises or speculative ventures.
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> Blue Field Water Works & Improvement Co. v. Public Service Comm'n of West Virginia, 262 U.S. 679, 692-93 (1923).
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> Similarly, in FPC v. Hope Natural Gas, the Court stated:
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> > . . . it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock . . . by that standard the return to the equity owner should be commensurate on risks on investments and other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.
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> Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944) (Hope Natural Gas). Cf., Charles F. Phillips, Jr., The Economics of Regulation, 260 (Rev. Ed. 1965) (". . . a regulated company must be afforded the opportunity not only assuring its financial integrity so that it can maintain its credit standing and attract additional capital as needed, but also for earnings comparable to those of other companies having commensurate risks.")[15]

[15] Local Competition Order, FCC 96-325, CC Dockets 96-98 and 95-185, para. 700, note 1707 (August 8, 1996).

Within the Act's framework for increased competition, the only way to meet the three standards of capital attraction, comparable return and financial integrity is to base the cost-of-capital for local telephone companies on market value capital structures.[16]

C. The FCC's TELRIC Rules Require Cost of Capital to be Calculated On a Forward-Looking Basis.

The FCC's TELRIC rules specifically require the forward-looking economic cost of an element to be calculated using a forward-looking cost of capital. Section 47 C.F.R. Section 51.505(b)(2) states: "The forward-looking cost of capital shall be used in calculating the total element long run incremental cost of an element."[17]

While regulators had traditionally used historical book value capital structures to calculate cost of capital, it was done in a context of rate of return regulation. As SBC Missouri witness Dr. Avera explained, using book values made sense under that regulatory paradigm because the regulatory compact assured the utility an opportunity to earn a return on and return of the book value of equity invested.[18] But this is not the appropriate standard under TELRIC.[19] As even the MoPSC acknowledged in its Report and Order, the FCC's TELRIC rules specify that book value is not to be considered in calculating the forward-looking economic cost of an element:

> § 51.505 Forward-looking Economic Cost
>
> (d) *Factors that may not be considered.* The following factors shall not be considered in a calculation of the forward-looking economic cost of an element:
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> > (1) *Embedded cost*. Embedded costs are the costs that the incumbent LEC incurred in the past and then are recorded in the incumbent LEC's books of accounts.[20]

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[16] Ex. 1, Avera Direct, Sch. 1, pp. 5-6.

[17] 47 C.F.R. Section 51.505(b)(2) was placed into evidence for the convenience of the MoPSC as Exhibit 22.

[18] Exhibit 2, Avera Surrebuttal, p. 3; T. 169-170.

[19] T. 170-171, Avera.

[20] 47 C.F.R. Section 51.505(d)(1). The MoPSC quoted this regulation in the "Conclusions of Law" section of its August 6, 2002 Report and Order at p. 160.

TELRIC's clear prohibition against considering historic book value can be seen in the FCC's direction that "regulators should adjust the cost of capital to reflect the risks faced by the incumbent LEC as competition is introduced into its local market."[21] In its third Motion for Reconsideration, SBC Missouri made the Commission aware of a Notice that had recently been released by the FCC confirming SBC Missouri's position that the cost of capital component must reflect the risk associated with a competitive market:

> Clarification of TELRIC Rules - - The order clarifies two components of its TELRIC pricing rules to ensure that UNE prices send appropriate economic signals to incumbent LECs and competitive LECs. First, the order clarifies that the risk-adjusted cost of capital used in calculating UNE prices should reflect the risks associated with a competitive market. The order also reiterates the Commission's finding from the *Local Competition Order* that the cost of capital may be different for different UNEs.[22]

In its Order vacating the Commission's capital structure determination and remanding this case back to the Commission, the U.S. District Court in no uncertain language confirmed the FCC's prohibition against the use of historic book values in the cost of capital determination:

> SBC argues that the MPSC erred when it used SBC's book value to predict the capital structure of a hypothetical LEC. The Court agrees . . . FCC regulations explicitly prohibit the consideration of embedded costs in calculating the forward-looking economic costs of an element . . . Instead, FCC regulations mandate that cost of capital calculations be made within the context of a competitive market environment . . . The Court finds no persuasive support for the contention that FCC regulations permit state Commission's to use an incumbent LEC's book value even as a "starting point" for cost of capital determinations. Such an interpretation is foreclosed by the plain language for the regulations, which states simply that embedded costs shall not be considered. . . .[23]

In explaining the standard, the Court specifically quoted from paragraph 680 of the FCC's Triennial Review Order:

> [t]he objective of TELRIC is to establish a price that replicates the price that would exist in a market in which there is facilities-based competition. In this type of

[21] TELRIC NPRM, para. 22.

