## REVENUE REQUIREMENT – DEPRECIATION RATES AND EXPENSE

Q. Staff witness Jolie Mathis provides the Staff's testimony regarding depreciation rates. Are you in agreement with the depreciation rates proposed by the Staff?

A. I am in agreement with many, but not all of the rates proposed by Staff, although I disagree with Staff's proposal not to include salvage in depreciation rates as I indicated earlier in this testimony. Such a procedure is not consistent with the Commission's and the FCC's accounting rules.

Q. Please indicate the depreciation rates that you take issue with the Staff on.

A. I am in agreement with the depreciation rates proposed by the Staff except for the rates for Central Office Switching equipment, Aerial Cable, and Buried cable, both metallic and fiber (BPS Adj. #15).

Q. Let's turn first to the depreciation rate for Central Office Switching equipment. Please provide your rationale for using a different rate than the Staff proposed rate.

A. First of all, under an "HB 360" depreciation rate filing, BPS is accumulating depreciation currently based on a 10% rate and a ten year service life. The Staff witness Ms. Mathis is proposing a 15 year life and 6.67% rate for this equipment based on analysis last done four years ago and unchanged from the value based on 1994 data. BPS installed its digital switches in the first half of 1996, so at this time less than 9 years of the 15 years projected by Ms. Mathis has elapsed.

Already manufacturers are offering "softswitch" replacement switches for digital switches with updated software and hardware platforms and with the capability, potentially, of being able to switch calls using IP protocol in the future. Based on the rapid shifting of voice traffic from wireline to wireless phones and the potential for more traffic to be transmitted over the internet using Voice Over Internet Protocol (VOIP) technologies, it is unlikely that the BPS switches will be in service for the additional six years projected by Ms. Mathis and the Staff's normal depreciation rates. In its last review of depreciation lives for central office switching the FCC established a range of lives from 12 years to 18 years. Given the late installation date of the BPS switches (1996) and the potential for replacement by a softswitch in the next few years, I am recommending that a depreciation life of 12 years and a rate of 8.33% be used for the digital switching accounts.

Q. What is your recommendation regarding aerial cable?

A. I am recommending a rate of 5.50% based on a 20-year service life and 10% cost of removal. This compares to the 4.76% proposed by the Staff based on a 21 year life and no salvage. There is a definite cost of removal of aerial plant that one frequently doesn't incur with buried plant, since the aerial cable must be physically removed from the poles upon which it is hung and carried away for disposal. BPS's aerial cable is virtually all metallic cable and may be subject to technological as well as physical obsolescence. With the accelerating use of broadband service and the expansion of the large Regional Bell Operating

Companies into fiber transmission for video service in the next few years, it is likely that BPS's aerial plant will reach its point of obsolescence sooner than may have been thought four or eleven years ago. The twenty-year life and 10% salvage that I propose is consistent with FCC guidelines for this type of plant.

Q. The third account that you mentioned where your proposal differs from the Staff is in the Buried Plant accounts. How does your proposal compare to the Staff proposal?

A. Staff's proposal is based on a 28 year projected life for buried fiber cable and a 24 year projected life for metallic buried cable. I believe that these projected lives are too long and am proposing a 25 year life for buried fiber cable and a 20 year projected life for metallic buried cable. Because buried plant is normally abandoned in place I have not considered any cost of removal or salvage. The lives I am proposing are the lower end of the projected lives within the FCC guidelines, lives which were established several years ago.