[22] See, Attachment to FCC Triennial Review Press Release, issued February 20, 2003, at p. 4 (emphasis added), attached to SBC Missouri's Motion.

[23] Southwestern Bell Telephone v. MoPSC, slip op. at pp. 6-7 (internal citations omitted).

> competitive market, all facilities-based carriers would face the risk of losing customers to other facilities-based carriers and that risk should be reflected in TELRIC prices.[24]

D. Dr. Avera's Use of Market Value Capital Structure.

In arriving at a 14% debt/86% equity structure, Dr. Avera employed the market value capital structure approach, which the FCC specifically endorsed in the Verizon-Virginia Arbitration:

> In calculating TELRIC prices, the theoretically correct capital structure is based on market values of debt and equity, not book values. In section 252(d)(1) of the Act, Congress specifically prohibited the use of traditional rate-base, rate-of-return ratemaking. The Commission has interpreted this section to require prices based on forward-looking costs, because forward-looking costs best replicate the costs a carrier would face in a market with facilities-based competition. Under the Commission's TELRIC rules, we calculate the investment necessary to build a network using the most efficient technology currently available. The TELRIC rules provide for the recovery of the investment in that efficient network through the use of economic depreciation and they provide for a return on that investment through a risk-adjusted cost of capital. The book value of Verizon's existing network is irrelevant for these purposes. Investors would not earn the return that they require if a cost of capital that is based on book value is applied to the economic value of their assets, given that rational investors value these assets at market value. Thus, the use of a capital structure based on market values, rather than book values, represents a departure from traditional ratemaking, but one that is entirely appropriate under the Act.[25]

Dr. Avera's market value capital structure approach is also the standard approach for determining cost-of-capital both in modern corporate finance textbooks and in actual use by practitioners dealing with concrete finance problems in business. For example, Dr. Shannon P. Pratt, a leading authority on business evaluation, emphasizes in a widely-used handbook for

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[24] Southwestern Bell Telephone v. MoPSC, slip op. at p. 8.

[25] In the Matter of Petition of WorldCom, Inc. Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon-Virginia, Inc., and for Expedited Arbitration, CC Docket No. 00-218, and In the Matter of Petition of AT&T Communications of Virginia, Inc., Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia Corporation Commission Regarding Interconnection Disputes with Verizon-Virginia, Inc., CC Docket No. 00-251, Memorandum, Opinion and Order, released August 29, 2003 (Verizon-Virginia Order) at para. 102 (internal citations omitted, emphasis added). There, the Virginia Corporation Commission declined to serve as the arbitrator. Pursuant to 47 U.S.C. Sections 252(e)(5) and 155(c)(1), the FCC Common Carrier Bureau, acting through authority expressly delegated by the FCC, conducted the arbitration. Id., para. 2.

appraisers that market-value weights must be used when estimating the weighted average cost-of-capital:

> [W]e have to compute or estimate the weight . . . for each component of the capital structure. The critical point is that the relative weightings of debt in equity or capital components are based on the market-values of each component, not on the book values.[26]

As Dr. Avera testified, equity can only obtained at current market values. Unless a cost-of-capital is based on market-value capital structure, it will fail to provide a competitive market-determined return sufficient to attract capital.[27]

Even Mr. Hirshleifer, the CLECs' cost of capital witness, agreed that the debt to equity weighting should be based on market value capital structure and that it is what he would have used in his own calculations if a "pure-play" UNE-leasing company existed.[28] In fact, he used SBC Missouri's market value capital structure -- and those of the other LECs he used as comparables -- to adjust their betas for the different amount of debt leverage employed by the individual companies before he calculated an average.[29] And the market value capital structure he calculated for SBC Missouri (15% debt and 85% equity) is very close to that calculated by Dr. Avera (14% debt and 86% equity).[30] See, Ex. 29, Hirshleifer Rebuttal, Sch. JH-10, appended as Attachment 1.

E. How Dr. Avera Determined SBC Missouri's Capital Structure.

In developing the capital structure for SBC Missouri for use in its UNE cost studies, Dr. Avera calculated the market-value capital structure of a comparable group of other LECs. Specifically, Dr. Avera used the Standard & Poors LEC group, which at that time consisted of the former Bell System Regional Holding Companies, Cincinnati Bell, and GTE (he excluded Carolina

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[26] Shannon P. Pratt, Cost of Capital: Estimation and Application, p. 45 (1998) (emphasis in original), quoted in Ex. 1, Avera Direct, Sch. 2, pp. 16-17.

[27] Ex. 1, Avera Direct, Sch. 2, p. 17.

[28] T. 644.

[29] Ex. 29, Hirshleifer Rebuttal, p. 24; T. 644-645,

[30] T. 646, Hirshleifer; Ex. 29, Hirshleifer Rebuttal, Sch. JH-10.

Telephone, because its parent is not followed by Value Line, one of the primary sources of financial market information). As he explained, the average capital structure for a group is less affected by observation errors or temporary distortions that may affect one company, and this group capital structure approach is also consistent with the use of groups in estimating the cost of equity and debt.[31] Mr. Hirshleifer agreed that the use of the Standard & Poor LEC group was appropriate as he also used it in his ananlysis.[32]

As Dr. Avera testified, an 86% equity/14% debt capital structure is a very conservative estimate. At the time Dr. Avera conducted his study, SBC had a capital structure of approximately 88% equity, 11% debt, and 1% other sources. The average for the LEC group was approximately 86% equity and 14% debt. For the purposes of his study, however, he used the lower and more conservative group average of 86% equity and 14% debt.[33]

Accepted legal and economic standards require that a regulated utility be allowed an opportunity to earn a return sufficient to fairly compensate capital investment, attract new capital, and maintain financial integrity. As Dr. Avera testified, if the company is not allowed a return sufficient to attract investors -- who necessarily measure their investment in the company on <u>market</u> value -- the legal and economic standards will not be met. Clearly, where the market value of company's equity differs significantly from its book value as it does here, the standards require the regulatory authority to base its cost-of-capital determination on the market value of the company's capital.[34]

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[31] Ex. 1, Avera Direct, Sch. 2, pp. 21-22.

[32] T. 647-648.

[33] Ex. 1, Avera Surrebuttal, Sch. 2, pp. 21-22.

[34] Ex. 1, Avera Direct, Sch. 2, p. 5.

F. The FCC Has Specifically Rejected the Capital Structure Proposed by the Joint Sponsors and Their Underlying Methodology.

In the Verizon-Virginia Arbitration, AT&T/WorldCom -- like the CLECs in this case -- proposed a capital structure of 34.5% debt and 65.5% equity, which was the mid-point between a market value capital structure and a book value capital structure.[35] And like this case,[36] AT&T/WorldCom did not argue that a capital structure based on market value is incorrect as a matter of theory. Rather, they argued that market value capital structure does not reflect the relevant risk of providing UNEs and they therefore adjusted it using the book value capital structure:

> AT&T/WorldCom recommend the capital structure of 34.5% debt and 65.5% equity by using a mid-point WACC [Weighted Average Cost of Capital] estimate. The WACC formula was applied using book and market average weights. AT&T/WorldCom argue that a company with low operational risk can afford the risk associated with more debt in its capital structure, and that Verizon's assumption of less debt is inappropriate given the low risk associated with wholesale provision of network elements.[37]

The FCC, however, rejected AT&T/WorldCom's attempt to employ book value capital structure in determining the appropriate capital structure under TELRIC rules:

> For the reasons described above, we give no weight to the portion of AT&T/WorldCom's proposal that is based on incumbent LECs' book value capital structure. Based on the data on which the parties estimated their market value-based capital structures, a range of 77-80% equity and 20-22% debt could be justified.[38]

Using a 20% debt 80% equity capital structure, the FCC determined the weighted average cost of capital in that case to be 13.068%. But because the parties employed baseball-style arbitration,

[35] Verizon-Virginia Arbitration Order, para. 44; Ex. 29, Hirshleifer Rebuttal, pp. 35-37.

[36] Ex. 29, Hirshleifer Rebuttal, pp. 23-24; T. 644-645.

[37] Verizon-Virginia Arbitration Order, para. 101 and fn 293 (internal citations omitted, emphasis added).

[38] Verizon-Virginia Arbitration Order, para. 103 (emphasis added).

under which the FCC was required to choose one of the two proposals presented in the case, it adopted the 12.95% overall cost of capital proposed by Verizon to develop UNE rates.[39]

G. The Commission May Consider Mr. Hirshleifer's Evidence of Market Value Capital Structure.

In the proceedings before the Commission, the CLECs' cost of capital witness, Mr. John Hirshleifer, presented his view on what the market-based capital structure would be. Although he improperly attempted to downwardly adjust the market-based capital structure by averaging it with the book-value capital structure, Mr. Hirshleifer presented the individual market-based capital structures for SBC as well as for Verizon, BellSouth, ALLTEL and CenturyTel.[40] He then determined the "value-weighted average" market-based capital structure of 80% equity and 20% debt for the group[41] and portrayed it as providing the "upper bound estimate of the cost of capital for the network element leasing business."[42]

While the Commission, pursuant to the orders of the FCC and District Court (outlined above), may not consider the "adjustment" performed by Mr. Hirshleifer using book value, the Commission may and should consider the market-based capital structure evidence Mr. Hirshleifer presented. Mr. Hirshleifer's market-based estimate is consistent with Dr. Avera's opinion.