Q. Why do you think that the Staff's projected lives are too long?

A. While from a physical obsolescence standpoint, the Staff's lives may be reasonable, I am concerned that technology and competition will make the buried plant, particularly the metallic plant, obsolete sooner than the Staff projects. Small telephone companies such as BPS are facing increasing competition from a variety of sources including wireless providers and cable TV providers. There are expectations that competition will increase in the near future from electric utilities

using their facilities to provide broadband services with the potential for VOIP as a voice medium over those broadband facilities. The large RBOCs have made announcements within the past year of their intentions to build fiber to a large part of the customer's homes in the next three to five years so they will be able to provide video and high speed data services in addition to traditional voice service. It is their belief that this will be necessary in order to compete with other providers of communications services. While digital subscriber line (DSL) technology has been advancing quite rapidly to extend the life of metallic plant in providing higher speed services, it is not unlikely that BPS may find that it, too, needs to replace a substantial amount of its buried plant with fiber plant in order to maintain its customer base. For these reasons, I believe that a shorter life than that proposed by the Staff is appropriate for buried plant. In our revenue requirement model, Schedule RCS-7, a composite rate of 4.91% for the combined buried plant has been used.

Q. Have you prepared a schedule summarizing the depreciation rates at issue in this proceeding?

A. Yes. Schedule RCS-10 which is attached to this testimony shows the current depreciation rates being booked by the Company, the rates proposed by the Staff, and the rates that I propose with comparisons to the current and Staff proposed rates. The Company asks that the depreciation rates under column (e), "Company Proposed Rates", be approved as the minimum depreciation rates for BPS to implement on the first of the month following the conclusion of this case.

## REVENUE REQUIREMENT - REVENUE ADJUSTMENTS

Q. Please explain the revenue adjustment to account for USF revenue reductions (BPS Adj. #16).

A. Staff adjustment R 5.2 anticipates that BPS will receive $299,055 in federal high cost loop (HCL) universal service payments based on the 2004 USF payment levels. BPS has been notified by NECA that it will receive $193,888 for HCL USF in 2005, $105,167 fewer dollars than what is assumed by Staff in its calculations. Accordingly, I have made a downward adjustment by this amount in Account 5082. The expected decrease in USF revenue is attributable to a lower subscriber plant balance for BPS in the 2003 data year upon which the 2005 payments are based, and a considerably higher national average loop cost that is used in the USF calculation.

Q. Please explain the revenue adjustment to account for the traffic compensation agreement with Cingular Wireless (BPS Adj. #17).

A. In the test year, BPS was receiving payment from Cingular Wireless and AT&T Wireless for terminating wireless calls at a per-minute amount equal to the rates contained in BPS's terminating wireless tariff. However, BPS is finalizing a traffic termination agreement with Cingular Wireless that would significantly alter the per-minute rate that BPS will charge Cingular Wireless to terminate calls. Specifically, BPS' per-minute rate for terminating calls from Cingular Wireless will decrease from $0.0585 to $0.035. In addition, Cingular Wireless

has recently purchased AT&T Wireless. It is my understanding that former AT&T Wireless customers are now Cingular Wireless customers and that the traffic compensation agreement between BPS and Cingular Wireless will apply to traffic terminated from AT&T Wireless as well. Applying the rate reduction to the total minutes terminating from Cingular Wireless and AT&T Wireless during the test year, and then annualizing a 10-month average (computed by removing the high and low volume months), results in a total annual revenue reduction of $53,482. I reduced Account 5084 by a corresponding amount.

Q. Please explain the negative revenue adjustment to account for the reduction in ISP circuits (BPS Adj. #18).

A. The test year included revenues received from digital circuits provided to ISPs. BPS has experienced a decrease in the number of circuits it provides to ISPs from 268 per month at the beginning of the test period (and 216 at the end of the test period) to 168 currently. I calculated the annual difference in revenue that can be expected with the current number of ISP circuits from the ISP circuit revenue amount that was booked in the test year. The calculated reduction in revenue is $15,562, which was assigned as a negative adjustment to Account 5040.

Q. Please explain the negative revenue adjustment to account for the reduction in access lines (BPS Adj. #19).

A. From December, 2003 to December, 2004, BPS has lost 2.77% of its access lines. I applied this percentage decrease in access lines to the revenues obtained from

BPS' local customers during the test year to arrive at an annual revenue reduction of $15,017, which was split between Accounts 5001 and 5060 in proportion to the revenue assigned to those accounts during the test year. I believe this adjustment is appropriate since it better reflects the going forward level of access lines than does the average over the test period. BPS's access line reduction likely results from elimination of second lines as DSL service is expanded and from loss of lines to wireless carriers and other competitors. Thus, I believe that access line loss is likely a permanent loss that will impact BPS's revenues and should be accounted for in calculating BPS's revenue requirement.