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[39] Verizon-Virginia Arbitration Order, para. 104.

[40] Ex. 29, Hirshleifer Rebuttal, Schedule JH-10. For the Commission's convenience, a copy of Hirshleifer Schedule JH-10 is appended as Attachment 1.

[41] Id.

[42] Id., p. 35. The entire question and answer is as follows:

> **Q. GIVEN YOUR PRECEDING TESTIMONY, WHAT IS THE UPPER BOUNDARY OF THE APPROPRIATE RANGE FOR THE WEIGHTED AVERAGE COST OF CAPITAL FOR SWBT'S PROVISION OF UNES?**
>
> A. As the network element leasing business is less risky than the overall risk of a telephone holding company, estimating a cost of capital using a market value capital structure (which results in a cost of capital estimate for the SBC telephone holding company itself) will provide an upper bound estimate of the cost of capital for the network element leasing business.

H. Mr. Hirshleifer's Misperception of Risk in the UNE Leasing Business Incorrectly Lowered His Recommended Cost of Capital.

Although Mr. Hirshleifer agreed that market value of equity (as opposed to embedded book value) was the appropriate standard to use in cost of capital determinations, he adjusted SBC Missouri's market value capital structure (using book value) to reflect his belief that the provision of UNEs is a less risky line of business than a diversified telephone holding company. Given the Remand Order, the CLECs must abandon their attempt to adjust Mr. Hirshleifer's market-value capital structure estimate using book value. Any attempt to rely on book value either alone or as a way to "adjust" a market value capital structure would directly violate the Remand Order and the FCC's TELRIC rules. Any such approach would run a substantial risk of sanctions for violating the Remand Order.

It is also possible that the CLECs will attempt another method to manipulate the market value capital structure. The CLECs might, for example, propose general downward adjustment based on Mr. Hirshleifer's opinion that the UNE leasing business is <u>less</u> risky than a diversified telephone holding company. In addition to his failure to offer any support for his opinion, Mr. Hirshleifer's underlying risk assumption is exactly <u>backwards</u>. As Dr. Avera explained, in the real world, small and less diversified businesses have <u>higher</u> capital costs. As capital costs originate in capital markets, it is the perception of investors that determine what risks are relevant.[43]

While investors in the 1960s and '70s viewed the equipment leasing business as a low-risk business, that is no longer the case. Investors are aware that great fortunes have been lost leasing long lived assets, (<u>e.g.</u>, IBM 360 computers, rail cars, oil tankers and drilling rigs). Investors understand that the only way to earn a return on -- and return of -- capital invested in a leased asset is to generate revenue over its entire life cycle sufficient to pay all costs and appropriate profit. And

[43] Ex. 2, Avera Surrebuttal, p. 23.

as experience has shown investors, there is a great amount of risk in this line of business, which has led them to demand higher returns.[44]

And UNEs have unique risks, over and above those encountered by firms in the equipment leasing business. As Dr. Avera explained, investors see that UNEs have a unique disadvantage in being partially regulated and partially competitive. They have the disadvantage of being regulated in that their prices are set in administrative hearings, not in the marketplace.[45] (Even Mr. Hirshleifer agreed that holding all else constant, a company whose rates are set by a regulatory Commission would have higher risk than a company with pricing flexibility.[46]) In addition, UNE providers like SBC Missouri do not have a choice about whether to offer the UNEs or not. They are obligated to offer the UNEs to a host of CLECs, wherever and whenever they request them. But these regulatory burdens come without the traditional benefits of regulation in that the UNE provider is not assured that it will get a return on its capital over the long run.[47]

LECs providing UNEs also face the danger of competition, without the rewards of competition. As Dr. Avera explained, LECs like SBC Missouri are required to maintain their investment in plant and equipment and allow CLECs to use those facilities to provide service to their customers. In addition, incumbent LECs may be required to invest additional capital to provide UNEs to CLECs. These might be 30, 20 or 10-year investments. Yet, competing CLECs are free to bypass the incumbent's UNEs at any time by using their own facilities or any other facilities or technologies that may be available or developed (e.g., bypassing the wireline network using wireless, cable TV or satellite service). And when the CLEC begins providing service over its own alternate facilities, it no longer has use for the UNE facilities it may have demanded from

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[44] Ex. 2, Avera Surrebuttal, pp. 23-24; T. 157.

[45] T. 151, Avera.

[46] T. 671, Hirshleifer.