**REVENUE REQUIRMENT – SEPARATION FACTORS**

Q. Please explain why there are differences between the separations factors you have used in your revenue requirement schedules (Schedules RCS-2-8) (BPS Adj. #20), and the separations factors used by the Staff in their accounting schedules.

A. There are two or three reasons for these differences. First, during the final preparation of this testimony, it was discovered that BPS had erroneously sent an incorrect cost separations study to Staff in response to one of its data requests. Specifically, in Data Request No. 26, Staff requested BPS' last cost separations study. BPS incorrectly responded to that Data Request with a "test" study (used for internal evaluations of the traffic factors and DSL costs) instead of the official latest study that was actually filed with NECA. This "test" study used allocation factors that did not reflect frozen factors required by Part 36 of the FCC rules and treatment of DSL investments that was non-standard. These differences affected

virtually all of the separations factors. Schedules RCS-2-8 reflect separations factors from the current study, while the Staff revenue requirement does not, because the erroneous "test" study was provided to them. Concurrent with the filing of this testimony we are providing a revised response to Data Request No. 26 which contains the correct cost study. In addition to these differences we were unable to identify where the separations factors for the seven General Support Asset Plant in Service accounts came from as we could not find them on the "test" study which was provided to the Staff. We also note that there are differences in the allocation factors used in Schedule RCS-4 and Staff Accounting Schedule 9, the income statements in both revenue requirement models, because Schedule RCS-4 presents expenses at a more detailed level with corresponding allocation factors specific to the accounts while Staff Accounting Schedule 9, uses summarized major expense categories and composite allocation factors for those accounts.

**REVENUE REQUIRMENT - RATE BASE**

Q. Staff Adjustments P-9 and R-9 remove Digital Subscriber Loop (DSL) equipment and depreciation reserve from the rate base. Do you agree with these adjustments?

A. No. Staff's very briefly described rationale for this adjustment is that DSL service is a non-regulated service. That is incorrect. BPS offers DSL service as an interstate service provided through the National Exchange Carrier Association (NECA) interstate tariff for which BPS is one of many issuing carriers. The

service is offered as an interstate regulated service because the FCC has specifically determined that it is an interstate service. DSL service provides high-speed data transmission capability over the regulated telephone plant to customers who subscribe to the service.

Q. What are some of the ramifications of treating DSL as a non-regulated service rather than as a regulated interstate service as it is currently being offered?

A. First, in relationship to the calculation of the revenue requirement in this case, the separations factors would change significantly if DSL equipment was classified as non-regulated. The separations study which is being provided under the revised response to Staff Data Request #26, and which I have used in my revenue requirement schedules, correctly treats DSL equipment as directly assigned to the interstate jurisdiction. This causes the separations factor for COE circuit equipment to be much more heavily weighted to the interstate jurisdiction than would be the case if this equipment was treated as non-regulated equipment. Due to the nature of the separations process, many of the other separations factors would also be impacted by this change. Thus, if this equipment is treated as non-regulated equipment, a different separations study would need to be prepared and revised separations factors provided in conjunction with such an adjustment. For informational purposes, the Commission should be aware that the likely result of such changes would be an increase in the assignment of costs such as General Support Facilities and Corporate Operations Expense to the intrastate jurisdiction and an increase in the overall intrastate revenue requirement.

Second, as an interstate regulated service, DSL service can, and is, priced on an incremental basis with the cost of the loop being recovered from other services which use the loop. However, under the FCC's cost accounting rules, if DSL service is an unregulated service, a portion of the loop cost would have to be permanently allocated to unregulated activities. This would have the affect of reducing BPS's interstate common line recovery and its interstate HCL USF recovery. The reduction in HCL USF would directly increase the intrastate revenue requirement. In addition, BPS's DSL service would have to be priced considerably higher than it now is, limiting its affordability for end user customers. In short, treatment of DSL equipment as non-regulated equipment, as proposed by the Staff, would have substantial negative consequences to the Company and to its end users.

BPS Adj. #21 and #22 reverse the proposed Staff adjustments.

Q. Please explain the adjustment to account for SONET Fiber and Bits Clock installation (BPS Adj. #23).

A. SONET fiber termination equipment will be installed in Bernie, Parma, and Steele by the second quarter of 2005. This state-of-the-art equipment will replace the existing Nortel FMT150 fiber termination equipment. The current FMT150s are in need of replacement because it is becoming difficult to find parts as well as a technician to work on them. SONET equipment will bring BPS up to the industry standard, providing increased reliability for customers and the capability to quickly react to increased bandwidth needs. As a result of installing the SONET

fiber termination equipment, it is necessary to provide internal timing for the DMS-10 switches and certain peripherals. The Bits Clocks are being installed to provide this timing. Previously BPS's switches received their timing externally from the SBC network. That will no longer be an option. I have made a positive adjustment to Account 2232 by the expected cost of the SONET fiber installation and Account 2212 by the expected cost of the Bits Clock installation.

Q. Please explain the adjustment to add cash working capital to the rate base (BPS Adj. #24).

A. The FCC defines cash working capital (CWC) as "an estimate of the average amount of investor-supplied capital needed to provide funds for a carrier's day-to-day operations."[1] As a component of the rate base, a company is entitled to earn a return of 11.25% on the interstate portion of the CWC amount. Correspondingly, it is appropriate for a company to earn a level of return on the intrastate portion of the CWC amount. Therefore, I have developed a calculation of CWC for use in the development of BPS's proposed revenue requirement. The calculation used is the intrastate portion of CWC that results from using the FCC authorized Standard Allowance Method to calculate CWC. Specifically, as one of three FCC-approved methods of calculating CWC, the Standard Allowance Method applies an FCC-approved 15-day net lead/lag factor of to an interstate cash operating expense base. My calculation applied the 15-day net lead/lag factor to the intrastate cash operating expense base. The resulting $78,473 CWC amount was

[1] Amendment of Part 65 of the Commission' Rules to Prescribe Components of the Rate Base and Net Income of Dominant Carriers, Order on Reconsideration, 4 FCC Rcd 1697 ¶ 4, (1989) (Reconsideration Order).

then added to rate base in the revenue requirement calculation and adjusted by the appropriate separations factor to develop the intrastate portion of the CWC.

Q. There is a Staff rate base adjustment that is hidden in the deferred tax account that you propose that the Commission not accept (BPS Adj. #25). Please explain why you disagree with Staff's adjustment on deferred taxes.

A. Line 19 of Staff Accounting Schedule 2 shows an amount of $178,567 as the jurisdictional deferred tax amount. This number represents the actual deferred taxes recorded on the Company's books of $266,394 plus a hidden "adjustment" of $8,338 which was then multiplied by the jurisdictional factor to arrive at the $178, 567. Although the Staff does not explain that adjustment in its testimony or schedules, it appears that the adjustment was calculated by amortizing over ten years $47,700 in deferred taxes related to the assets that BPS purchased from GTE in April, 1996. It is my understanding that Staff made such a calculation based on the following instructions contained in the Stipulation and Agreement that was part of the Order approving the exchange purchase:

> BPS agrees to use an additional offset to rate base <u>in any BPS filing for a general increase in telecommunications rates</u> in Missouri initiated in the next ten years to compensate for rate base deductions eliminated by this transaction, unless BPS can show that the deferred tax reserve is the same as or greater than that reserve would have been, absent the sale of these exchanges. The amount of the offset for the first year shall be $47,700. The amount shall reduce by $4,770 per year on each anniversary date of the closing of the subject transaction. (Stipulation and Agreement attached to Order in Case No. TM-95-135) (emphasis added)

Since BPS did not initiate this proceeding, nor is it seeking an increase in rates, the conditions of the Stipulation have not been met and the adjustment should not

be made. Schedule RCS-3 reflects the actual balance for Account 4360, Deferred Taxes, as the correct balance for this account.