[47] T. 151, Avera.

the LEC and the UNE lease payments stop. Thus, UNE facilities have both the disadvantages of regulated utilities and the risks of competitive businesses. In Dr. Avera's opinion, investors would require higher returns on equity invested in the UNE leasing business than they would require for investments in assets in the regulated electric or gas industries.[48] And they certainly would view the business of providing UNEs as at least as risky, and probably more risky, than they would view the business of a diversified telephone holding companies.[49]

II. THE COMMISSION SHOULD DIRECT PARTIES TO CORRECT THE PREVIOUS TRUE-UP AND PERFORM AN ADDITIONAL TRUE-UP BASED ON LAWFUL RATES RESULTING FROM THIS REMAND.

A. Only Lawful Rates May Be Used in M2A-Based Agreements and True-Up Purposes.

In a very transparent and self-serving attempt to limit the practical application of the United States District Court's order, the CLECs have claimed that any rate changes resulting from this remand proceeding will neither apply to their individual M2A agreements nor result in any monetary true-ups from the rate corrections the Commission must necessarily make in this case:

> Once the Commission makes a decision on remand, presumably the affected rates in the model M2A will change. But there is no provision in the CLEC-specific agreements that would allow the Commission to change those agreements in the course of this proceeding . . . the permanent rates set in Case No. TO-2001-438 remain the effective "permanent" rates in the CLEC-specific interconnection agreements and are not subject to retroactive change or true-up . . . [50]

A refusal to modify the existing M2A-based interconnection agreements would, in SBC Missouri's view, constitute a flagrant and unlawful refusal to comply with the U.S. District Court's Remand Order. The CLECs apparently view this proceeding as a game, but it is not. The U.S. District Court's Order is to be obeyed, not avoided. A refusal to apply revised UNE rates on a

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[48] Ex. 2, Avera Surrebuttal, pp. 8-9; T. 147-148, 151-152.

[49] T. 121, 143, 149, 153, Avera.

[50] CLECs' Proposed Procedural Schedule and Supporting Suggestions, p. 5.

prospective basis would place the Commission in direct violation of the Remand Order and should not be considered.

With regard to the true-up, the claims advanced by the CLECs would turn the language in the M2A on its head. The entire premise underlying the need to replace the interim rates in the M2A was that they were to be replaced by permanent rates that were lawful. The CLECs erroneously contend that the M2A permits the Commission to issue an admittedly unlawful order and have that unlawful order serve as the basis of the true-up. That is not consistent either with wording of the true-up language or the considerations that let to its adoption.

In its Interim Order Regarding Missouri Interconnection Agreement, the Commission identified several deficiencies in the M2A that would have caused it to fall short of the requirements of the Section 271(2)(B) "competitive check list." In the pricing area, the Commission specifically pointed to the rates the Commission established in Case No. TO-98-115 (the future of which the Commission characterized as "uncertain" due to a recent court decision) and rates for 95 unbundled network elements (identified by Staff as not having been reviewed at all by the Commission for conformance with the FCC's standards). The Commission found that

before it could find the M2A compliant with Section 271, SBC Missouri would have to amend the M2A to make the previously established TO-98-115 rates and those for the 95 UNEs (using Texas rates) interim subject to true-up with permanent prices.[51] SBC Missouri agreed to offer these interim rates and revised the M2A accordingly.

The rates established by the Commission were, of course, required to be consistent with the FCC's local competition order and the TELRIC methodology imposed by that order. In its Order Regarding Recommendation of 271 Application Pursuant to the Telecommunications Act of 1996 and Approving the Missouri Interconnection Agreement (M2A), the Commission made

[51] Interim Order Regarding Missouri Interconnection Agreement, Case No. TO-99-227, issued February 13, 2001, pp. 2, 4-6.

clear its understanding that the replacement permanent rates were not simply to be any old permanent rates, but <u>lawful</u> rates that comply with the Act and applicable FCC rules:

> The fact that the M2A contains interim rates is no barrier to our approval. The FCC has made clear that "the mere presence of interim rates will not generally threaten a section 271 application so long as an interim solution to a particular rate dispute is reasonable under the circumstances, <u>the state commission has demonstrated its commitment to our pricing rules</u>, and provision is made for refunds or true-ups once permanent rates are set." <u>Texas Order</u> ¶ 88 (approving SWBT's Texas application despite interim rates for interconnection). The Commission finds that the M2A reflects a reasonable effort under the circumstances to set interim rates "<u>in accordance with the Act and the FCC's rules</u>." <u>Id</u>. ¶89. [52]

In following the approach sanctioned by the FCC under which interim rates could be used in support of a Section 271 Application, the Missouri Commission specifically committed to follow the law as set out in the Act and the FCC's rules in setting permanent replacement rates, and to provide for true-ups to the lawfully set rates. The FCC's <u>Memorandum, Opinion and Order</u> granting SBC Missouri's Section 271 application acknowledges that commitment and makes clear that the final permanent rates must be lawful and that the true-up be made to those lawful rates:

> We disagree with commenters who argue that SWBT's interim rates cause it to fail this checklist item . . . the commission has previously held that interim rates may be acceptable as part of a 271 application if: 1) the interim solution to a particular rate dispute is reasonable under the circumstances; 2) <u>the state commission has demonstrated its commitment to our pricing rules</u>; and 3) <u>provision is made for refunds or true-ups once permanent rates are set</u>. SWBT passes the test. The <u>Missouri commission has demonstrated its commitment to TELRIC. All of SWBT's interim rates are subject to refund or true-up once the permanent rates are set</u>. The Missouri commission has scheduled hearings for December 2001 to conclude the setting of permanent rates in Missouri. We find the interim rates in question are reasonable under the circumstances.[53]

[52] <u>Order Regarding Recommendation on 271 Application Pursuant to the Telecommunications Act of 1996 and Approving the Missouri Interconnection Agreement (M2A)</u>, Case No. TO-99-227, issued March 15, 2001, at p. 18 (internal footnote cites to other FCC orders omitted, emphasis added).

[53] <u>In the Matter of Joint Application by SBC Communications, Inc., Southwestern Bell Telephone Company and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance Pursuant to Section 271 of the Telecommunications Act of 1996 to Provide In-Region, InterLATA Services in Arkansas and Missouri</u>, CC Docket No. 01-194, <u>Memorandum, Opinion and Order</u>, released November 16, 2001, para. 64 (internal citations omitted, emphasis added).

B. The Rates Resulting From this Proceeding Must be Applied to M2A-Based Agreements and for True-Up Purposes.

In arguing that the "interim rates are to be replaced on a one-time basis" and that there will only be "a single true-up,"[54] the CLECs would have the Commission completely ignore federal law, the FCC's scheme for the replacement of interim rates, and the Commission's own previous decisions, as well as violate the clear terms of the M2A interconnection agreement. As the District Court's Order makes clear, the rates the Commission set in Case No. TO-2001-438 were not lawful, due to the Commission's erroneous interpretation of the requirements for determining capital structure under the FCC's TELRIC standard. Accordingly, the District Court remanded the case to the Commission "for reconsideration of the appropriate capital structure and resulting rates."[55]

The District Court did not intend for these rates to be corrected in a vacuum. The Court was fully aware that the purpose of Case No. TO-2001-438 was to establish permanent rates to replace the interim rates in the M2A as adopted by the CLECs. In remanding this matter to the Commission, the District Court appropriately intended the corrected rates to be used for that same purpose. Certainly nothing in the Act, the FCC's rules, the District Court's Order, the M2A or any Commission Order authorizes rates found to be unlawful by the Federal Court to remain in any individual M2A. The Commission was required to establish lawful rates, but failed to do so. That failure cannot now be used as a basis for refusing to adjust the rates in all the M2A interconnection agreements on a prospective basis.

Nor do the terms of the M2A permit such a result. The parties agreed to a true-up to the rates established by a <u>lawful</u> commission order, not a true-up to a rate that has been declared unlawful and violative of the Act by the United States District Court.

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[54] CLECs' Proposed Procedural Schedule and Supporting Suggestions, p. 4.

[55] <u>Southwestern Bell Telephone, L.P., d/b/a SBC Missouri v. Missouri Public Service Commission, et al.</u>, No. 03-04148-CV-C-NKL, slip op. at 12 (D. Mo. June 12, 2004).

The CLECs' proposal that the Commission essentially ignore the decision of the District Court and the terms of the M2A would leave the Commission in clear violation of the District Court's mandate. Such an unlawful proposal should not be given serious consideration.

C. The Prohibition Against Retroactive Ratemaking Does Not Apply Here.

The CLECs in this proceeding have argued that the Commission cannot engage in retroactive ratemaking: "even if the court's order were to reach back and invalidate the rates as charged for prior periods, that would not authorize the Commission to do more than set new prospective rates."[56]

While the Commission is ordinarily prohibited from engaging in retroactive ratemaking,[57] that principle does not apply here. By contractual provision, the parties agreed to a retroactive true-up for services previously rendered:

> Each of the rates listed in the following Appendix Pricing UNE Schedule of Prices that are interim will be in effect only until the effective date of the Missouri Public Service Commission's order establishing permanent rates, in Case No. TO-2001-438 or otherwise. These rates include rates for UNEs/Services for which the Commission set interim rates in Case No. TO-98-115 and rates for listed UNEs for which the Commission has not set rates, including unbundled local transport rates. The rates listed in the following Appendix Pricing UNE Schedule of Prices that are interim are subject to true-up to the permanent rates established by the Public Service Commission, in Case No. TO-2001-438 or another appropriate case. Any refund or additional charges due as a result of true-up shall be paid within 30 days of the effective date of the Commission's order adopting permanent rates. The time period subject to true-up shall be limited to six months, retrospectively from the effective date of the Commission's final order adopting permanent rates, but shall not include any period prior to the effective date of this agreement with CLEC.[58]

There is no "final order" adopting permanent rates until the Commission adopts lawful rates in compliance with the District Court's Remand Order. The true-up should cover the period from

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[56] CLECs' Response to SBC Missouri and Staff Replies Regarding Procedural Schedule, Case No. TO-2005-0037, filed September 20, 2004, p. 2.