If the Commission should choose to accept this type of adjustment, the correct amount of the adjustment would be $4,770 (before jurisdictional allocation) since by the end of this proceeding there will be less than one year of the amortization period remaining.

**COST OF CAPITAL**

Q. Please explain the adjustment to account for BPS' proposed increase in cost of capital (BPS Adj.#26).

A. BPS witness John C. Dunn provides testimony explaining why it is appropriate to use BPS' proposed cost of capital factor of 11.25%. I have used that factor in my revenue requirement calculation.

**RATE DESIGN**

Q. Staff witness Voight proposed that all of the reduction in earnings be attributed to reductions in access rates, bringing the Company's access rates to the fourth lowest level of any company in the state. What was your reaction to Mr. Voight's rate design proposal?

A. While BPS agrees that basic local rates should not be reduced below their current rates, the Company has some alternative proposals for rate design that should be considered by the Commission, if the Company is required to reduce its rates.

Q. What is the first proposal you have in the rate design area?

A. Under BPS's current tariff for directory assistance charging the Company provides a three-call allowance per month before charging individuals for the use of directory assistance calling. The charge for this service after the allowance is $0.40. This provision has been in place for years and is outdated. Most providers of directory assistance service no longer give any call allowance and frequently charge rates well over $1.00 per call. Since a change in this tariff can only be made in the context of a rate proceeding, BPS proposes to update its directory assistance tariff by eliminating the three call allowance. Based on DA traffic from January to July, 2004 BPS provides an average of 1,313 free calls per month. The annual impact of charging for these calls would be $6,302. The Company specifically requests that the Commission allow the Company to implement this tariff change in this proceeding.

Q. Does the Company have another proposal for the Commission's consideration before applying the reduction to access rates?

A. Yes. BPS has a proposal that would provide benefits directly to the subscribers of local service. Reductions in access rates are unlikely to result in lower toll rates from the providers of such services to BPS' customers because toll providers typically average their rates over large geographic areas and the impact of BPS' decreased access rates would have minimal effect on the total costs of providing toll services for those providers. Thus, a reduction in access rates as proposed by

Mr. Voight would primarily benefit interexchange carriers rather than the Company's end user customers.

Q. Can you be specific regarding BPS's proposal?

A. Yes. The Company proposes to expand the local calling area of its customers. Specifically BPS proposes, first of all, to provide two-way extended area calling between its Bernie and Parma exchanges. In addition, the Company proposes to provide a one-way local voice calling service from BPS's exchanges to specific SBC exchanges with which its customers have a calling interest. This would provide unlimited voice calling from the BPS exchanges to the SBC exchanges, but would have limitations related to internet and data calling. The calls would be dialed on a seven-digit basis.

Q. What SBC exchanges are you proposing that BPS customers be able to call?

A. The Bernie exchange would have calling to Malden and Bloomfield, the Parma exchange would have calling to Risco, New Madrid, and Bloomfield, and the Steele exchange would have calling to Hayti and Deering.

Q. Have you prepared a schedule that shows the financial impacts of implementing such a plan?

A. Yes. Schedule RCS-11(HC) show the calculations of the financial impact of such a plan.

Q. What are the financial ramifications of implementing this plan, and how have they been calculated?

A. There are several financial impacts that have been taken into account in this analysis. Calculations of the impacts are made based on actual traffic originating from the BPS exchanges during the first quarter of 2004. I will describe each of them.

First, in regard to the two-way calling plan between Bernie and Parma, the Company would lose both the originating and terminating access it currently receives for long-distance calls between these two exchanges. This impact has been calculated at the currently existing access rates.

Second, the Company would lose the originating access currently received on long-distance calls from the BPS exchanges to the SBC exchanges. This impact has been calculated at the currently existing access rates.

Third, the Company would incur new expenses to terminate calls in the SBC exchanges. The Company expects that with the change in pricing from a usage-based long-distance rate to unlimited calling under the monthly local rate that there would be a stimulation of calling from the BPS exchanges. We have estimated that such calling would triple from current calling volumes, and have calculated the additional access expense based on SBC's current access rates and the stimulated calling volumes. We have been in informal communication with SBC regarding the correct calculation of the transport portion of this access cost. It is our belief that the calls are terminating from BPS to SBC and that the cost should be calculated based on a single transport leg from BPS to the SBC end

office. However, SBC has provided their calculation showing a two-legged transport calculation apparently assuming that the call is "originating" until it reaches the SBC tandem and terminates from the SBC tandem to the terminating end office. This increases the access cost that BPS would be required to pay to SBC substantially. We will be pursuing further SBC's rationale for such a two-legged transport calculation. I believe it may be related to agreements that were reached during the now defunct PTC agreement. The impacts we have calculated assume the SBC calculation.

Third, BPS expects that with a one-way unlimited calling between the BPS and SBC exchanges that there will be some changes in the calling that originates in the SBC exchanges and terminates in the BPS exchanges. The communities in this area are close knit and there are strong personal relationships between individuals in these communities. BPS would expect that an individual in an SBC exchange that currently calls to a personal acquaintance in the BPS exchange would likely, under this plan, make a quick call to the BPS customer and tell them to call back under the BPS customer's unlimited calling plan. Thus the Company believes that the direction of the traffic will be skewed from its current ratio to one with a greater amount of traffic originating in the BPS exchanges and a smaller amount of traffic originating in the SBC exchanges. This would cause a loss of terminating traffic and access revenues from the SBC to BPS exchanges. BPS estimates that this will cause a loss of one-third of the current traffic originating in the SBC exchanges and has included in its calculation of the financial impact this loss of terminating access revenue. At the present time, BPS

does not have the actual data originating in the SBC exchanges and terminating to BPS but is trying to obtain that data. The current estimate assumes that the minutes terminating from SBC are the same as the minutes originating to SBC from the BPS exchanges. If the additional actual data is obtained, we will file an amended schedule reflecting that actual data.

Q. What is the overall financial impact of the plan that you are proposing?

A. It would cause an annual revenue loss and expense increase to BPS of $305,055

Q. The two rate design proposals that you are making do not equate to the revenue reduction reflected in your revenue requirement calculation. Where would you apply the rest of the rate reduction, if required?

A. I would apply the remainder of the reduction to access rates, although slightly differently than Mr. Voight proposes. Mr. Voight proposes combining the Local Switching and Line Termination rate elements into a single rate. In reviewing the tariff, I find that the rate that Mr. Voight identifies as the Line Termination rate should properly be identified as a Switched Transport Termination rate. As such, it should not be combined with the Local Switching rate. However, I would agree that it is appropriate to combine the Local Switching and the Information Surcharge element, which Mr. Voight doesn't mention, into the Local Switching element to be more consistent with industry practice regarding the Local Switching element. I would propose that the existing rates simply be added together to produce the rate level for Local Switching. Rather than apply the

access rate reduction to most of the switched access rate elements as Mr. Voight proposes, I would apply all the reduction to the Common Line rate elements. I would propose this since this rate element is the element under the most contention by various parties in the industry and since that element has been completely eliminated in interstate rates.

Q. Have you prepared a schedule showing the access rate reduction needed to arrive at the rate reduction amount that you have supported?

A. Yes. Schedule RCS-12 shows the access rate changes need to arrive at the total rate reduction reflected in my revenue requirement calculation.

Q. If the Commission ultimately finds the need for a revenue reduction greater than that indicated by your calculations, what would your proposal be for rate design. I would propose 1) the increase in DA revenues associated with eliminating the three call allowance, 2) that the Company be allowed to propose a local calling plan to reach additional exchanges based on the revised revenue reduction, and that 3) any additional amount be included in access rates using the structure that I have proposed.

Q. Does this conclude your testimony?

A. Yes, it does.