[57] Lightfoot v. City of Springfield, 236 S.W.2d 348, 353 (Mo. 1951) ("The Commission fixes rates prospectively and not retroactively.").

[58] M2A, Appendix Pricing UNE, Ex. 1.

the effective date of a lawful order back to the time six months prior to the effective date of the Commission's June 17, 2003 Order adopting the rates that were found to be unlawful (i.e., back to December 27, 2002). This application of the true-up provision places the parties in the position they would have occupied had the Commission's August 6, 2002 Report and Order properly reflected a lawful application of the FCC's TELRIC rules.

D. Contractual Change of Law Provisions Have No Application Here.

The CLECs also have claimed that the M2A contains change of law provisions that "arguably will come into play as a result of Commission action following the Federal Court remand regarding the appropriate capital structure and resulting rates." Specifically pointing to Section 18.4 of the M2A's General Terms and Conditions, the CLECs claim that:

> . . . if any rates are modified by subsequent legal actions, the change shall be effective immediately (not retroactively) consistent with the regulatory action upon written request of a party to the contract. Negotiations and dispute resolution procedures are the means identified for fulfilling such a request. There is no provision for a true-up process or any retroactive application of a change in rates pertinent to this proceeding.[59]

Contrary to the CLECs' suggestions, Section 18.4 has no application here because no change in law occurred. The District Court's Order did not change the law. Rather, it simply found that the Commission's August 6, 2002 Report and Order applied the wrong legal standard to the evidence on capital structure and accordingly remanded the case to the Commission "for reconsideration of the appropriate capital structure and resulting rates."[60] Rather than constituting a change in law, the prior proceeding in Case No. TO-2001-438 was designed to implement the provisions of the M2A to establish permanent rates. As determined by the District Court, the Commission failed to lawfully establish those permanent rates and must do so on remand.

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[59] CLECs' Proposed Procedural Schedule and Supporting Suggestions, p. 5.

[60] Southwestern Bell Telephone, L.P., d/b/a SBC Missouri v. Missouri Public Service Commission, et al., No. 03-04148-CV-C-NKL, slip op. at 12 (D. Mo. June 12, 2004).

By its terms, Section 18.4 has no application to the remand of proceedings the Commission conducted subsequent to the adoption of the M2A for the purpose of establishing permanent rates for those designated as interim in the M2A. Instead, Section 18.4 provides that if rates, terms and conditions previously established in arbitrations before the Commission are overturned, or if the laws or regulations that were the basis of the prior arbitration decisions are overturned, the change of law provisions come into play:

> This agreement is entered into as a result of the Missouri Public Service Commission's Order in Case No. TO-99-227, reviewing SWBT's compliance with Section 271 of the federal Telecommunications Act of 1996, <u>and incorporates some of the results of arbitrations by the Commission</u>. <u>In the event that any of the rates, terms and/or conditions herein</u>, or any of the laws or regulations that were the basis or rationale for such rates, terms and/or conditions in the Agreement, are invalidated, modify or stay by any action of any state or federal regulatory or legislative bodies or courts of competent jurisdiction, including but no limited to any decision of the Eighth Circuit relating to any of the costing/pricing rules adopted by the FCC in its First Report and Order . . . the affected provision shall be immediately invalidated, modified, or stayed, consistent with the action of the legislative body, court, or regulatory agency upon the written request of either Party. . . .[61]

But here, it is the Commission's failure to implement permanent rates <u>after</u> the M2A was established that is at issue. The Commission failed to apply the FCC's TELRIC rules, and must do so in compliance with the District Court's Remand Order.

The permanent replacement rates from Case No. TO-2001-438 were not contained in the M2A. Rather, the M2A contains a separate and specific provision (Exhibit 1 to Appendix-Pricing UNE) that set out the mechanism for replacing rates designated in the M2A as interim. Clearly, this specific section of the M2A, and not the general change of law provisions from the General Terms and Conditions section of the M2A, is the governing section that provides the procedure for establishing permanent rates. As determined by the District Court, the Commission failed to lawfully establish those permanent rates and must do so now on remand. The District Court did not purport to effect a change of law.

[61] M2A, Appendix-Pricing UNE, Exhibit 1.

E. <u>The M2A Does not Preclude An Accurate True-Up</u>.

In an effort to avoid having to disgorge any overpayments they may have received as a result of the prior true-up to rates that have been found to be unlawful, the CLECs have argued that there was to be only one retroactive true-up in order to protect them from uncertainty.[62] The CLECs point to a passage in the Commission's March 15, 2001 Order in Case No. TO-99-227 that stated:

> The interim rates contained in the M2A are subject to a limited true-up. The Commission has four cases pending to determine permanent prices, terms and conditions for the interim prices subject to true-up in the M2A. Because of the concern of the lack of certainty for CLECs to establish a business plan, the Commission finds that a limited true-up period is reasonable. Therefore, the Commission determines that a true-up period that is six month retrospectively from the date of the Commission's order establishing a permanent rate is appropriate. The true-up period that has been included in the M2A is consistent with these Commission findings.[63]

The concern expressed in the Commission's March 15, 2001 Order, however, has no application here. When the Commission approved the M2A, no party had any information on how the rates designated in the M2A as "interim" would change. At that point, the Commission had just established four cases, including TO-2001-438, to determine permanent pricing. And many of the interim rates had been in effect since December, 1997.[64] In order to help dampen the impact on CLECs of potentially wide upward swings in rates going back to March 15, 2001, and potentially beyond, the Commission limited the retroactive true-up to six months. As the Commission's <u>Order</u> approving the rates in Case No. TO-2001-438 became effective on June 26, 2003, the retroactive true-up performed by the parties extended back to December 27, 2002.

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[62] CLECs' Reply to SBC and Staff Regarding Procedural Schedule, Case No. TO-2005-0037, filed September 10, 2004, p. 4, fn. 2.

[63] <u>Order Regarding Recommendation on 271 Application Pursuant to the Telecommunications Act of 1996 and to Approve the Missouri Interconnection Agreement (M2A)</u>, Case No. TO-99-227, issued March 15, 2001, pp. 36-37.

[64] The recurring and nonrecurring rates in Case No. TO-98-115 were set in the Commission's December 23, 1997 <u>Report and Order</u> in that case.

Here, SBC Missouri seeks only the correction of the prior true-up that was based on rates that had been found to be unlawful, and a true-up on charges for subsequently provided services. It does not seek a retroactive adjustment for any prior periods (e.g., back to the approval of the M2A with interim rates, or beyond). And the true-up SBC Missouri seeks is limited in scope. It results from a mandatory change to one component of the cost of capital input to the cost studies that were employed in this case. Moreover, the CLECs were certainly aware of the issues SBC Missouri raised on appeal and the potential magnitude of the rate change if SBC Missouri was successful on appeal. Thus, the same "uncertainty" that the Commission previously perceived that might have prevented the CLECs from developing business plans does not exist here. Rather, the CLECs here were in a position to factor a potential wholesale rate increase (based on the potential result of this appeal) into their business plans.

And the Commission, in weighing the parties' positions on this true-up issue, should note that it was the CLECs' and the Staff's outside cost of capital witnesses that suggested to the Commission that book value evidence be used by the Commission to determine the appropriate capital structure in this case. SBC Missouri consistently and vehemently opposed this approach as unlawful and instead provided the Commission with a market value capital structure that was endorsed by the FCC. The Commission's adoption of the CLEC' and Staff's book value capital structure approach likely resulted in lower permanent rates than had the rates been based on a cost of capital with an appropriate market-based capital structure input. Having advocated an approach that was clearly contrary to FCC rules that existed at the time, the CLECs now should not be permitted to profit at SBC Missouri's expense from advocating a method for determining capital structure that has been found to be unlawful on appeal.

CONCLUSION

The United States District has issued a clear mandate which the Commission must follow. In setting the appropriate capital structure, the Commission should base its decision on the market values of debt and equity, and should give no consideration to book value, which the FCC and the Court explicitly rejected. As contemplated by the M2A, prior Commission orders, and the Court's mandate, the rates from this remand proceeding are the only lawful rates that may be applied in the parties' M2A-based agreements. The language and intent behind the M2A's true-up provision as well as fundamental fairness, require correction of the prior true-up and any subsequent charges that were based on unlawful rates.

WHEREFORE, SBC Missouri respectfully requests the Commission to (1) adopt the 86% equity and 14% debt capital structure advocated by Dr. William Avera, SBC Missouri's cost of capital expert witness, and use this factor to recalculate the rates set in Case No. TO-2001-438 in accordance with the US District Court's mandate; and (2) direct the parties to use these recalculated rates to correct the prior true-up (for the period December 27, 2002 to June 26, 2003) that was based on rates that have been found to be unlawful, and to true-up charges for subsequently provided services based on the recalculated rates.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing document were served to all parties by e-mail on November 29, 2004.

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